Today's *Astonishing* Risk

By Roland G. Caldwell

Thoughts on the meaning of the phrase, "real dollar purchasing power."

For as long as I can remember during my half century of managing people's money and estates, it has always been a challenge to try to describe in words the meaning of "dollar purchasing power." More by accident than intention, I recently came up with a way to visualize what I have been unsuccessful in describing. The chart shown displays the real price of gold since 1972, adjusted for inflation using the consumer price index. The chart is then inverted in order to display the opposite side of the gold-dollar equation, that is, the price of the dollar in terms of gold in the identical periods of time.

Trying to explain real dollar purchasing power is almost metaphysical. There is no certain benchmark to determine whether any paper currency, such as the dollar, has increased or declined in relative terms that are universally acceptable in some measurable and useful way. Far too many variables influence currency exchange rate changes to ever pinpoint which way a currency is moving relative to all other currencies. Thus the necessity, for anyone seeking to understand what is changing, is for dollar purchasing power to be quantitatively determined in reference to some constant or in relationship to some other form of tangible commodity that possesses characteristics that are also widely accepted as to that commodity's tangible intrinsic value.

Gold, long abandoned as a practical medium of exchange, is still regarded by many investors as an ultimate store of value, particularly in Middle Eastern and in older sovereign societies. Its known qualities—malleability, corrosion resistance, durability, and beauty—have made it valuable throughout history. In recent years, many have begun to refer to oil as "black gold," and it is now being hoarded by some as a substitute for gold. Oil remains, however, a commodity that is actively pumped, refined, and sold for practical and vital usage everywhere. Its qualifications as a store of value are affected because

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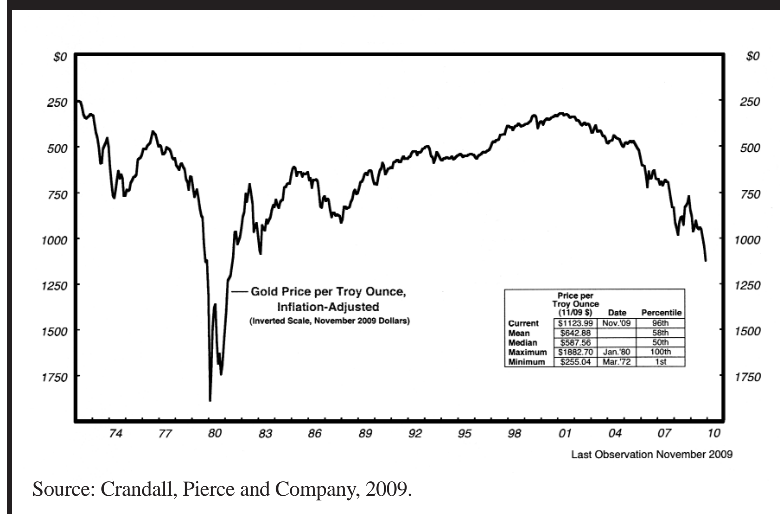
Dollar Purchasing Power: Gold



	Price per Troy Ounce (11/09 $)	Date	Percentile
Current	$1123.99	Nov.'09	96th
Mean	$642.88		58th
Median	$587.56		50th
Maximum	$1882.70	Jan.'80	100th
Minimum	$255.04	Mar.'72	1st

Source: Crandall, Pierce and Company, 2009.

it is liquid, has bulk storage problems, and because it has only a relatively short shelf life. This gives oil a supply and demand aspect that makes it less than an ideal substitute for gold, which unlike oil has a fairly limited commercial supply demand component to impact its price.

Gold remains the best proxy, or reliable benchmark, against which a paper or fiat currency's value or purchasing power change can be measured. The volatility of the purchasing power changes shown in the chart also happen to coincide fairly closely with what history has repeatedly defined as classic economic reasons for such changes, including rising prices for goods and labor, high and rising interest rates, and a general loss of confidence among a society's citizens and investors.

Two obviously noteworthy periods are apparent on the chart. Briefly, the first was after the "gold exchange standard" was abandoned finally by presidential order in 1971, when gold was withdrawn completely as a metallic backing for the dollar. The price rose steadily for a number of years before it spiked sharply upward when inflation and interest rates soared into double digits. It then gradually and grudgingly settled back before finally leveling out over the next two decades as free markets became more comfortable that monetary policy was capable of protecting the purchasing power of the dollar absent gold as a paper dollar issuance limiter. This stability in gold prices and dollar stability was accomplished in the United States by the Federal Reserve's having proved to the market's satisfaction that it was able to control the quantity and availability of dollars within an expanding economic climate. During the two-decade period of economic expansion and rising stock prices, the price of gold was primarily set by its ardent proponents, by speculators, and by industrial demands, rather than by concerns for dollar purchasing power changes.

The second crisis period of note appears to have begun about 2001 when federal fiscal deficits in the United States continued while the economy was growing. That was viewed as fiscal irresponsibility at the federal level and inspired both gold and oil to start a move upward in free market trading, oil being notably more volatile in sync with changing energy and terror-related factors. That crisis period, now growing in severity, is markedly different than the earlier period in that interest rates today are holding at relatively low levels, slow economic activity is holding price inflation rates at reasonable levels, and free markets worldwide appear to be willing to continue to accept the dollar for settlement purposes at respectable levels in an almost seeming disregard of wholesale issuance of new dollars by the United States. Most trading partner nations seem willing to accept the fact, as the United States argues, that it must raise these funds by way of new debt rather than by way of increasing taxes, as being necessary if the United States is to avoid a worldwide economic and banking calamity.

It has now been shown that, despite some comments to the contrary a few years ago, the United States remains the economic engine for the industrial world's major economies. As such, that dependence on the United States seems to be serving to protect the dollar's integrity. Other nations hope by doing so they will assist in reigniting U.S. economic growth in order to improve their own exports. Also, most nations already hold so many dollars within their own banking systems that a vested interest has been created to protect the value of those dollars, thus making it in their own interests that the dollar be protected and remain acceptable.

By choosing to experiment with radically new and untested monetary policies, the consequences in event of failure could be monumental.

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The chart shows clearly when gold and oil in free market trading began rising again—this time much less dramatically—which is again relaying messages of a growing unease with dollar purchasing power integrity, this time largely due to the issuance of so many new dollars rather than because of out-of-control inflation and interest rates.

Paul Volcker, now 82 years old and one of the original advocates for ending the role of gold as an official money issuance restriction, was appointed in 1979 as Chairman of the Federal Reserve Board to orchestrate badly needed changes in monetary policy. He proved successful in quickly subduing high inflation and interest rates during the tumultuous times of the first dollar crisis period. He did this by influencing and instituting highly restrictive money supplies and raising interest rates to extraordinary levels to reduce economic growth. Those were fairly classic policy implementations, which in turn resulted in a very serious economic near-depression in 1981–82, for which he was roundly criticized at that time.

It is noteworthy that Volcker is now helping the Obama administration as an advisor on monetary policy, and his credibility has helped mute some criticism as the Fed and Treasury deal with the present economic crisis. But rather than follow a classical approach again of allowing interest rates to rise while holding down money supplies, the United States has chosen money creation, more than doubling debt issuance and paper dollar creation as a percentage of GDP. The U.S. unemployment rate is now closer to the percentages found in Europe and other countries—10 percent or more—which so far has not triggered a crisis internationally, except, that is, in the market prices for both gold and oil, which are outside the control of federal authorities, and which are now rising steadily in a trend.

Whether or not the United States will be able to weather this period of economic malaise by holding free market support without causing traders and investors to panic both here and abroad is becoming the major question. We will learn whether a major crisis can be averted by simply flooding the marketplace with more dollars.

Because this risky approach is so contrary to classical economic remedies, much more is at stake today than simply having to endure another difficult recession if the cure doesn't work as hoped. Such a crisis could become more dangerous than the last, should more nations and individual dollar holders lose confidence in the dollar and instead choose to move more aggressively out of large debt/dollar positions into classically reliable "stores of value" such as gold and oil. Prices for most goods and services would then rise rapidly, causing havoc in all phases of the commercial and industrial economy.

It behooves all investors to monitor real purchasing power change carefully because it is one of the few indicators that shows simply, visually, and clearly that first, a trend is underway when the purchasing power for the dollar is changing; and second, that that trend is distinctly downward in the dollar's real purchasing power. The remaining unknown in this crisis compared to the last one is what interest and inflation rates will do if dollar purchasing power in real terms continues to decline.

These two factors can eventually confirm if and when the trend in the loss of dollar purchasing power is reversing or getting worse. At present, the trend shows little evidence of moving off a dangerous course despite the able efforts of Volcker and the present political team in Washington, D.C. Their strategy seems to be to try to avoid the known hardships free markets inflict on all of us if a serious recession were to prove unavoidable. By choosing to experiment with radically new and untested monetary policies, the consequences in event of failure could be monumental. There is much more at risk for the United States this time around than it has ever confronted before. ◆

Obama Savior?

Paul Volcker

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—R. Caldwell