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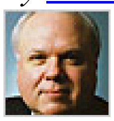
Gold's Declining Price Is a Reversion to the Mean

By BRUCE BARTLETT



Bruce Bartlett held senior policy roles in the Reagan and George H.W. Bush administrations and served on the staffs of Representatives Jack Kemp and Ron Paul. He is the author of "The Benefit and the Burden: Tax Reform – Why We Need It and What It Will Take."

Since the beginning of the economic crisis in 2008, conservatives have been predicting that inflation is right around the corner. They base this prediction on the vast increase in the money supply that the Federal Reserve brought about in order to keep the financial system from imploding. Because a too-rapid rise in the money supply did indeed bring about inflation in the 1970s, conservatives believe that a repetition of that experience is inevitable.

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Many conservatives jumped heavily into the gold market in 2009 based on their expectation of inflation or even hyperinflation. They believe that gold is the best possible hedge against inflation because it is something real, whereas "fiat money" is essentially worthless.

Initially, gold investors were rewarded. The price of gold roughly doubled between 2009 and 2011, from about $900 an ounce to about $1,800 an ounce. Since then, however, the gold price has fallen fairly steadily, reaching about $1,600 an ounce before a sharp break in the last two weeks that brought the price down to about $1,400 an ounce. (Kitco, a precious metals dealer, is a good source of recent gold price data.)

The rise in gold also led some conservatives to renew their advocacy of the gold standard. They believe that all our economic problems are fundamentally caused by the unstable value of money, which results from Federal Reserve manipulation. The Lehrman Institute, a well-financed conservative organization, has been actively promoting a return to the gold standard.

The core argument for the gold standard is that the real price of gold doesn't vary over time. All nominal price changes result solely from changes in inflationary expectations, gold standard advocates believe. They point to research by the economists Roy W. Jastram and Stephen Harmston to the effect that over very long time periods the real, inflation-adjusted gold price is roughly constant.

What gold standard advocates tend to forget, however, is that the "very long time periods" part of the analysis means over centuries. The short-run price of gold basically indicates nothing insofar as monetary policy is concerned. As a thinly traded market, gold is often subject to manipulation and prone to bubbles and crashes.

Warren Buffett warned about a gold bubble in a 2011 letter to investors in his company, Berkshire Hathaway, in which he said:

> Gold, however, has two significant shortcomings, being neither of much use nor procreative. True, gold has some industrial and decorative utility, but the demand for these purposes is both limited and incapable of soaking up new production. Meanwhile, if you own one ounce of gold for an eternity, you will still own one ounce at its end.
>
> What motivates most gold purchasers is their belief that the ranks of the fearful will grow. During the past decade that belief has proved correct. Beyond that, the rising price has on its own generated additional buying enthusiasm, attracting purchasers who see the rise as validating an investment thesis. As "bandwagon" investors join any party, they create their own truth – for a while.
>
> Over the past 15 years, both Internet stocks and houses have demonstrated the extraordinary excesses that can be created by combining an initially sensible thesis with well-publicized rising prices. In these bubbles, an army of originally skeptical investors succumbed to the "proof" delivered by the market, and the pool of buyers – for a time – expanded sufficiently to keep the bandwagon rolling. But bubbles blown large enough inevitably pop. And then the old proverb is confirmed once again: "What the wise man does in the beginning, the fool does in the end."

In the long run, the price of all assets revert to their fundamentals. For the last four years, gold speculators have implicitly believed that the rise in gold represented an adjustment to the fundamental fact of underlying inflation resulting from expansion of the money supply. But in that time, the actual rate of inflation has not confirmed gold's signal. According to the Bureau of Labor Statistics, the Consumer Price Index rose 2.7 percent in 2009, 1.5 percent in 2010, 3 percent in 2011 and 1.7 percent in 2012.

Inflation so far in 2013 has been so modest that some analysts are anticipating deflation – a falling price level, the opposite of inflation. The Wall Street Journal reports that prices for gourmet cupcakes are crashing. Even a longtime "inflation hawk," James Bullard, president of the Federal Reserve Bank of St. Louis, is now warning that downward price pressure is becoming a problem that may require the Fed to further ease monetary policy.

In an recent paper, the economists Claude B. Erb and Campbell R. Harvey present strong evidence that the gold market was severely overbought. The increase in gold prices did not represent a change in the trend of inflation. As the chart indicates, even with the sell-off, the price of gold is still high and has a long ways to fall to get back to the "golden constant" that gold-standard advocates cite as proof that the dollar should be pegged to gold.

Claude B. Erb and Campbell R. Harvey

Most gold bugs consider themselves to be libertarians and support the gold standard and gold as an investment because of their deep distrust of government. But the greatest libertarian of the 20th century, the economist Milton Friedman, always thought that the gold standard was nuts. His argument was put forward most thoroughly in a 1961 academic journal article, "Real and Pseudo Gold Standards."

I was going to close this post by making fun of a just-published book, "$10,000 Gold: Why Gold's Inevitable Rise Is the Investor's Safe Haven" and suggest putting it on the same shelf with "Dow 36,000," published in 1999, or "Are You Missing the Real Estate Boom? The Boom Will Not Bust and Why Property Values Will Continue to Climb Through the End of the Decade — And How to Profit From Them," published in 2005. But then I noticed that the publisher of the gold $10,000 book also published "Gold Bubble: Profiting from Gold's Impending Collapse" in April 2012, so I will let it pass.

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