

## OPINION

## Beyond the Gold and Bond Bubbles

By David Malpass

Treasury bond yields have been at near-record lows and gold prices at record highs, attracting millions of investors into idle assets through coins, exchange-traded funds and even warehousing facilities. This reflects fear about inflation and the stability of the financial system and, for some, the coming breakdown of society under the weight of \$3.6 trillion in annual Washington spending and transfer payments.

Last week's letup in the gold and bond-buying bubbles was good news. It meant less fear that the financial system will collapse. The Federal Reserve and the Obama administration should pile on by championing sound money and fiscal restraint as a way to rechannel capital into growth.

Fed Chairman Ben Bernanke's Jackson Hole speech last Friday, in which he did not announce still more quantitative easing, was a welcome step back from the frenetic central-bank activism that has been adding uncertainty to an already weak economy. The Fed has bought over \$2 trillion of bonds since 2008 and forced interest rates to near-zero, which hasn't helped small businesses or created jobs.

Mr. Bernanke should directly confront the fear index imbedded in high gold prices and low bond yields. Gold

at more than \$1,800 per ounce is a loud public statement of no confidence in our central bank. It means people would rather buy gold than hire workers or start businesses—that they don't trust the central bank to maintain the value of their money.

Former Fed Chairman Paul Volcker thought of high gold prices as his enemy and repeatedly said so as a way to build confidence in the central bank. In the 1970s, high gold prices reflected Fed incompetence that had produced inflation, stagnation and malaise. Jimmy Carter named Mr. Volcker to replace G. William Miller as Fed chairman in 1979, a rare moment of Washington accountability. Gold then fell in the 1980s and '90s in what was called affectionately "The Great Moderation." Inflation and oil prices followed gold prices down, tax rates were cut, and jobs became plentiful. Foreign capital beat a path to America's door, the mirror image of the exodus of growth capital the Fed's weak dollar is fueling.

Equally harmful in our current environment, low bond yields (negative yields in some cases) signal fear of deflation and a collapse in the financial system. Investing on these fears hurts growth—investors buy billions in gold to protect from inflation and billions in government bonds to protect from deflation. It's like a farmer plagued by both floods and droughts and having

to buy insurance against both extremes.

It's not an abstract fear. The Fed caused high inflation in the 1970s and participated in a weak-dollar policy in the 2000s that made gold a vital investment for capital preservation.

### Shouldn't the Fed try to improve incentives to invest in growing businesses?

And the Fed has repeatedly warned of a Japan-style deflation over the last decade, itself buying bonds in huge quantities and now forcing more capital into dead-end government bonds by assuring near-zero interest rates into 2013.

Reinforcing investor fears, the Fed has caused extraordinarily wide and harmful swings in interest rates, the value of the dollar, gasoline prices and inflation in recent decades. This makes precautionary investments like gold, bonds and foreign diversification more profitable than investing the old-fashioned way in small, growing businesses.

The result: Growth has stagnated. With gold prices flying through the roof, interest rates at near-zero and

10-year bond yields at only 2%, too much capital has been diverted into protecting investors from monetary-policy extremes.

The Fed takes the view that gold prices have limited meaning and that low bond yields are desirable as stimulus, not a market-based indicator of slow growth and high risks to the financial system. This leaves the financial world in suspense over whether the Fed will buy back more of the national debt or even new types of assets as some are urging. The uncertainty is great for the Fed-watching community and Wall Street, which profits by buying bonds in advance of Fed purchases. But the suspense hurts growth and jobs.

To break this cycle, the Fed needs to rebuild a monetary system in which the dollar is a strong and stable store of value and capital is allocated based on interest rates and market forces rather than the rationing of regulatory capital. Gold prices would be lower and bond yields higher in anticipation of a growing economy and a safer financial system.

Unless the Fed breaks the cycle, many of the arguments for buying gold and bonds still pertain. The Fed owes \$2.8 trillion in liabilities, undercutting confidence in the dollar and the financial system. It is willing to promise zero interest rates for years but not willing to criticize the declining value of the dollar, one of the most important metrics of central banking.

These missteps aren't fatal. The Fed's plump balance sheet can be pared back when growth starts. Last week's improvement in the gold/bond fear index provides an opportunity for the Fed and the administration to talk up the economy and put a bullish top on the price of gold.

Instead of locking in 2013 interest rates, as it has done, the Fed should reassure markets that sound monetary policy will produce lower gold prices and higher bond yields over time, an important step in restarting growth. The status quo—piling trillions into foreign countries, gold and idle Treasury bonds—sucks capital away from growth. The Fed should put an end to it.

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