Gold Rally Points to Eroding Faith in Central Banks Worldwide

In Japan, as in the U.S., a new leader wants the central bank to make government debt more bearable, which could feed inflation

By Greg Ip Follow
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Sanae Takaichi was elected leader of Japan's Liberal Democratic Party on Saturday. PHOTO: KYODONEWS/ZUMA PRESS

On Saturday, Japan got a new prime minister. On Tuesday, gold topped $4,000 for the first time.

It wasn't a coincidence.

Sanae Takaichi, the surprise nominee to lead Japan's ruling Liberal Democratic Party, is a fiscal and monetary dove. She wants more economic stimulus, and the Bank of Japan to help by not raising rates too much. News of her selection sent the yen down and Japanese stocks and bond yields up.

The news also added to gold's epic run this year, with a further 2.6% jump Monday and Tuesday. It turns out the U.S. isn't the only country where massive debts and populist politics threaten the value of "fiat" currencies like the dollar—i.e., those backed by nothing tangible—and the central banks that issue them.

Last month, Nigel Farage, leader of the populist Reform UK party, now ahead in polls in Britain, criticized the Bank of England for selling bonds, because the resulting losses and upward pressure on interest rates were costing taxpayers.

The European Central Bank, designed with near total independence from politicians, looks secure for now. But pressure on it could build, too. France just lost its fourth prime minister in a little over a year amid an impasse over taming its debt. In both France and Germany, populists who in the past advocated abandoning the euro are leading the polls.

Gold's rally has come in several stages. The first began after Western nations froze Russia's foreign currency reserves in the wake of its full-scale invasion of Ukraine in 2022. Central banks and foreign governments, in search of something that adversaries couldn't seize, began piling into gold.

The second came this past April with President Trump's trade war, which undermined faith in the U.S. as a stabilizer of the global economic system and the dollar's pre-eminent place in that system.

The third began in late August, when the Federal Reserve signaled it would cut rates to counteract weak labor markets, despite inflation running above its 2% target. Days later, Trump, who had been agitating for lower rates all year, sought to increase his control over monetary policy by firing Fed governor Lisa Cook for alleged mortgage misrepresentations. She has disputed the allegations and retains her job for now.

Gold's rally is starting to look like a speculative frenzy. Wall Street has dubbed it the "debasement trade." Gold generates no income, so whether it is correctly valued at $4,000 for a troy ounce is impossible to assess. Traditionally, its main appeal is as insurance—against geopolitical or economic instability, or loss of trust in other assets such as the dollar.

Ken Griffin, chief executive of fund manager Citadel, citing the dollar's steep drop this year, said earlier this week: "Sovereigns, central banks, individual investors around the world now say, 'You know what? I now see gold as a safe harbor asset in a way that the dollar used to be viewed.'"

Gold rose above $4,000 a troy ounce for the first time on Tuesday. PHOTO: DENIS BALIBOUSE/REUTERS

Still, as Robin Brooks of the Brookings Institution noted, the dollar has been stable since August, suggesting gold's recent rally is about eroding faith in all fiat currencies.

Although circumstances differ in each country, what Japan, the U.S. and Western Europe have in common is debt, now in or approaching triple digits as a share of gross domestic product.

A simple formula determines how sustainable that debt is. When the average interest rate on that debt is below the nominal growth (i.e., unadjusted for inflation) of GDP, debt tends to fall as a share of GDP. When the interest rate is higher, that ratio tends to rise.

From 2008 to 2022, debts across developed economies soared in response first to the global financial crisis and then to the Covid-19 pandemic. But because interest rates were much lower than nominal GDP growth, those debts were easy to sustain.

No more. With the return of inflation, interest rates are returning to historic norms.

In a new report, Morgan Stanley noted that across developed markets, "In the last year, on average, nominal growth has slowed, cost of debt has risen, and deficits deteriorated—a triple whammy for debt sustainability." It predicts that by 2030, the average cost of debt service will equal growth rates. Preventing an explosive rise in debt would require a sizable budget surplus excluding interest—i.e., steep spending cuts or tax increases. That is proving politically unpalatable.

Trump inherited an annual budget deficit of around 6% of GDP and debt (the sum of all deficits through time) approaching 100% of GDP and has done little to change their trajectory. Revenue from tariffs do offset the tax cuts in Republicans' fiscal bill signed in July but could disappear if the Supreme Court rules some tariffs were imposed illegally. Meanwhile, the government has shut down over Democratic demands that certain healthcare subsidies be extended, to which Trump and Republicans appear open.

Trump thinks there is an easier way to lower deficits: Get the Fed to lower rates and thereby make servicing the debt cheaper. When central banks shift their priority from inflation to helping the Treasury, it is called fiscal dominance, and it usually leads to inflation.

Seth Carpenter, chief global economist at Morgan Stanley, said while no one can be sure what the Fed will look like after current chair Jerome Powell steps down, "Trump gets to make some picks, and he's been clear what he wants." The Fed, he said, might be shifting toward generally easier policy over time, which implies a lower dollar, higher expected inflation, and higher gold than otherwise.

Fiscal dominance also looms in Japan. Takaichi, the incoming prime minister, is an advocate of former Prime Minister Shinzo Abe's "three arrows" strategy for economic revival: structural reforms to boost competitiveness and fiscal and monetary stimulus. Last year, she said it was "stupid" of the Bank of Japan to raise interest rates. She has since slightly softened her tone, while reiterating the government should "determine the direction of economic and monetary policy."

Markets have concluded that Bank of Japan Gov. Kazuo Ueda will be slower to raise interest rates. The problem is that, as in the U.S., inflation in Japan is notably higher than before the pandemic. Deferring to the government's demands risks letting inflation rise further.

Japanese 10-year bond yields are still quite low at around 1.6%. But Brooks, of the Brookings Institution, noted that 30-year yields are up sharply, especially since Takaichi's selection, and they imply 10-year yields will be over 4% in 20 years' time. The same pattern is visible in other countries, he said.

"The market is saying, 'You guys are going to inflate away the debt, not now but in the long term,'" Brooks said.

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