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The Golden Paradox

If, as many believe, the recent sharp decrease in the dollar price of gold has been the result of a liquidation by hard-pressed Asian investors, it would illustrate an important and somewhat paradoxical aspect of the market for gold: gold is prized for the long-term stability of its purchasing power, but it is most useful in a short-term crisis.

The market for gold is unique. For other commodities — agricultural items, building materials, fuels, or even most other metals — the "carryover" stocks are seldom much more than one year's production and consumption, and often much less. In contrast, virtually all the gold ever produced remains in someone's possession, somewhere in the world, and this stock of gold may be as much as 25 times annual mine production.

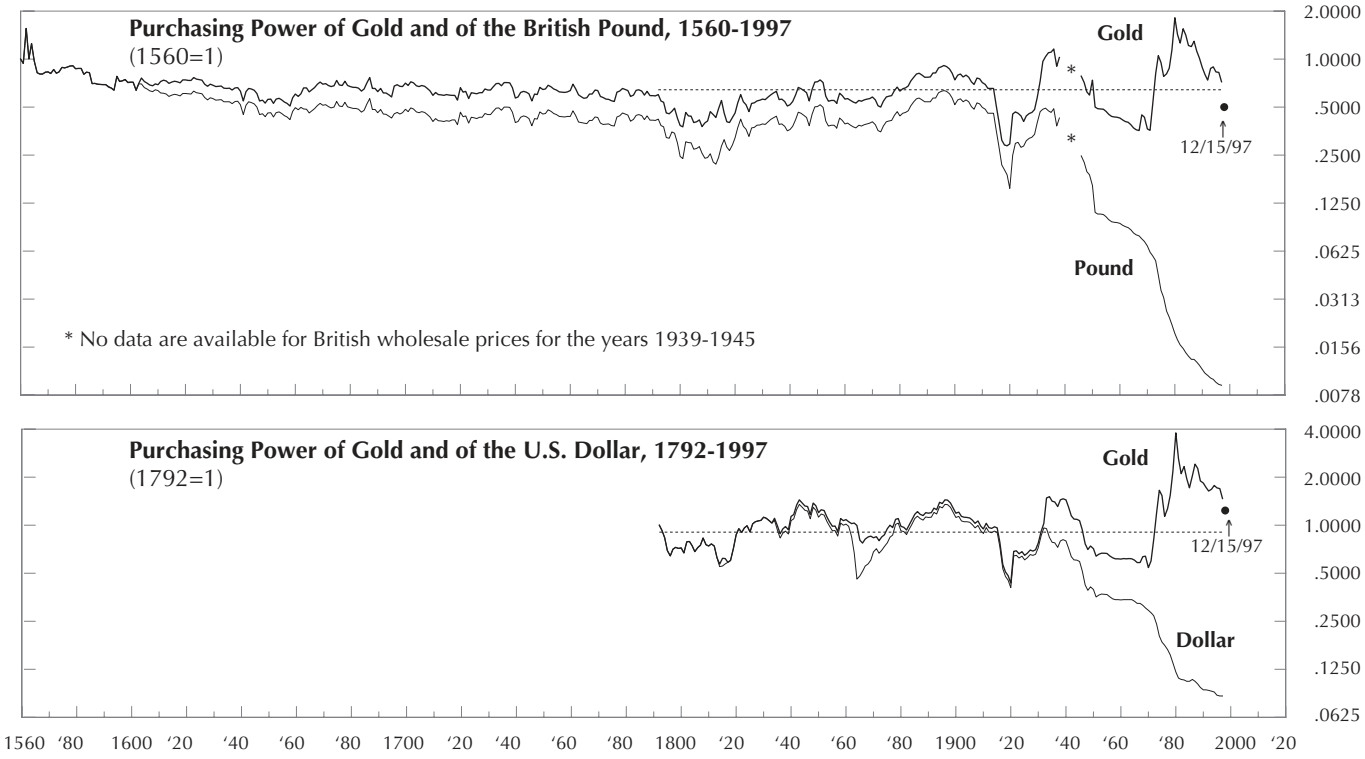
Roughly three-quarters of such "above ground" gold is held in bars, coins, or relatively crude and heavy "Asian" type jewelry — forms that are readily marketable and can be sold at bullion value with little or no expenses for assay or refabrication. The remainder could be brought to market with varying degrees of effort and expense.

Thus the major use of gold is not for "consumption" as fine jewelry or art objects, or in dentistry and electronics. The major use of gold is as a store of value. This is because gold doesn't rot or corrode so that it is relatively easy to store. Moreover, the spreads between bid and asked prices for marketable gold are minuscule compared to, say, those for real estate, gems, fine art, or other tangible things.

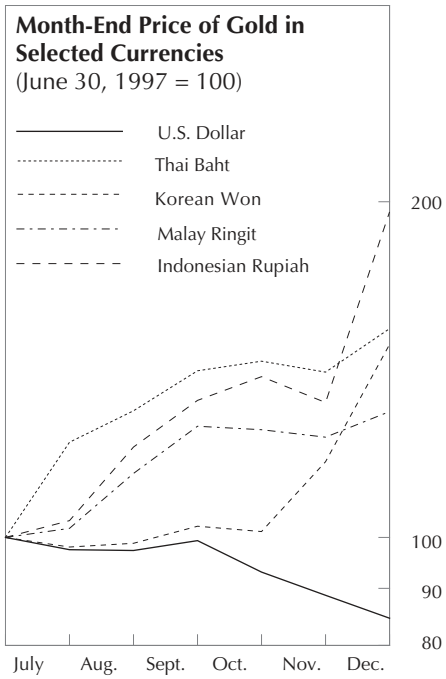
Above all, and in stark contrast to paper claims of all types, *gold cannot default and it cannot be seized "with the stroke of a pen."* This is why central bankers continue to hold so much gold (roughly 40 percent of all marketable stocks) even though their gold holdings pay no interest and they have without exception flaunted their rejection of convertible currencies. Paper assets in the form of IOU's from other governments can be "frozen" in an instant, but gold bars will always remain a potential source of funds.

The Golden Constant

That gold retains value over the long term is evident in the accompanying charts of the purchasing power of gold. The upper panel is our update of the work of the late Roy Jastram, which shows the annual average purchasing power in England of



Note: On April 2, 1792, Congress established the dollar (then legally equivalent to 24.75 grains of pure gold) as the Nation's monetary unit. The changes in purchasing power shown in the chart were calculated from annual averages of the wholesale price index (source: U.S. Department of Labor) and the annual averages of the exchange ratio of dollars for gold.



Note: December prices are as of the 15th of the month.

the British pound and of gold for the years 1560-1997[1]. The data plotted for 1997 are the averages for the first 10 months of the year, and the bullet is the purchasing power of gold in England as of December 15. The bottom panel similarly plots the purchasing power in the United States of the U.S. dollar and of gold for the years since 1792, when Congress established the dollar as the Nation's currency.

Both charts indicate that the purchasing power of gold has fluctuated in a relatively narrow range over the years. The fluctuations of the purchasing power of the pound and the dollar were within a similarly narrow range as long as those currencies were convertible into gold at a fixed rate. The average level of the purchasing power of gold in both countries during the years 1792 through 1971 is shown as the horizontal line in both charts. Prior to 1971, divergences between the purchasing power of the dollar and the currencies reflected relatively brief periods when convertibility was suspended, as in England during the Napoleonic wars and during the Civil War in the United States, the relatively small devaluation of the dollar in 1837, and the large devaluation in 1933.

After 1971, however, both the dollar and the pound became pure fiat currencies and their purchasing power plummeted. At the same time, the purchasing power of gold quickly increased to the upper portion of its historical range and in 1980 soared to unprecedented heights. Since then the currencies have continued to lose purchasing power and the purchasing power of gold returned to the upper portion of its historical range.

While the purchasing power of gold has been far from "constant" (at least in terms of the price indexes used to construct the charts) it has been far more stable over the long term not only than that of inconvertible currencies but also any other widely traded commodity. This is all the more remarkable inasmuch as the potential supply of gold in the market place includes all the gold held as a store of value around the world as well as what the mines produce, while the potential demand can come from anyone with funds to invest as well as jewelers, dentists, and other fabricators.

During the past decade or so, the price of gold has seldom increased above $400, or decreased below $350, per ounce for long. With continued price inflation, the purchasing power of gold in the United States and Great Britain has been in a gradual downtrend. However, during the past 6 months, the gold price has decreased sharply, to below $300 per ounce for the first time since 1985.

The Recent "Collapse"

The December 15th purchasing power of gold in the United States was somewhat above its historical average when the dollar was a convertible currency. Because of the "strengthening" of the pound against the dollar, and low British price inflation, the recent decrease in the dollar gold price has brought the U.K. purchasing power of gold below its average for the same 1792-1971 period.

The "flip" reason for the sudden decrease in the dollar price of gold is that there have been more sellers than buyers. As the gold price drifted downward toward $350 per ounce during the first three quarters of 1997, central banks and other official institutions were often mentioned as sellers. In particular, it was widely rumored that European central banks were selling gold in order to realize substantial bookkeeping profits to help some countries "cook their books" to meet the budget and debt requirements of the Maastricht Treaty. But it may have been that bankers simply wanted to sell gold before losing control of the disposition of the proceeds to the authorities of the monetary union. These rumors may be confirmed when official reports of the banks become available. On the other hand, estimates of the activities of other gold holders typically involve much guesswork.

Nevertheless, the coincidence of the move from over $350 per ounce to under $300 per ounce with the turmoil in Asian financial markets would appear to be significant.

The accompanying very short-term chart shows indexes of the price of gold in U.S. dollars and selected Asian currencies during the past six months. As this chart shows, from the point of view of Asian investors, the gold price has *increased* markedly. Indeed, for Indonesian, Thai, or Malaysian investors, gold is one of the few financial assets to have increased in value during the crisis.

We have no idea how much gold such investors held or were purchasing before the crises hit, or how much gold they may have sold recently, but recent price changes in Asian stock and exchange markets suggest that they have had great incentives to switch from gold buyers to gold sellers during recent months. Many of the businesses in these countries are owned and managed by "overseas" Chinese with a strong tradition of gold ownership, as they have little reason to trust their local governments and currencies. However, to the extent that this has happened, it is simply another instance when gold has come to the rescue of its holders. ❑

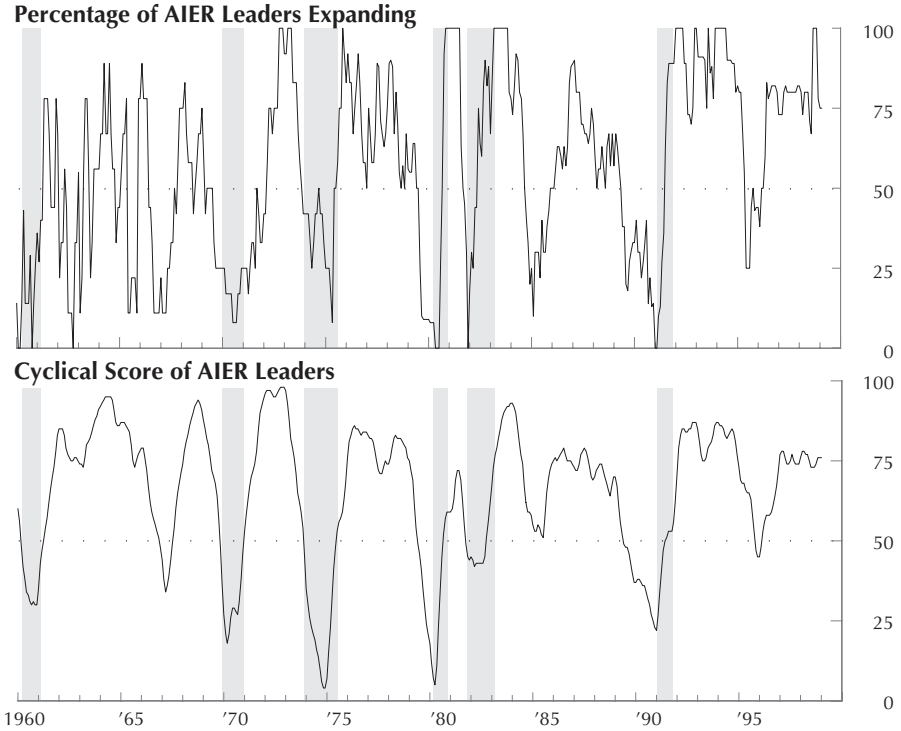
BUSINESS-CYCLE CONDITIONS

The overall status of the statistical indicators is little changed from that of a month ago. According to the latest round of economic statistics, further expansion is expected for the next several months.

The outlook for business conditions remains favorable. This month, seven of our 12 primary leading indicators are clearly expanding, and two others are probably expanding. Of the seven leading indicators that are clearly expanding, five are at new highs. They are *M2 money supply*, *new orders for consumer goods*, the *index of common stock prices*, the *ratio of manufacturing and trade sales to inventories*, and *contracts and orders for plant and equipment* (contracts and orders for plant and equipment and all other dollar denominated series are reported in constant dollars). Although not at new highs, the other two series that are also clearly expanding are *vendor performance*, the percentage of purchasing managers reporting slower deliveries from their suppliers, and *initial claims for state unemployment insurance* (inverted).

For the past eight months there was

[1] Roy W. Jastram, *The Golden Constant,* John Wylie and Sons, 1977.



no discernable trend in *new housing permits*, but the latest increase in the series to 1,448,000 new permits was enough to suggest that this series is probably expanding. The *average workweek in manufacturing* rose to 42 hours per week and remains appraised as probably expanding.

The only leading indicator with no discernable trend is the *3-month change in sensitive materials prices*. Since the middle of 1996, this typically volatile series has fluctuated very little and offers no useful indication of future business-cycle activity. In hindsight all series must be either expanding or contracting, but it will not be possible to identify the trend in sensitive materials until more data become available.

Because of a one-month reversal, our appraisal for the *3-month change in consumer debt* was upgraded from clearly contracting to probably contracting. Currently, the only leading indicator that is clearly contracting is *M1 money supply*.

Overall, the leading indicators improved slightly: 82 percent (9 out of 11) of the primary leading indicators with apparent cyclical trends are expanding. This is up two percentage points from last month's 80 percent expanding. Any level above 50 percent indicates that over the next few months further expansion is more probable than contraction. The cyclical score, AIER's objective assessment of the leading indicators, rose two points to 78. A cyclical score above 50 also indicates that further expansion is expected. That both of these aggregate measures of the leading indicators are above 50 is a strong indication that the economy will continue to grow into the new year.

The accompanying chart shows our historical assessments of the statistical indicators. As the chart indicates, this series is not always 100 percent reliable. This series has given false signals in the past of possible contractions during periods of expansion (most recently in June 1995-April 96). However, when analyzed next to other indicators, such as the cyclical score, it still offers a useful early clue as to the future direction of business activity.

Once again, all six of our primary roughly coincident indicators reached new highs. Last month we downgraded *civilian employment as a percentage of the working-age population* from clearly expanding to probably expanding, but because of this month's new high its appraisal returned to clearly expanding. The labor report for November was very strong. *Nonagricultural employment* rose sharply during that month when 404,000 new jobs were created.

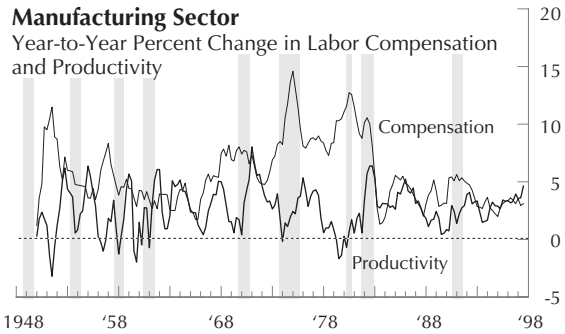
Revised data for the *index of industrial production* shows stronger growth over the past few years than the earlier estimates indicated. According to the new revisions, the annual rate of growth since 1992 (the base year of the index) averaged 4.5 percent — 0.7 percentage point higher than the earlier data indicated.

Personal income in manufacturing, *manufacturing and trade sales*, and *gross domestic product* (quarterly) all continue to grow as well. Overall, 100 percent (6

Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Aug.	*Sep.*	*Oct.*	*Nov.*	***Primary Leading Indicators***	*Oct.*	*Nov.*	*Dec.*
+	-	-		M1 money supply	-	-	-
+	+	+		M2 money supply	+	+	+
+	-	-		Change in sensitive materials prices	?	?	?
+	-	-		New orders for consumer goods	+	+	+
-	+	+		Contracts and orders for plant and equipment	+	+	+
-	+	+		Index of new housing permits	?	?	+?
-	+			Ratio of manufacturing and trade sales to inventories	+?	+?	+
+	-	-	+	Vendor performance	+	+	+
+	+	+	+	Index of common stock prices (constant purchasing power)	+	+	+
nc	+[r]	+	+	Average workweek in manufacturing	+?	+?	+?
-	+	+		Initial claims for unemployment insurance (inverted)	+	+	+
+	-[r]	+		Change in consumer debt	-	-	-?
				Percentage expanding cyclically	80	80	82
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+	+	+	+	Index of industrial production	+	+	+
+	+	+		Personal income in manufacturing	+	+	+
-	+			Manufacturing and trade sales	+	+	+
-	-	+	+	Civilian employment to population ratio	+	+?	+
+	+			Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	100	100	100
				Primary Lagging Indicators			
+	-	-	+	Average duration of unemployment (inverted)	+?	?	?
+	+			Manufacturing and trade inventories	+	+	+
+	+	+		Commercial and industrial loans	+	+	+
-	-	+		Ratio of consumer debt to personal income	-?	-	-
-	+	+		Change in labor cost per unit of output, manufacturing	-?	-?	-?
-	-	+	+	Composite of short-term interest rates	?	?	?
nc No change.		[r]Revised.		*Percentage expanding cyclically*	60	50	50

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.



out of 6) of the primary roughly coincident indicators with apparent cyclical trends are expanding. Except for one instance last month when we downgraded our appraisal of the employment to population ratio, the coincident indicators have all been clearly expanding through all of 1997.

There were no changes in our appraisals for the six primary lagging indicators. Both *manufacturing and trade inventories* and *commercial and industrial loans* reached new highs and both are appraised as clearly expanding.

The *average duration of unemployment* (inverted) increased this month to 16.1 weeks. However, there is still no clear trend to the series and its cyclical status remains indeterminate. There also is still no identifiable trend for the *composite of short-term interest rates*. Although short-term rates did rise slightly in November to 5.6 percent, the increase was not enough to suggest that interest rates have a positive trend.

Despite the latest increase in the data, it still appears that the *percent change from a year earlier in manufacturing labor cost per unit of output* is probably contracting. Unit labor costs have remained relatively low, especially during 1997, mainly as the result of rapid increases in productivity — measured as output per hour. This productivity number is divided into total hourly compensation to derive the labor cost per unit of output. As long as productivity increases faster than compensation, growth in unit labor costs will be negative. The chart above plots the year over year change (quarterly) in these two indexed components used to calculate the labor cost per unit of output series. As the chart shows, recently there was a surge in labor productivity coupled with relatively stable compensation. Although the recent trend in labor compensation is positive, compensation has not advanced as fast as productivity. As long as this remains so, there is no reason to suspect that wage pressures will squeeze profits, which could then translate into higher prices for manufactured goods.

However, these data only measure events in the manufacturing sector. The comparable data for the total business sector suggest that labor compensation is increasing faster than output. Unfortunately, the figures for total business are suspect. It is probably the case that much of the productivity in the business sector as a whole has not been accounted for in the official productivity statistics. A considerable portion of the problem has to do with the ever-increasing service sector of the economy, where output is notoriously difficult to measure. If productivity in the total business sector is higher than the data show, it would help to account for the current coincidence of relatively low unemployment and stable prices.

The ratio of consumer debt to personal income increased slightly this month to 17.68 percent, but this increase was not enough to suggest that the series is not still clearly contracting.

Overall, 50 percent (2 out of 4) of our primary lagging indicators are expanding. This is unchanged from last month. The seemingly moderate percentage of lagging indicators expanding masks some of our concern over the inventories series and the commercial and industrial loans series. Historically, buildups in either of these series raised concerns that businesses may be overextending themselves. So far, inventory build ups do not warrant concern, especially given the matching growth in the sales data. Moreover, in view of the favorable lending environment, it is premature to suggest that the buildup in commercial and industrial loans is excessive. These series do, however, warrant close monitoring.

For now, however, the business outlook for early 1998 is positive. Eventually, of course, the current expansion will reach a peak and begin to contract. But we would expect to see marked deterioration in the leaders, and stronger indications of "bottlenecks" in the laggers, before that happens. ❑

Season's Greetings and Best Wishes for the New Year

PRICE OF GOLD

	1995	*1996*	*—— 1997 ——*	
	Dec. 21	*Dec. 19*	*Dec. 11*	*Dec. 18*
Final fixing in London	$388.05	$369.00	$284.80	$290.00

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