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Ten-Thousand-Dollar Gold?

Why gold and reason are difficult to reconcile.

BY KENNETH ROGOFF

It has never been easy to have a rational conversation about the value of gold. Lately, with gold prices up more than 300 percent over the last decade, it is harder than ever. Just last December, fellow economists Martin Feldstein and Nouriel Roubini each penned op-eds bravely questioning bullish market sentiment, sensibly pointing out gold's risks.

Wouldn't you know it? Since their articles appeared, the price of gold has moved up still further. Gold prices even hit a record-high $1,300 recently. Last December, many gold bugs were arguing that the price was inevitably headed for $2,000. Now, emboldened by continuing appreciation, some are suggesting that gold could be headed even higher than that.

One successful gold investor recently explained to me that stock prices languished for a more than a decade before the Dow Jones index crossed the 1,000 mark in the early 1980s. Since then, the index has climbed above 10,000. Now that gold has crossed the magic $1,000 barrier, why can't it increase ten-fold, too?

Admittedly, getting to a much higher price for gold is not quite the leap of imagination that it seems. After adjusting for inflation, today's price is nowhere near the all-time high of January 1980. Back then, gold hit $850, or well over $2,000 in today's dollars. But January 1980 was arguably a "freak peak" during a period of heightened geo-polit-

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Gold prices are very difficult to predict over the short to medium term.

ical instability. At $1,300, today's price is probably more than double very long-term, inflation-adjusted, average gold prices. So what could justify another huge increase in gold prices from here?

One answer, of course, is a complete collapse of the U.S. dollar. With soaring deficits and a rudderless fiscal policy, one does wonder whether a populist administration might recklessly turn to the printing press. And if you are really worried about that, gold might indeed be the most reliable hedge.

Sure, some might argue that inflation-indexed bonds offer a better and more direct inflation hedge than gold. But gold bugs are right to worry about whether the government will honor its commitments under more extreme circumstances. In fact, as Carmen Reinhart and I discuss in our recent book on the history of financial crises, *This Time Is Different,* cash-strapped governments will often forcibly convert indexed debt to non-indexed debt, precisely so that its value might be inflated away. Even the United States abrogated indexation clauses in bond contracts during the Great Depression of the 1930s. So it can happen anywhere.

Even so, the fact that very high inflation is possible does not make it probable, so one should be cautious in arguing that higher gold prices are being driven by inflation expectations. Some have argued instead that gold's long upward march has been partly driven by the development of new financial instruments that make it easier to trade and speculate in gold.

There is probably some slight truth—and also a certain degree of irony—to this argument. After all, medieval alchemists engaged in what we now consider an absurd search for ways to transform base metals into gold. Wouldn't it be paradoxical, then, if financial alchemy could make an ingot of gold worth dramatically more?

In my view, the most powerful argument to justify today's high price of gold is the dramatic emergence of Asia, Latin America, and the Middle East into the global economy. As legions of new consumers gain purchasing power, demand inevitably rises, driving up the price of scarce commodities.

At the same time, emerging-market central banks need to accumulate gold reserves, which they still hold in far lower proportion than do rich-country central banks. With the euro looking less appetizing as a diversification play away from the dollar, gold's appeal has naturally grown.

So, yes, there are solid fundamentals that arguably support today's higher gold price, although it is far more debatable whether and to what extent they will continue to support higher prices in the future.

Indeed, another critical fundamental factor that has been sustaining high gold prices might prove far more ephemeral than globalization. Gold prices are extremely sensitive to global interest rate movements. After all, gold pays no interest and even costs something to store. Today, with interest rates near or at record lows in many countries, it is relatively cheap to speculate in gold instead of investing in bonds. But if real interest rates rise significantly, as well they might someday, gold prices could plummet.

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Most economic research suggests that gold prices are very difficult to predict over the short to medium term, with the odds of gains and losses being roughly in balance. It is therefore dangerous to extrapolate from short-term trends. Yes, gold has had a great run, but so, too, did worldwide housing prices until a couple of years ago.

If you are a high-net-worth investor, a sovereign wealth fund, or a central bank, it makes perfect sense to hold a modest proportion of your portfolio in gold as a hedge against extreme events. But despite gold's heightened allure in the wake of an extraordinary run-up in its price, it remains a very risky bet for most of us.

Of course, such considerations might have little influence on prices. What was true for the alchemists of yore remains true today: gold and reason are often difficult to reconcile. ◆