Published by

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230 www.aier.org

RESEARCH REPORTS

Vol. LXXII No. 7 April 11, 2005

Gold and Inflation Expectations

In an age of fiat currency, the price of gold is determined by supply and demand, as with any other commodity. But, because of gold's monetary role, gold is demanded not only for fabrication and industrial purposes, but for investment purposes as well. Investors often buy gold when their confidence in currencies weakens. The increase in the gold price since 2001 suggests investors may expect price inflation to accelerate. However, inflation expectations also influence long-term interest rates, and these remain relatively low.

The price of gold is determined by supplies offered in the market and by demand, as with other commodities. But gold is not "just another commodity." It has a unique monetary role. Although currencies are no longer officially linked to gold in this age of fiat currency, gold still serves as a store of value. Gold *is* money. Thus it is demanded not only for fabrication and use, like any commodity, but also for investment purposes.

Changes in the price of gold thus reflect more than changes in the supply (for example, mine production or bullion sales by various countries' governments) or in the demand for its use in the fabrication of jewelry, industrial, or medical products. Price changes also reflect changes in investors' valuation of gold relative to alternative stores of value.

If, for example, investors who hold gold became more confident in other assets, especially those denominated in paper currencies, they probably would reduce their gold holdings, and this would tend to depress its price.

On the other hand, a weakening of confidence in currencies could increase the demand for gold as a store of value. This might be occasioned by increasing rates of general price inflation, by political turmoil, by financial instability, or by increasing concern over perceived imbalances and risk in the economy or the financial markets.

In light of gold's special role as a store of value, what should we make of the marked increase in the price of gold in recent years?

The average price of gold for the month of July 1999 fell to a 20-year low of $256 per ounce. It was relatively stable for the next couple of years, and by March 2001 it was still just $263. After that, however, the price began to rise markedly.

By last December the price of gold was at a 16-year high of $442. Since then it has decreased somewhat and also has been relatively volatile, fluctuating from $410 to $445, and in March, it averaged about $435.

In sum, the price of gold has increased by 65 percent over the past four years. Although this pales in comparison to the 1970s, when gold surged by more than 300 or 400 percent during some four-year spans, it is the largest such increase in over 20 years.

The list of concerns that might have fueled interest in gold as a store of value is long. Since 2000, the country has been attacked, the government has declared a war on terror and invaded Iraq, the stock market has plummeted, and there has been a recession. In an effort to limit the economic impact of these developments, the government's fiscal and monetary policy

Chart 1: **Gold and Price Inflation**

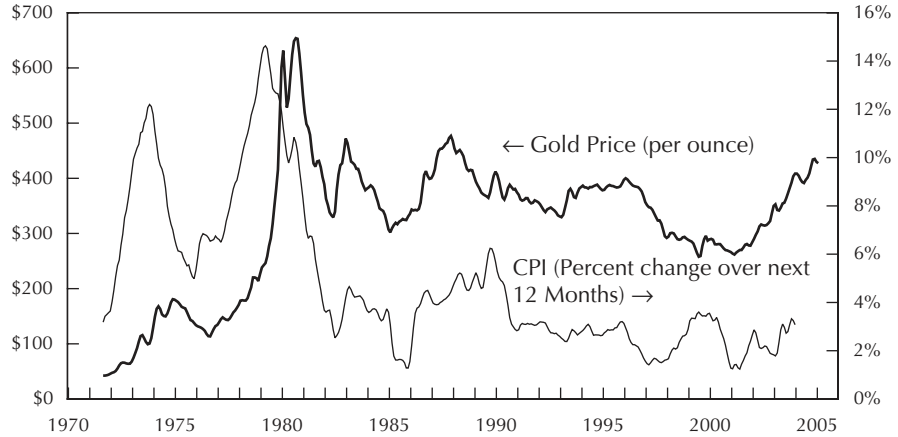
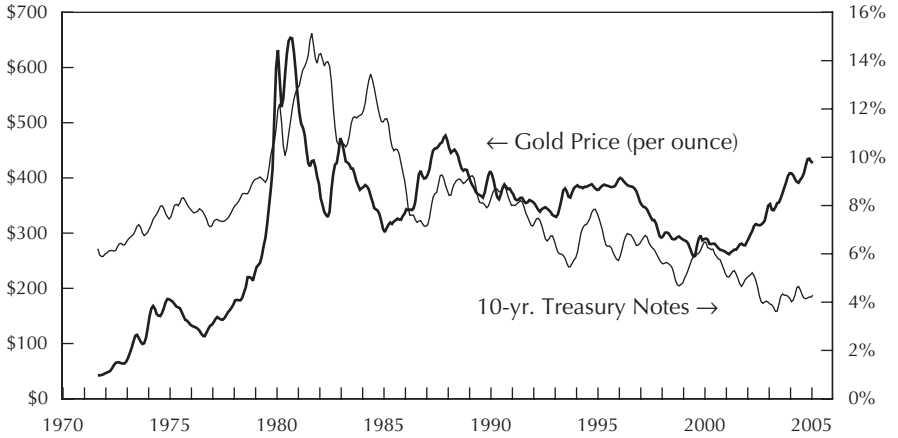


Chart 2: **Gold and Long-term Interest Rates**



has been extraordinarily stimulative. The Federal budget swung from a $236 billion surplus in 2000 to a $412 deficit last year, and the Federal Reserve pushed short-term rates to a 50-year low.

Too Much Stimulus?

There are growing signs that the Fed may have kept rates too low for too long. The rate of price inflation has accelerated. The Consumer Price Index increased by 3.0 percent over the 12 months ending in February, up from a rate of 1.7 percent in the same period a year earlier. "Real" short-term interest rates are negative and have been so for an unusually long time. Low rates fueled a housing boom that seems increasingly based on speculation.

The price of oil has increased from $23 a barrel in 2001 to over $50 now. The dollar has weakened in foreign exchange markets, losing roughly a third of its value against the euro and the Swiss franc and a quarter of its value against a trade-weighted basket of the world's major currencies since 2001.

The higher gold price may reflect increased concern over the potential for these developments to lead to higher price inflation down the road. Historically, changes in the trend of the gold price have generally been a useful guide to the future trend of price inflation.

Chart 1 on the preceding page shows the price of gold and the rate of change in the Consumer Price Index over the following 12-month span. As can be seen, broad shifts in the gold price tend to be associated with similar shifts in the rate of price inflation. The correlation is far from rigid. But the recent increase in the price of gold suggests that the rate of price inflation is headed higher.

If investors expect price inflation to accelerate, however, we would also expect to see long-term interest rates increase. Chart 2 shows the rate on 10-year Treasury notes and the price of gold. Although the 10-year rate has increased since 2003, the increase has been relatively small, and it was actually lower in March than it was last June. This suggests that investors' inflation expectations have not changed all that much.

What Does It Mean?

These diverging trends—the gold price has increased markedly while long-term interest rates have only recently begun to edge up—are unusual. One possible explanation is that the gold market has overestimated the risk of higher price inflation. One argument for this scenario is that the recent demand for gold may have become self-reinforcing, with the rising gold price attracting buyers who are purchasing it more for potential price appreciation than as a store of value.

However, the diverging trends could also mean that bond buyers have underestimated the risk of accelerating price inflation. In this regard, it is notable that the Federal Reserve itself had not expressed much concern with price inflation until very recently. When the Fed's Open Market Committee met in February, it released a statement that said "inflation and longer-term inflation expectations remain well contained." However, when the Committee met again in March and raised the target Federal funds rate by another quarter point, it said that "pressures on inflation have picked up in recent months and pricing power is more evident." Maybe the Fed and the bond markets are catching up with the gold market. ❑

A WOLF AT THE DOOR OF THE WORLD BANK

Dictators and demagogues have used the IMF and the World Bank as a source of funds and as scapegoats for unpopular measures that are imposed as conditions for continued financial assistance. As a result, the record of the latter institution in fulfilling its mission has been very spotty. The new President of the World Bank, Paul Wolfowitz, appears more likely than his predecessors to implement needed reforms. But don't count on it.

The International Monetary Fund (IMF) and the World Bank were established after the Bretton Woods Conference at the end of World War II. At the time, we observed that:

> Dictators and demagogues always have two urgent needs. The first is money, and the second is a scapegoat. Unless the people can be convinced that some agency other than the political faction in power is responsible for their ills, they may turn against the group of political gangsters in office. . . . Is it wise to run the risk of strengthening foreign dictatorships and political machine governments by providing extra funds and a convenient scapegoat for them?[1]

The IMF helped postwar governments to abolish exchange controls, while maintaining exchange rates to within one percent of official gold values. It was able to do this by lending to countries having difficulty in "pegging" their currencies and providing cover for the unpopular measures required to support their currencies. Devaluations and revaluations reflecting "fundamental disequilibria" were relatively infrequent.

One reason that things ran relatively smoothly was that the United States came out of the war with an enormous amount of gold. The other countries of the world gained liquidity when much of the U.S. gold stock was gradually paid out to cover U.S. balance of payments deficits. The system broke down in 1971 when the United States refused to redeem any more dollars in gold at a fixed price.

Since then, exchange rates have been determined by supply and demand, *i.e.*, they were left to "float." With international payments balanced by changes in exchange rates rather than by settlement in gold or other reserves, the IMF lost its fundamental reason to exist. But it is still around, as a "lender of last resort" to countries facing financial difficulties.

Critics have asserted that the IMF's record of "bailouts" has been a major cause of the excessive borrowing that typically precipitates such crises, because the very existence of the IMF tends to make lenders less circumspect. Oppositely, the IMF has received heavy criticism for requiring "austerity measures" that mainly hurt the poor rather than the elites who usually have been the major beneficiaries of the loans.

The World Bank's Mission

The rationale for the creation of the World Bank was a presumption that private lenders were averse to loans to underdeveloped countries. A large sign over the entrance to the World Bank's Washington headquarters proclaims, "Our dream is a world without poverty." After nearly six decades of operation, few would argue that the dream is much closer to its realization, or that the World Bank's activities contributed much to whatever progress has occurred.[2]

Remarkably, it was only after 50 years or so of failure that the World Bank even considered corruption, which nearly anyone trying to do business in the third world would immediately identify as a major

[1] AIER *Weekly Bulletin*. June 11, 1945.

[2] For a detailed account of an insider's view of the various failed initiatives of the World Bank, see *The Elusive Quest for Growth by William Easterly*, reviewed in *Research Reports*, April 14, 2003.

Announcing the Spring 2005 AIER Conference

The Future of the Dollar

May 5–6, 2005

American Institute for Economic Research
250 Division Street, Great Barrington, Massachusetts 01230 (413) 528-1216

The foreign exchange value of the dollar has fallen markedly against other major currencies in the past few years, while the prices of gold, oil, and a host of other things recently have surged. This conference will explore the possible factors behind the dollar's weakness and the outlook for both the dollar's value and its role in international markets. Issues to be explored include: Is the dollar locked into a long-term decline? Can it rebound from its recent lows? Do financial or economic factors determine its value? Should the Treasury intervene to defend it? Would an explicit link to gold restore its value?

Conference Program (All events at AIER)

THURSDAY, MAY 5, 2005

9:00 a.m.–12:00 p.m.
Do Factors Affecting Foreign Exchange Today Resemble the Factors Before October 1979?
Martin Mayer (Author of *The Fate of the Dollar*)
What to Do About the Dollar
Anna J. Schwartz (National Bureau of Economic Research)
Discussants:
Walker F. Todd (Consultant, AIER)
Lee Hoskins (Pacific Research Institute)
Margaret (Gretchen) Yeo (Yeo Farms; former V.P., Federal Reserve Bank of New York; by phone)

12:00–2:00 p.m.
Lunch in the Helen F. Harwood Ballroom

2:00–5:00 p.m.
The Treasury's Foreign Exchange Policy in the 1990s
Karin Lissakers (Consultant, Soros Funds Management; former U.S. Executive Director, IMF)
Foreign Perspectives on the Dollar's Role as a Reserve Currency
Marshall Auerback (Prudent Bear)
Global Exchange Rate Imbalances in Historical Perspective
Michael Bordo (Rutgers University)
Discussants:
Owen F. Humpage (Federal Reserve Bank of Cleveland)
William T. Gavin (Federal Reserve Bank of St. Louis)

5:00–8:30 p.m.
Reception and Dinner in the Helen F. Harwood Ballroom
Speech: Why the Current Situation Is Not Like the 1970s
Roger M. Kubarych (Adviser, HypoVereinsbank Americas; former General Manager, Henry Kaufman & Company)

FRIDAY, MAY 6, 2005

9:00 a.m.–12:00 p.m.
Exchange Rate Regime Choices: Developing vs. Developed Countries in an Increasingly Globalized World
Kenneth Rogoff (Harvard University; former Director of Research, IMF; by phone)
Does Foreign Exchange Policy Affect Commodity Prices and Trade Flows?
Robert Taylor (Auburn University)
The Role of Financial Futures Contracts in Foreign Exchange Markets
Leo Melamed (Melamed Associates; Chairman Emeritus, Chicago Mercantile Exchange; by phone)
Discussants:
John McPartland (Consultant, Federal Reserve Bank of Chicago)
John Wood (Wake Forest University; Consultant, AIER)

12:00–2:00 p.m.
Lunch in the Helen F. Harwood Ballroom

Registration • Transportation • Accommodations

There is no charge for the conference, but seating is limited and reservations are required. To reserve, please contact Susan Gillette at AIER, (413) 528-1216, fax (413) 528-0103, gillette@aier.org. Travel and lodging information is available from the Berkshires Visitors Bureau at 800-237-5747 or at *www.berkshires.org*.

problem, as an obstacle to development. Even then, the Bank delicately termed pervasive thievery as "problems of governance."

Concern over the poor performance of the World Bank and the IMF led Congress to create an advisory commission in 1999 to review these and other international financial institutions and recommend reforms. The "Meltzer Commission" (the International Financial Institution Advisory Commission, chaired by Allan Meltzer of Carnegie Mellon University) concluded that the World Bank and its three regional counterparts—the African Development Bank, the Asian Development Bank, and the Inter-American Development Bank—would be more effective in serving their mission if they switched from making loans to making grants. The Commission recommended that the grants be monitored to ensure performance, and also that the institutions bypass local governments and agencies by making direct payments to vendors after verifying delivery of services. This approach, the Commission said, would be more likely to raise the quality of life for people living in impoverished countries where inefficient or corrupt governments too often squander or steal the money loaned to them.

The recommendations to move to grants instead of loans and to establish outside monitors for development programs are linked to each other. It is recognized generally that the poorest countries cannot repay their loans. Moreover, less poor countries (including so-called "middle-income" countries like China and Brazil) have access to global capital markets. It makes no sense to channel scarce development bank resources to middle-income countries.

Independent monitoring of performance-based grants would insure that the World Banks' stated goals were being achieved. Independent auditing of the Bank would provide transparency and accountability at the organizational level (as distinguished from the grant-making level). These and other reforms recommended by the Commission would make the operations of the World Banks and the development banks more effective in aiding the world's poorest nations.

Finally, perhaps the most important of the Commission's recommendations was to develop incentives for countries implement structural reforms, such as strengthening the rule of law, accountability, transparency of public spending, private property rights, and openness to trade. Needless to say, this last recommendation is a tall order. But many analysts have concluded that these kinds of institutional reforms are essential, and that without them, all other measures and programs are likely to come to naught.

The Commission made its recommendations nearly five years ago. During the second half of outgoing World Bank President James Wolfensohn's tenure, which began in 1995, the Bank began to address some of the concerns raised by the Meltzer Commission and other reform advocates. It provided funding for programs for the treatment and prevention of HIV/AIDS, as well as health care for girls and women, in developing economies. But many of the recommended fundamental reforms have yet to be been made.

More recently, testifying before Congress last summer, Professor Meltzer noted that the greatest ongoing need of the World Bank is for an independent internal group or an outside agency to evaluate the effectiveness of the Bank's programs. He added that the Bank should "concentrate on the hard cases, the impoverished countries, and that the Bank should have an explicit program for graduation" from its lending programs. Meltzer also called for the World Bank to avoid overlapping responsibilities with the IMF and to concentrate on becoming a more effective development bank, especially standing against bribery and corruption in developing countries.

Is there anyone who can make the needed changes in the face of bureaucratic inertia, entrenched "kleptocracies, "anti-globalization" activists, and the often divergent views of non-governmental organizations operating in these countries?

Enter Wolfowitz

Paul Wolfowitz gained a reputation as an "arch hawk" even before serving as U.S. Deputy Secretary of Defense, and he has been widely perceived as a main architect of the Iraq war and of U.S. policies in Iraq after the war. Thus, when President Bush nominated Wolfowitz to head the World Bank many observers were dumbfounded. This nomination followed on the heels of Bush's choice of Under Secretary of State John Bolton to be the new U.S. Ambassador to the United Nations, an organization that Bolton has strongly criticized. Both nominations were viewed by Bush's critics as further examples of the administration's disdain of multilateral organizations and diplomatic niceties.

Nevertheless, the World Bank's executive directors quickly, and unanimously, confirmed Wolfowitz as President of the Bank with surprising alacrity. Perhaps they recognized the Wolfowitz appointment as a chance to break with "business as usual." As the London *Times*[3] editorialized on April 4, 2005:

> ….the President's choice of one of his chief lieutenants to run the World Bank can only be further testimony to the seriousness attached to tackling the plight of the developing world. Bush could easily have alighted instead on a pygmy from amongst Washington's apparatchiks—past Presidents have inflicted mediocrities on the bank
>
> What about Wolfowitz himself? For all his depiction as a hardline hawk bent on the pursuit of American imperialism, closer examination of his credentials suggest that he may bring to the job many of the qualities essential for success.
>
> Contrary to his image, Wolfowitz is said to be a brilliant and thoughtful intellectual, whose views are founded in and idealistic belief in freedom, democracy, and free markets. As an intellectual compass for his role at the bank, such an outlook, far from being a handicap, is what is needed in a world in which experience had shown that, the freer people are—both politically and economically—to improve their own fortunes, the sooner poverty is eliminated.

In his March 31 acceptance speech at the World Bank, Mr. Wolfowitz reportedly expressed some support for the Meltzer Commission's package of reforms. A more important and larger message to European and other world leaders from the Wolfowitz appointment may well be that the Bush Administration is determined that it will no longer be business as usual at the international institutions.

With adequate safeguards and occasional outbreaks of truth-telling from the inside, the World Bank still might yet become a fit development partner for the world's poorest people. ❑

PRICE OF GOLD

	2003	*2004*	*—— 2005 ——*	
	Apr. 10	*Apr. 8*	*Mar. 31*	*Apr. 7*
Final fixing in London	$324.60	$419.50	$427.50	$428.00

Research Reports (ISSN 0034–5407) (USPS 311–190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: $16 per quarter or $59 per year. POSTMASTER: Send address changes to ***Research Reports***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.