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GOLD: BARBAROUS RELIC OR USEFUL INSTRUMENT?

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GOLD: BARBAROUS RELIC OR USEFUL INSTRUMENT?

The world is at a critical juncture in its monetary affairs. No newly mined gold has of late flowed into the monetary stocks of governments and central banks, the entire output having been absorbed into private uses and holdings. At the same time, the governments and central banks of some of the leading Continental European countries have enlarged their share of the unchanged total of the world's monetary gold stocks through conversions of U.S. dollars or purchases from the International Monetary Fund against their own currencies. Governments reluctant to purchase gold from the U.S. Treasury have frequently had recourse to a variety of transactions by which they replaced nonguaranteed dollars with claims on the United States in terms of their own currencies or with claims on the Fund that carry a gold-value guarantee.

Against such a background, this essay will describe, in Part I, the explosion of private demand for gold; review, in Part II, the demand for gold by the governments and central banks of most of the large industrial nations abroad; and discuss, in Part III, the future of gold.

Written from the vantage point of a student of international finance who is close to day-to-day business, and yet far enough removed to see trends and developments in perspective, the essay seeks to contribute to practical realism in the discussions of international monetary affairs.

The essay will accordingly argue that, in the world today, gold is neither an eternal standard (as those who advocate the return to the traditional gold standard would make us believe) nor a barbarous relic (as Keynes once called it). Treading halfway between the firing lines, it will disapprove of the politico-psychological guerilla skirmishing in certain French quarters against the international monetary system as it operates today and against the established price of gold. But, by the same token, it will reject such propositions as cutting loose from gold through steps like an embargo on U.S. Treasury sales to foreign governments and central banks—propositions that have of late been advanced on this side of the Atlantic as if everything would be all right if only Europe did not insist on receiving gold rather than dollars in the settlement of its payments surpluses. A unilateral action to change the present gold arrangements and practices is not open to the United States as a practical policy—for reasons the essay will endeavor to set forth convincingly and conclusively.

All things considered, therefore, the essay regards gold as a useful international monetary instrument. In our suspicious and unsettled world, the governments of the key nations hold by far the largest part of their international reserves in gold in preference to other forms of reserves, including dollars. The principal countries of Continental Europe with balance-of-payments surpluses—surpluses that are, directly or indirectly, the counterpart of United States deficits—want to retain gold as the ultimate means of international settlements. They are unwilling to grant to deficit nations, bilaterally or under intergovernmental, inter-central-bank or international arrangements, credits in unspecified amounts for unspecified periods of time. Furthermore, gold can provide, year in year out, an appreciable increment to international monetary reserves—so long at least as conditions are not developing, as they are today, under which a rise in the price of gold would appear inevitable. Also, gold can help assure the smooth and efficient functioning of the international monetary system.

So far ahead as can be seen, therefore, gold will remain the inner circle of our monetary universe—a circle which may, with the passage of time, become relatively smaller. For this to happen, however, it will be necessary to enhance respect for the dollar as the form of international reserves second only to gold, as well as respect for such new international monetary instruments as may be created as a supplement to or, perhaps, a substitute for gold. This problem, if it is ever to be mastered, will have to be resolved by protecting real values of the principal national currencies.

The essay will end with the pragmatic conclusion that the twin problems of international liquidity and balance-of-payments adjustment will be with us forever: as some of these problems are dealt with, others arise. Today, the real threat to world prosperity and trade comes from the shortage of monetary gold—the consequence of private gold absorption and official propensity to convert dollars into gold, which are themselves the inevitable accompaniment of uncertainties about the dollar and, hence, uncertainties about the continued maintenance of the present gold arrangements and practices. Their breakdown would, almost certainly, bring about more inflation and submerge nations in more economic and financial controls. And it would, quite certainly, damage—perhaps beyond repair for years to come—the substantial degree of convertibility, at fixed exchange rates, among the leading currencies and the reasonably free, multilateral, and nondiscriminatory world trade that the nations have achieved through imaginative and determined efforts over the past twenty years. This is the real contingency against which it is urgent for governments to plan today.

I. THE EXPLOSION OF PRIVATE DEMAND

The entire world gold output is currently being absorbed into private hands—roughly one third for the fabrication of jewelry and gold articles of all sorts and two thirds for additions to private holdings, whether for investment or speculative hedging against a possible gold-price rise. For 1966, private gold absorption may be estimated at $1.5 billion, roughly the same as in 1965. These are the highest amounts ever attained—$0.5 billion more than in 1964. For the past ten years, about $10 billion worth of gold has gone into private uses and holdings.

As a result, governments and central banks are not only being deprived of additions to monetary gold reserves from current output and Russian sales but they have also, in the aggregate, lost gold out of accumulated stocks—though only marginally thus far. During 1966, official gold stocks, as published, fell by $90 million—the first such decline in modern monetary history. Last year's decline compares with a gain of $250 million in 1965—the smallest such addition since 1952.

Attenuating Circumstances

There are attenuating circumstances for this state of affairs. Among these is, first of all, the fact that in 1966, for the fourth consecutive year, world gold output rose less than in the preceding year. (See Appendix, Table 1.) The flattening in the rate of growth reflects production trends in South Africa, whose output represents about three fourths of the world total (excluding the Soviet Union, other Eastern European countries, and Mainland China). At only 1 per cent over 1965, last year's rise in South African output compared with 5 per cent, 6 per cent, and 8 per cent during 1965, 1964, and 1963, respectively.

The flattening out in the hitherto dramatic increase in South African output is due to a slowdown in the rate of production of the new mining areas in the Orange Free State, which had begun operations in the early 1950's. The rise has been the outcome of such factors as the richness of deposits, a geological formation that allows low-cost extraction methods, and efficiency of operation. At the same time, production in "older" mines has declined continuously, in large part because the scope of profitable operations is limited by production costs. For South Africa as a whole, the pace of output, at the present price of gold, is believed to be slowing down even more and production may peak out by 1970.

Despite the slowdown in South African output, world gold production outside Russia amounted to $1.4 billion in 1966—the highest level ever recorded. It stood at 70 per cent over 1953, before the postwar rise in production began, and 14 per cent over 1940, when output reached its previous peak following the worldwide currency devaluations in the 1930's.

Last year's increase in output, however, was not large enough to make good the absence of gold sales by the Soviet Union—for the first time in the past decade. Russia's improved harvest made it unnecessary to sell gold to finance purchases of Canadian wheat. Perhaps, Soviet bankers are unwilling to sell gold under present circumstances. As sketched in the Appendix, Russian gold sales from 1956 through 1962 averaged close to $250 million a year; in 1963-65 they averaged above $500 million a year; and for the period 1953-65 as a whole they totaled close to $3.5 billion. As a result, total new supplies of gold, which in 1965 had reached $2 billion—the highest figure on record—amounted in 1966 to only three fourths of the 1965 supplies, or $1.5 billion.

A third attenuating circumstance for last year's gold performance was the fact that South Africa, which sells gold to the extent necessary to bridge gaps in its balance of payments, had a payments surplus. Shipments of gold from South Africa to the United Kingdom declined from $1,210 million in 1965 to $834 million in 1966. Later in the year, as South Africa substantially relaxed restrictions on merchandise imports and reportedly stockpiled vital materials such as oil, it again sold gold, not only out of current output but also, to a limited extent, out of reserves.

The Extraordinary Rise in Industrial Demand

Statistical estimates are available of the uses of gold during recent years: additions to official stocks, industrial uses in the United States and other leading countries, and additions to private stocks. (See Appendix, Table 2.) Additions to private stocks are a no-man's land, to be explored later in this essay.

The demand for industrial and artistic uses has risen markedly. For the United States in 1965 (the latest year for which data are available), such uses amounted to $185 million (net); only a few years ago they had averaged about $100 million a year. Gold uses in industry and the arts represent approximately three times domestic gold production. The deficit is covered by imports and from the Treasury stock; during 1966 the Treasury released $141 million, compared with $118 million for 1965. In eleven other countries, gold consumption has also shown a sharply rising trend—reaching some $300 million in 1966. (See Table 1.) In a few of these countries, industrial uses of gold are believed to be under-reported by, perhaps, over 10 per cent.

Roughly three fourths of industrial uses in the twelve countries included in the statistics are for jewelry and gold objects of all sorts. Increases in employment and incomes to all-time highs obviously stimulate the buying of gold articles—articles that have become relatively cheap, given the persistent rise in the cost of living. A development

worth noting here is the stoppage, in April 1966, of the manufacture and sale of medals, medallions, tablets, etc., in the United Kingdom on the ground that these practices tended to avoid exchange-control provisions prohibiting the hoarding of gold; in February 1967, the use of gold was permitted for the manufacture in the United Kingdom of charms, tablets, and other trinkets provided they were not worth more than £2 apiece.

The Rapid Build-up of Private Holdings

Something like $1 billion went last year into what, for lack of a better label, is described in Appendix II as "Added to Private Stocks, etc." Some of this gold may have gone into unpublished reserves of governments and central banks. In 1966, for the second successive year, Mainland China and certain Eastern European countries were reported as official buyers in the London market.

The great bulk of "disappeared" gold, however, undoubtedly consists of additions to private gold holdings. Some of this goes into the customary mode of savings in the Far East, the Middle East, and parts of Africa. The war in Vietnam, the plight of India, and political unrest in many countries in these parts of the world have increased the traditional demand for gold. Some of the "disappeared" gold goes for investment in gold to secure protection against the continuing depreciation of national currencies and against political upheavals, as in much of Europe and Latin America. Some is to hide funds in order to avoid inheritance taxes. Some reflects short-term speculation on, or hedging against, a possible world-wide rise in the gold price—activities nourished by debates, not always well informed, about weaknesses of the international monetary system and the lack of liquidity.

Given the tightness and the high cost of credit throughout much of the world, the persistence and the volume of gold buying are extraordinary. In the judgment of the Bank for International Settlements, "the indications are that most of this component of private gold offtake over the years is accounted for by fairly firmly held savings in gold, rather than by large blocks of speculative holdings awaiting a shorter-term capital gain."

Despite the strong and persistent private demand, the price in the London gold market has at no time during recent years exceeded $35.20 per fine ounce. This is not much in comparison with the $40 level momentarily reached in October 1960. To keep the price on an even keel, gold sales from British reserves were initiated in 1960 under a broad understanding that the Bank of England could recover from the United States gold it had sold in the London market. In 1962 this "gold bridge" was supplemented by a wider informal agreement among leading

central banks to refrain from buying gold in London whenever the supply is short and to participate with the United States in channeling gold to the market. The "gold pool" has thus maintained control over the market—at some cost to official reserves whenever gold offerings from "normal" sources fall short of demand, as they did in 1966.

The strength of demand has brought prices of coins to sizable premiums over bar gold. In Paris the popular Napoleon (the 20-French franc gold piece) has of late reached the highest level in a decade and a half, commanding a premium of over 50 per cent. In the Federal Republic of Germany, the 20-mark gold coin stands at a premium of about 90 per cent.

Prohibiting Private Ownership of Gold?

Private demand for gold in recent years has almost certainly been smaller that it would have been if citizens of a number of countries had not been barred from the market. As is well known, citizens of the United States are not allowed to hold gold in monetary form except for coins of recognized numismatic value minted before April 5, 1933. The United Kingdom, South Africa, and certain other countries also forbid their citizens to hold or trade in gold; only residents of nonsterling-area countries may buy gold in the London market.

Suggestions have repeatedly been made to prohibit private ownership of gold on the ground that leakages of gold into private holdings are undesirable. It has also been urged that the London gold market be abolished, because it serves no useful function in the monetary system and complicates the task of central banks. It has also been proposed that the price of gold should be raised gradually in such a way as to eliminate uncertainty and knock the bottom out of gold speculation. Another proposal aims at gradual and periodic preannounced reductions in the official price of gold. Yet another suggestion is for central banks to stop buying gold from private holders at the full official price—after a stated deadline—while continuing to buy newly mined gold or gold offered by other central banks at the official price.

There are many doubts about suggestions like these. In earlier postwar years, attempts were made by the International Monetary Fund to protect official stocks by asking member nations to refrain from selling gold in free markets, but this proved unenforceable. Private gold trading persisted. France and some other member nations found it necessary to legalize and deal in free markets to stabilize the price of gold and thus help ensure confidence in paper money. In much of the world private ownership of gold is deeply rooted in monetary ideas, attitudes, and experiences which—especially against the background of runaway infla-

tion, twice in one generation, in several European countries—cannot be dismissed as mere anachronisms.

To close the legitimate free markets would be to attack the symptoms rather than the cause of private demand for gold and to drive gold trading from efficient open markets into shadowy markets underground. Such a move would almost certainly be regarded as a recognition of the failure of efforts to hold down the price of gold and would give added fuel to speculation that the official gold price would be raised.

II. THE GROWING PREFERENCE FOR GOLD BY GOVERNMENTS

The explosion of private demand has left virtually no gold for governments and central banks to add to monetary reserves. As noted above, the record in 1965 was already bad; in 1966 it was disastrous. This experience can best be understood if it is placed in broader perspective. (See Appendix, Table 2.) Among other years during the past decade, the worst years, in absolute terms, were 1960 and 1962, when only somewhat over $300 million was added to official reserves; the best years were 1959, 1963, and 1964, when $750 million or more moved into official stocks. For the ten years ending in 1964, before the explosion of private demand in much of the world, the annual average was approximately $600 million.

A Bird's Eye View of International Gold Movements

All additions to monetary gold stocks from new output and Russian sales since World War II have—on a net basis—accrued to governments and central banks outside the United States. For most of the period, the United States has, of course, had a balance-of-payments deficit with the rest of the world. As a result, many industrial countries, having rebuilt official dollar reserves to levels they regard as desirable, have used some of the dollars to purchase gold from the U.S. Treasury or in London.

International gold flows have also been importantly affected by transactions of member governments with the International Monetary Fund. Over the past two years, the Fund itself has received sizable amounts of gold following payments by member governments as part of their increased subscriptions and has thus, in effect, absorbed some of the gold that has flowed into official reserves outside the United States. On the other hand, the Fund has sold gold to a number of countries outside the United States to replenish the holdings of national currencies it had needed to extend aid to the United Kingdom in dealing with the sterling crisis. (A bird's eye view of these and other changes in world monetary gold stocks over the past three years is presented in the Appendix, Table 3).

Gold acquired from the United States and the International Monetary

Fund has principally gone into the stocks of Continental European governments and central banks. The redistribution of gold between the United States and Europe is as striking as that of the late 1930's and the 1940's, when an avalanche of gold descended from Europe on the United States. The U.S. share in the world total today is—at about one third—roughly the same as in the early 1930's; it reached a level in excess of two thirds in the late 1940's. Even now, after the substantial transfers of gold to other countries, the gold reserve of the United States—at $13.2 billion as of the end of April 1967—is far larger than that of any other country; but, as will be argued in Part III, the United States needs a comfortably large gold stock.

Among the Continental European nations themselves, much gold has gone into the stocks of France. As is well known, France—following an announcement in early 1965 that its external surplus would henceforth be taken in gold—was the largest buyer of gold from the U.S. Treasury until the closing months of 1966, when its balance of payments went moderately into deficit. It is less well realized that France has, in fact, merely reacquired the gold it had sold to settle its payments deficits between the mid-1930's and the late 1950's. At today's $5.2 billion, France's reserve is, as a matter of fact, $200 million below the all-time peak in early 1935, when it represented as much as one fourth of the world total; the proportion now amounts to about one eighth.

The second largest gold gainer during 1964-66 was the Federal Republic of Germany—not so much through purchases from the United States as through acquisitions from the International Monetary Fund against German marks. As Otmar Emminger, Member of the Directorate of the German Federal Bank, noted, while Germany has welcomed these gold accruals to its reserves "as they have brought the proportion of gold to total reserves more nearly to the intended magnitude, we have carefully avoided large-scale conversions at the expense of the U.S. Treasury, in order not to 'upset the apple cart' at an untoward moment." In March 1967, Germany agreed to regard dollars acquired through local expenditures by American troops as being, in effect, inconvertible into gold; this *quid pro quo* was, obviously, motivated by political considerations.

Italy disposed of gold in 1964 when its balance of payments was under severe strain, only to rebuild its stock in 1965 and 1966. On the whole, Italy's gold stock has thus shown practically no change over the past two years, as its large balance-of-payments surplus has been financed through offsetting operations, including a $250 million loan to the International Monetary Fund. In appraising recent international gold movements, it is of some interest to point out that Germany and Italy—two countries that had very little gold before World War II—are today among the world's largest gold holders. (See Table 3.)

Among other countries that added to their reserves during 1965 and 1966 are (in the order of magnitude of such additions) Canada, Spain, Austria, Belgium, Portugal, and the Netherlands. Canada enlarged its gold stock out of its own output—despite periodic sales to the United States; for other countries the main source of gold was the U.S. Treasury.

The United Kingdom is, as circumstances warrant, a large buyer of gold or a large seller out of official stocks. During much of the past three years, pressures on sterling in exchange markets necessitated sizable sales of gold to the United States. More recently, as sterling has strengthened, the United Kingdom has acquired substantial amounts of dollars; the bulk of these has been used to repay debts, not to show a rise in gross monetary reserves. The United Kingdom normally adds to its reserves from gold sold by producers in the London market.

The propensity of governments and central banks to hold gold has increased despite the fact that little gold was added to monetary reserves in 1965 and none in 1966. Several countries have during recent years increased the proportion of their monetary reserves held in gold. (See Table 4.)

During 1966 further increases in gold ratios occurred in France, Greece, Italy, Spain, and Canada. France's gold stock rose by some $500 million, while its foreign-exchange holdings declined by $250 million. On the other hand, in 1966 the gold ratios declined in the United Kingdom, Germany, and Switzerland. Each of these three countries had a small gold loss accompanied by gains in foreign-exchange holdings, which in the United Kingdom reflected borrowings in the wake of the sterling crisis, and in the cases of Germany and Switzerland a larger inflow of year-end "window-dressing" funds than in earlier years. For the United Kingdom, the ratio was until a few years ago in excess of 90 per cent, in line with Britain's traditional stand that a country serving as an international financial center should hold most of its reserves in gold; of late it has been lower as reserves have been enlarged through borrowings of foreign exchange.

Conversely, holdings of foreign exchange—for all practical purposes, U.S. dollars—in official monetary reserves of Continental European countries have declined substantially. While the governments and central banks of Continental Europe from 1958 through 1964 added $4 billion to their foreign-exchange reserves, they reduced them by $1.6 billion during 1965 and 1966; about half of this reduction was accounted for by France. This reduction, contrasting sharply with the build-up of dollar reserves prior to 1965, marks the end of an era.

Given the existence of ample official reserves in U.S. dollars, gold—once acquired—is often kept at the bottom of the reserve pile, payments deficits being financed by drawings on dollar reserves. Thus, Germany