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Real Money

All That Glitters May Just Be Gold

For several months, I have been writing about the US dollar. As the dollar has declined over the last year, US manufacturers received a boost while consumers suffered a decrease in purchasing power. However, this isn't the end of the story because when the dollar goes down, the price of gold goes up.

Until 100 years ago, gold was the standard measure of value. Our common use of the phrases "as good as gold," "solid as gold," and "backed by gold," indicates that for centuries, governments, businesses, and ordinary people knew that behind every piece of paper was a fixed amount of gold.

The "gold standard" was defined by the purchasing power of this set amount of gold. The amount of real, usable goods that could be acquired for an ounce of gold was the stable value for both gold and paper money, or currency, which were interchangeable with each other.

Gold was the universal, determining commodity that established value for the paper printed by governments. So, when a country extended itself too far, its gold reserves diminished and its citizens eventually demanded gold for their paper money. This cruel fact of life brought successive generations of royalty both despotic and benign to their knees. These century old constraints dissolved during the 20th century.

After World War II, the USA was the only financial powerhouse left standing and thus, created a set exchange ratio for gold to US dollars. The industrialized world had far outspent its reserves of gold in order to finance the two World Wars that ravaged Western civilization. The only drawback to the system created at Bretton Woods in 1944 was that we had to have gold to back up our promise to honor that arbitrary rate. Then the pledge to redeem dollars with gold was withdrawn. Since 1971, the "market" has set the value of gold versus all currencies with widely fluctuating prices. Gold remained a haven only for investors who were willing to speculate that it would eventually be worth more than paper currency.

Currently, there is some amount of natural expansion in the world's gold supply due to mining but it is a relatively small amount. The supply of paper money, however, is easily manipulated. When people believe that the value of their paper money is being undercut by irresponsible politicians or out of central political events, gold rises in reaction to uncertainty about the future. Paper money can lose its purchasing power and since gold is pretty darn inconvenient to cart around to use for buying groceries, many investors choose to hold some of each.

In 1935, between the two world wars, President Roosevelt declared private ownership of gold illegal, thereby forcing Americans to convert their gold to paper. The next year, he raised the price of gold 69%, devaluing the purchasing power of the dollars that US citizens had been forced to buy. Imagine the confusion and chaos that ensued!

From the 1930's until the 1970's, the US government set the price of gold. The oil-rich Middle Eastern nations and other factors ended that reign and so we entered into a market driven period of currency chaos. Capital flight is when a country's citizens doubt the ability of their domestic money to retain its value and so they look for the other nations' currencies to put their savings in. During the 1980's and 1990's one country after another saw its paper currency go down the tubes. Americans benefited from the chaos of the last two decades of the 20th century as imports became cheaper and other, less stable nations' money flowed into the US dollar. Gold went up and down in price but because the dollar could buy more and more goods from overseas no one really cared.

The US's ability to continue to attract money, essentially loans, from the rest of the world has been affected by our spending deficit of 600 billion dollars. To finance our activities worldwide, we have had to increase the amount of paper money by a huge amount. Between 1935 and 1971, the money supply, meaning the amount of paper currency that the public holds plus savings and deposits at banks, went up ten times. Meanwhile, the price of gold is not much higher than it was 30 years ago. Eventually, something has to give. We can stop printing money, produce more gold, or see the price of gold increase.

There are a variety of ways one can invest in gold. The most direct way is to own coins which are available through reputable dealers nationwide. Be careful not to pay too much over the "spot" price of gold as quoted in the newspaper. There are publicly traded stocks which represent ownership of bullion held in vaults somewhere. These companies take an intermediary role by dealing with physical possession, security, insurance issues, weight, etc. Their stock price is supposed to track the price of gold.

Gold mutual funds concentrate on holding mining companies stock. Mining companies, in addition to environmental concerns, tend to be quite volatile in price. They go way up and way down over fairly short time spans depending on the level of public enthusiasm for gold.

Gold is a worthwhile investment if there is a resurgence of inflation, or if the US government continues to successfully engineer a decline in the value of the US dollar; buying gold in some form would not be a good idea if the US brings its international trading and domestic spending deficits down and reverses the trend of money supply growth. A moderate purchase of gold related investments might be well advised.

As you hear the news, don't mistake reports of strong economic growth as an indication that all is well. Gold is the best harbinger of impending fiscal prudence. The past two decades have seen so much printing of money and deficit spending that there is little chance, in my opinion, that the realignment of the price of gold relative to the US dollar will happen painlessly. You just might want to plan your investment strategy accordingly.

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