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GOLD IN WORLD MONETARY AFFAIRS TODAY

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DEPARTMENT OF ECONOMICS AND SOCIOLOGY

PRINCETON UNIVERSITY

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This is the thirty-fourth number in the series ESSAYS IN INTERNATIONAL FINANCE *published from time to time by the International Finance Section of the Department of Economics and Sociology in Princeton University. It is the third in the series written by the present author, the first one, "Postwar International Lending," having been published in 1947 and the second, "The Price of Gold," in 1952; both have long since been out of print.*

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GOLD arrangements in the world today are the outgrowth of the world's currency experience of the last twenty-five years. For reasons that need not be dwelt upon here, the gold standard in the form in which it was reestablished after the First World War had ceased to operate in the 1930's. Gold, of course, has retained its importance in world monetary affairs—not merely because the British Commonwealth is the principal producer of gold and the United States its principal holder, but fundamentally because the currency arrangements of the community of nations continue to make an essential use of it.

The use of gold in international payments will be appraised here by reviewing, in Section I, the gold arrangements in the world today and by analyzing, in Section II, the policies and practices of monetary authorities with regard to international reserves (whether gold, dollars, or sterling). To round off this essay, Section III will discuss the contemporary monetary system in another essential but often neglected aspect—the relationships between domestic currency and international reserves. A few concluding remarks will then sum up the main distinctive features of the international monetary system today and the function of gold in that system.

I. GOLD ARRANGEMENTS IN THE WORLD TODAY

The principal trading nations make essential use of gold for external purposes by reason of the gold arrangements that have evolved in the world since the breakdown of the traditional gold standard in the early 1930's. These arrangements are different in many ways from the earlier ones; at the same time, however, they denote, in their very substance, a basic continuity with the past.

Disappearance of the Domestic Trimmings of the Traditional Gold Standard

In the world today, free and unlimited gold coinage, which has been the distinctive feature of the gold-coin (or specie) standard prior to 1914 in most countries and prior to 1933 in the United States, has been dispensed with everywhere. Most of the available gold has thus been concentrated in central banks to serve monetary purposes.

In most countries, gold coins were withdrawn from active circulation during the First World War; and when in the 1920's the gold standard was restored the currencies were linked with gold by legally requiring the central banks to redeem their notes not in coin but in bullion, and only in amounts that were set so high by monetary legislation that the general public was effectively discouraged from demanding gold. The reason why England and many other countries gave up gold coinage was that such use had come to be regarded as an "unwarranted extravagance" (the expression of Mr. Churchill, who was the Chancellor of the Exchequer at the time of Britain's return to gold in 1925); the idea of a gold-bullion standard, however, had been David Ricardo's as early as the beginning of the 19th century.

Free domestic redeemability in bullion was in turn abolished everywhere during the 1930's. In 1933, the United States itself withdrew gold coins from circulation, and a year later provided, under the Gold Reserve Act of 1934, that no United States currency should be redeemable in gold, that no gold should be coined, and that it should be unlawful for banks and the general public to hold gold or gold certificates (except gold in its natural state, i.e. nuggets, flakes, etc., and gold coins of recognized value to collectors). Under the Act, the U. S. Government took possession of all monetary gold in the country, including that held by the Federal Reserve Banks.

Like the United States, certain other countries—in particular the United Kingdom—do not allow their citizens to hold or trade in gold. A gold market exists in London, it is true, but—as will be explained later—it does not provide any facilities through which British and other sterling-area residents can obtain gold for sterling, except for bona fide use in the arts and industry. Most countries do allow the domestic holding of gold and some also permit or tolerate free markets where gold can be purchased or sold domestically; in France the authorities intervene on the gold market in order to smooth out day-to-day fluctuations. But nowhere do the monetary authorities deliver gold to their nationals at a fixed price for domestic holding. Recent legislation in Belgium, Canada, and Switzerland provides for the minting of gold coins, but only under certain stipulated conditions; since these are not fulfilled, no coins are being minted. In the United Kingdom new sovereigns are being issued, but only for sale—against United States dollars and other convertible currencies—in markets outside the sterling area.

The Purchase and Sale of Gold among Monetary Authorities

While free gold coinage and domestic redeemability of currency into gold have disappeared, gold remains the means of ultimate settlement among monetary authorities of the principal trading nations. To be sure, the bulk of international transactions is, as it always has been, "cleared" in the exchange markets, and the balances remaining after transactions have been set off against one another are settled, to an extent varying according to the country, by the use of the United States dollar and the pound sterling—currencies in which many central banks and Treasuries keep a part of their monetary reserves. But monetary authorities of leading countries buy and sell gold, at fixed prices or within prescribed margins on each side of a fixed par value, for the settling of international balances; such gold is in the form of bullion (i.e. uncoined or bar gold).*

As under the old gold standard, by far the largest volume of international gold transactions is carried out in New York or London; but the transactions are now effected in quite a different way. For one thing, unlike before the 1930's, the monetary authorities are committed neither to buy nor to sell gold. Monetary legislation no longer requires them to do so (apart from buying gold that nationals may be required by law to surrender to the monetary authorities), and under the Articles of Agreement of the International Monetary Fund, too, there is no obligation on any member to buy or sell gold in transactions with other members.** And, for another, the United States is today the only country that maintains the international value of its currency by making it interconvertible with gold through transactions with foreign monetary authorities. Other countries maintain the value of their currencies through operations in the exchange markets, their monetary authorities being ready to enter the markets as buyers or sellers of United States dollars at the limits of a given range.

Apart from the United States dollar, there are but few currencies whose value is defined by monetary legislation in terms of gold. Under the International Monetary Fund Articles of Agreement, however, the

* The usual bar weighs about 400 ounces, measures 7 by 3 9/16 by 1 11/16 inches, and is worth approximately $14,000.

** The only obligations provided for in the Articles of Agreement with regard to gold are that a member must sell its currency to the Fund for gold if that becomes necessary in order to replenish the Fund's holdings of the currency in question, and a member must buy its currency from the Fund with gold when it has to fulfill its obligations to repurchase its currency from the Fund. Apart from these requirements, a Fund member is free to buy or sell gold as it wishes, provided it does so at prices corresponding, within certain margins, to the par value of its currency accepted by the Fund.

sixty-eight participating nations have accepted the obligation to establish par values for their currencies that are binding for their foreign-exchange as well as their gold transactions. These par values are expressed in terms of gold, or in terms of the United States dollar of the weight and fineness in effect at the time that the Fund Agreement was signed (1944). Members are obliged to maintain stable rates of exchange based on these par values; and they are not to permit rates to vary by more than 1 percent on either side of the par values. The device of par values thus connects with the United States gold price the par values of currencies that are not themselves defined by statute in terms of gold, and accordingly makes the United States gold price serve as an anchor for the world's currencies. The United States itself fulfills its undertaking under the Fund Agreement to maintain the external stability of the dollar by buying and selling gold in transactions effected with other monetary authorities for the settling of international balances.

The U. S. Treasury thus sells gold at the official price for the settlement of international balances and other legitimate monetary purposes to foreign governments and central banks; these can exchange dollars for gold virtually automatically for these normal purposes. On the other hand, the U. S. Treasury stands ready to buy gold from foreign governments and central banks without limitation in amount at the official price.

Sales and purchases of gold by the United States are at its official price of $35 per troy ounce, plus or minus ¼ of 1 percent, i.e. at the buying price of $34.9125 and the selling price of $35.0875 per fine ounce. This price was established by Presidential Proclamation on January 31, 1934, under the authority conferred on the President by the Gold Reserve Act of 1934; the Proclamation reduced the gold content of the dollar from 25.80 grains nine-tenths fine to 15 5/21 grains of gold nine-tenths fine (13.71 + fine grains), thus changing the dollar parity from $20.67 to $35.00 a fine ounce. This reduction in the gold content of the dollar to 59.06 percent of its former parity fixed the value of the dollar in the foreign-exchange market at about the level to which it had depreciated in 1933. The President's power to devalue the dollar further (to 50 percent of its former parity) expired on June 30, 1943; only an Act of Congress can now alter the gold content of the dollar.

A distinction is sometimes made between the gold content of the dollar, which can be changed only by an Act of Congress, and the market price for gold, which could be changed under Sections 8 and 9 of the Gold Reserve Act authorizing the Secretary of the Treasury to buy and sell gold, at home and abroad, "at such rates and upon such terms and conditions as he may deem most advantageous to the public interest," i.e. at rates other than $35 per ounce. This authority has, however, been circumscribed by the obligations assumed by the United States as a member of the International Monetary Fund. Furthermore, it is stipulated in the Bretton Woods Agreement Act of July 31, 1945 that any change in the par value of the United States dollar shall require legislative action by Congress.

Present gold arrangements in London are likewise very different from those under the traditional gold standard. The London gold market was reopened in March 1954 after a closure of sixteen years. Only residents of countries outside of the sterling area may purchase gold on the London market (the exception is the sale for industrial, commercial, and artistic uses); furthermore, they may acquire gold only if payment is made in dollars or other currencies convertible into dollars simultaneously sold on the London exchange market or in the so-called "external-account" sterling, i.e. sterling earned—from trade, and not from sale of property or securities—by others than residents of the United Kingdom and overseas sterling countries. Such sterling, which is convertible for nonresidents at the official exchange rate, was established at the close of 1958; previously, gold could, in effect, be bought in London only against dollars.

Sellers in London of gold mined in the sterling area of course receive resident sterling, but the sterling area's gold-producing countries have free access to the London exchange market and their sterling holdings are thus convertible into dollars, subject to gentlemen's agreements not to convert existing balances at too rapid a rate. As to gold sold by nonsterling countries, it is paid for in external-account sterling, which can be freely converted into dollars or used to buy gold.

The London gold market thus functions, in effect, like a dollar market. Access to it is denied to residents, and even nonresidents can buy there only if payment is made in dollars or other currencies convertible into dollars. The chief differences between the London market and the gold arrangements in force in the United States are that, on the one hand, private interests can purchase gold in London but not from the U.S. Treasury, and, on the other, the London price is allowed to fluctuate within a prescribed range while the U.S. Treasury's buying and selling prices are fixed.

As already noted, the British monetary legislation does not define the pound sterling in terms of gold, as it did before September 1931. The United Kingdom has, however, the obligation under the International Monetary Fund's Articles of Agreement to maintain an official exchange parity of £ 1=$2.80, to which corresponds a gold parity or par value of 250s. per fine ounce. Furthermore, under the Fund's rules, a member can buy or sell gold only within prescribed margins based on the par value of its currency. The fluctuations in the London price of gold are thus strictly limited.

The price in shillings is established at the daily "fixing"—the ceremonial meeting of the six major bullion dealers at which they attempt to match up their orders to buy and to sell gold, in the light of their knowledge of the demand and supply in the market as a whole, including such interventions as the Bank of England, as a residual buyer and seller, may undertake in order to maintain an orderly market. The trading during the day is done on the basis of the price at "fixing," although it may vary from that price because of new developments or movements in the sterling-dollar rate. Generally, the sterling price of gold increases whenever the dollar price of sterling decreases and vice versa. This inverse relationship reflects, basically, two essential aspects of the working of the London market—the fact that it is mainly a market for central banks that have the alternative of operating in New York, and the fact that the British authorities, by adjusting their offerings of gold—selling more gold, for instance, when the dollar-sterling rate is weak—can influence the offerings of dollars by foreign gold buyers and thus reduce the necessity for themselves intervening in the exchange market.

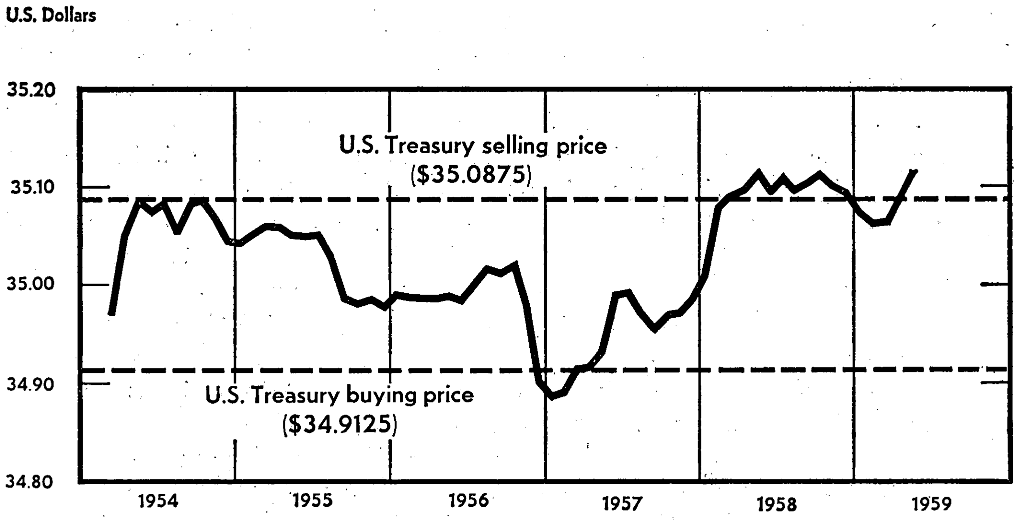
As appears from Chart I, the dollar equivalent of the London gold price from the reopening of the London market in 1954 through the end of 1957 fluctuated almost continuously between the United States buying and selling prices. On only a very few occasions did the dollar equivalent of the London gold price touch the U.S. Treasury's selling price (as at certain times in 1954) or fall slightly below the U.S. Treasury's buying price (as in late 1956 and at the beginning of 1957). In contrast, during 1958 it stood above the U.S. Treasury's selling price of $35.0875; the peak was reached in October 1958, but by the year-end the price fell to $35.09. It declined further during the first quarter of 1959, but rose subsequently to $35.12 in May (monthly average).

Bullion dealers are not able, as under the old gold standard, to purchase gold from the United States (they could, however, offer gold for sale here). But the impossibility of private gold arbitrage does not diminish the importance of the London gold price as compared with the U.S. Treasury's buying and selling prices. Central banks, stabilization funds, and Treasuries (and the international financial institutions) have the alternative of buying or selling gold in New York or in London, and in fact conduct their transactions where the price is most advantageous at any given time (assuming that the location of the gold itself is a matter of indifference, and that the London market can accommodate, at any given time, all possible sellers and buyers). The relationships between the sterling price of gold, the sterling-dollar exchange rate, and the dollar equivalent of the London gold price

CHART I

THE DOLLAR EQUIVALENT OF THE LONDON GOLD PRICE, 1954-1959

(Monthly averages in dollars per fine ounce)



therefore bear importantly on the direction and the volume of international gold movements today.

A Bird's-eye View of International Gold Movements

No comprehensive data are available on gold settlements among monetary authorities. The United States is the only country that publishes—with a lag of three months—certain information regarding its gold purchases and sales, in the aggregate as well as by countries and international institutions; these data are quarterly and on a net basis and, therefore, do not give a full account—only a broad statistical picture—of United States gold transactions with foreign monetary authorities. Until the reopening of the London gold market in early 1954, the pattern of world gold transactions had been marked principally by direct transfers between foreign monetary reserves and those of the United States. Since the development of trading in the London market, however, many central banks have been dealing in gold there, for reasons already explained; and since no data are released on transactions in that market, the pattern of international gold movements has actually tended to become less visible. Nevertheless, by collating and surveying the published data, including the periodic returns of central banks, it is possible to make a number of broad inferences regarding the magnitude and direction of international gold movements.

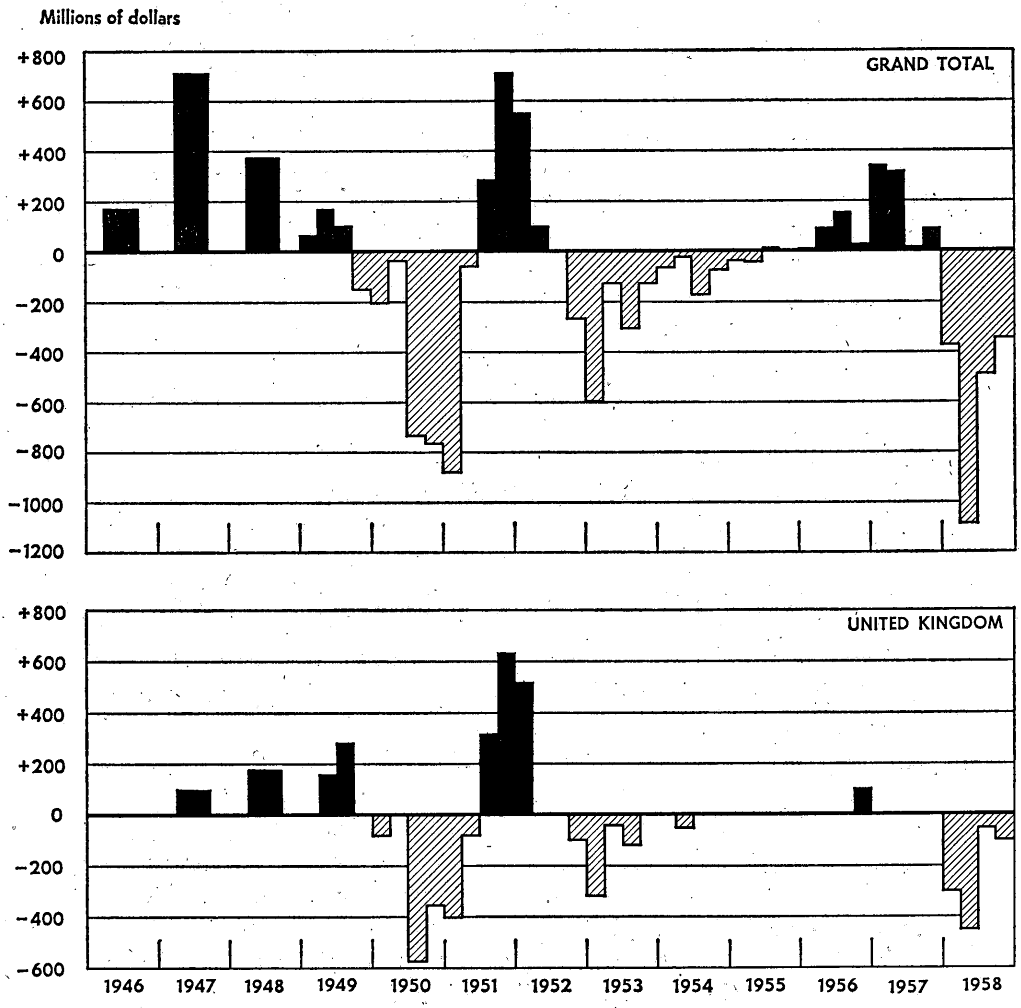
The magnitude and direction of United States gold transactions with foreign countries and the International Monetary Fund from 1946, following the end of the Second World War, through December 1958 are shown in the upper grid of Chart II. As clearly appears from it, there have been six distinct phases in United States gold transactions, with large-scale purchases alternating with large-scale sales. These shifts of the United States from the position of a net buyer to that of a net seller of gold—together with changes in the official dollar holdings of foreign countries—basically reflect, on the one hand, the state of the United States "cash" balance of payments (i.e. the excess of outpayments to foreign countries over receipts from them, and vice versa), and on the other, the decisions of foreign monetary authorities to purchase gold rather than build up dollar balances or to sell gold in order to replenish dollar balances.

To understand more fully the working of the international currency mechanism, however, it is necessary to look beyond these aggregate fluctuations in the United States gold position. Two aspects, in particular, are significant. The first is the importance of gold transactions between the United States and the United Kingdom. As may be seen from the lower grid of Chart II, the United States gold purchases from, or sales to, the United Kingdom accounted, as a rule, for a sizable portion of total United States gold transactions; and secondly, the United Kingdom frequently repurchased gold from the United States that it had sold during an earlier period. These alternating purchases and sales of gold reflect, of course, the wide fluctuations in the sterling area's gold and dollar payments; they also reflect, however, Britain's practice of holding most of its reserves in the form of gold, and of acquiring gold at times of balance-of-payments surpluses and disposing of it during periods of deficits.

Other countries also sell gold to, or purchase it from, the United States, but in amounts much smaller than the United Kingdom. Among the Continental European countries, Belgium, the Netherlands, and Switzerland have had transactions with the United States fairly frequently during the postwar years; France, Germany, and Italy, intermittently. Canada sold sizable amounts in some of the early postwar

CHART II

UNITED STATES NET GOLD PURCHASES AND SALES, 1946-1958
(+ = purchases; — = sales)



Note: 1946-1948 quarterly averages; 1949-1958 quarterly figures.
Source: *Federal Reserve Bulletin*