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GOLD AND THE DOLLAR

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Seventh International Working Conference

sponsored by

FOREX Research and The International Herald Tribune

Paris, France

Monday, November 23, 1981

SUMMARY

1. Over the decades, the dollar as an investment medium has held up better than almost any other currency.

2. Dollar savers today are getting a positive real rate of return, even though after taxes and inflation it often is very little.

3. The dollar has approximately maintained its international role under a floating exchange rate system.

4. A return by the United States to a meaningful gold standard in the foreseeable future is not likely.

5. If nevertheless a belief should gain ground that the United States was moving toward fixing a price for gold, many present holders of gold might conclude that it would not pay to hold gold.

6. The most desirable gold policy for monetary authorities is to sit on their gold as an ultimate reserve and to use it as little as possible.

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Gold and the dollar: both have long played important roles in the world's financial system. As a reserve asset held by central banks and governments, the dollar today is by far the more actively used. But at present market prices, officially held gold, though in an inactive role, exceeds in value official dollar holdings and indeed the totality of official reserves of foreign currencies, SDRs, and reserve positions in the International Monetary Fund.

In private portfolios, dollar-denominated assets, of course, far exceed privately held gold. The totality of dollar-denominated assets, estimated at $9 trillion, compares with an estimate of one billion ounces of privately owned gold. Privately owned gold, of course, appears in diffuse forms, from gold bars and coins to jewelry to gold teeth and gold held for industrial use. What is sure is that most of the gold ever mined or otherwise found is still in existence and, of course, being watched carefully by its owners. The rise in the market price of gold from $35 per ounce as late as 1973 to its present more than $400, let alone its short-lived surge to $850 in 1980, has added substantially to the wealth of many of its owners.

What Has Happened to the Dollar?

What are the principal things that can be said about the dollar, as a currency, as a store of official and private wealth, and as a measure of value? Over the long pull, the dollar probably has been a better store of value than almost any other currency, excepting the Swiss franc. It has had its periods of weakness, to be sure, although that has not been the case lately to any extensive degree. If you value people and currencies on the principle of "what have you done for me lately," the dollar's performance over the last 10 or 15 years has not been as good as that of some other currencies. But where money is concerned -- and in contrast to politics -- 15 years is not a very long time. Over the last hundred or even 50 years, the dollar has outperformed some currencies that today are strong but may owe some of their strength to the traumatic experience, at one point in their past or another, of total evaporation by inflation. The dollar has never had to go through a currency reform, nor have any zeros clipped. Dollar prices of familiar objects, even though sadly inflated, would perhaps not be totally unrecognizable to someone who had managed to escape to some desert island before the crash of 1929 and had just come back to collect his dividends.

Positive real interest rates. What is more, many dollar assets now are receiving a positive real interest rate, for the first time with brief exceptions in many years. This is true, at least, for nontaxable investors, such as pension funds in the United States, and many foreign investors outside the United States. In the United States, to be sure, there are still people who, when looking at their 15 percent money-market mutual fund interest, are compelled to conclude that about half of it goes for taxes, the other half for inflation, and nothing for them. But many investors abroad receive a very substantial real interest rate, because in the United States the marginal investor, who is important for the determination of the interest rate, is taxable.

The consequences of this rate, of course, are painful for borrowers in the United States and abroad. That much is obvious, even though nondollar interest rates may be high not only in reflection of dollar interest rates but also because of national factors such as large budget and current-account deficits, or high inflation. We are all so accustomed to seeing the saver and the investor cannibalized by negative real interest rates for the benefit of the borrower that we are tempted to respond with alarm and even outrage that he should ever be in a position of not gradually losing his principal.

The dollar in the international monetary system. The dollar has played an important and in one sense growing role also in the international monetary system, and here its relation to gold has been especially significant. Starting out as a currency based on gold and in only a modest way acting as a secondary reserve asset, after gold and sterling, the dollar has evolved to shed its link to gold and to become the largest actively used reserve asset. Official dollar holdings, as I have already noted, are nevertheless smaller than gold holdings at their present market price. In recent years there has been some diversification out of the dollar into other reserve currencies, especially while the dollar was weak. Now that it has strengthened, I have heard less about diversification. If there is a way of making money by selling cheap and buying dear, then dollar diversification may be it.

Recently, the reserve role of the dollar has been associated in good part with floating exchange rates, in contrast to the earlier period when currencies were tied to gold (and the dollar) and exchange rates were fixed. There is no necessary or unique relationship between the dollar and floating exchange rates. But there clearly is a relationship between an exchange-rate system based on gold and the prevalence of fixed rates. It is in this sense that one can associate an international monetary system using gold as its principal reserve with fixed rates and one using the dollar with predominantly flexible rates.

But I would be claiming too much, of course, if I were to argue that the recent experience with the dollar as a measure of value has been particularly satisfactory. The inflation of the last 15 years in the United States has been a terrible experience, with very damaging consequences for productivity, growth, and the social fabric. This experience has generated a profound sense of dissatisfaction, a longing to go back to the good old days of reasonably stable prices and reasonable exchange rates. With it has come a temptation to hope, for some a firm conviction, that the way to get there is by going back to the gold standard. This leads me to review the recent career of gold.

What Has Happened to Gold?

The functions of gold have greatly diminished even while the value of the world's gold stock has enormously increased. Gold no longer serves as the basis of, and as a means to control, national currencies. It no longer determines the value of currencies in terms of one another. It no longer, except in rare instances, serves as an international means of payment. Nevertheless, the world's official gold stock amounted to nearly $500 billion as of August 1981. It has been as high as $764 billion in the latter part of 1980. The world's private gold holdings I have seen estimated at 50-150 percent of official holdings, depending on the extent to which gold in the form of jewelry, etc. is included. All this is a far cry from the $12 billion which was the world's official gold stock when gold was valued at $20.67 per ounce in 1932, or even the $41 billion when gold was valued at $35.00 per ounce as late as 1971.

Private gold holdings, in all forms, perhaps on the order of one billion ounces undoubtedly have risen considerably in volume since the days of World War II. Growing uncertainty about paper currencies, and eventually the appearance of a two-tier market in which the price of privately held gold could fluctuate freely, created a motive for private gold ownership. This came on top, of course, of the traditional hoarding that has been going on for centuries in France and some countries of the East. Even at today's price, about one-half of its 1980 peak, the price of gold has risen far more above either its pre-1934 U.S. price of $20.67 per ounce or its post-1934 U.S. price of $35.00 per ounce than have U.S. price indexes, either retail or wholesale, since the 1920's or 1930's. Since 1929, the U.S. consumer price index has risen about 380 percent, the wholesale price index about 450. Since 1934, the consumer price index has risen over 500 percent, the wholesale price index about 600. There is almost nothing to anchor the price of gold to any particular relationship with other prices. It is entirely a creature of demand, because rising price under today's conditions does not lead to higher gold output but only to the use of lower grade ores and therefore in effect lower gold output. Demand for industrial uses, of course, tends to diminish with price, as substitutes are employed. But demand for speculation and even hoarding may at times actually increase as the price rises.

Among people who are serious investors in gold, two attitudes seem to prevail. One is that gold is an asset like any other and must produce a competitive rate of return in order to be held. The only way in which gold can produce a rate of return, of course, is to appreciate in price. If such an investor did not get a rate he considered appropriate for the average of the years, allowing for risk, he would sell and buy something else. At today's interest rate on long-term bonds of about 15 percent, the price of gold would have to double in a little less than five years to be competitive, and since 1978 it has done better than that.

An alternative investment view would be to focus on the contribution that gold could make to reducing the risk of a portfolio, even if the investor expected little or no positive rate of return. The investor may believe that gold goes up whenever war, recession or other misadvantures cause other assets to go down. He might, therefore, want to include it in his portfolio without regard to its own rate of return. In a primitive way, that is what small hoarders of gold trinkets and coins have done over the centuries.

One can look at the price of gold futures quoted on exchanges as a guide to the expected price of gold. However, that price tends to be above the spot price pretty regularly by an amount equal to the cost of carrying spot gold, i.e., interest and storage. If it were less, it would pay a holder of gold to sell spot, buy futures, and meanwhile save the carrying charges. If it were more, it would pay to sell gold futures and buy gold spot to deliver at a profit when the forward contract matures. Thus, it is not quite clear to what extent one can interpret the price of gold futures as the expected future spot price of gold. In other words, spot and forward prices of gold relate to each other in the same way as spot and forward exchange rates. One may regard the forward price as the least worst and in any event unbiased predictor of the future spot price, but I would not want to bet much money on it.

<u>The price of gold under a gold standard</u>. The way investors look at gold -- as an appreciating asset, or as a portfolio diversifier and hedge against contingencies -- is of considerable interest if one asks oneself what might happen to the price of gold in case the United States decided to go back to the gold standard. Presumably that action would imply a fixing of a new official price at which, under the traditional rules of the gold standard, the United States would be obligated to buy and sell gold freely. For those who expect their gold to produce a competitive rate of return, a fixed price would end such expectations provided they believed that the price will be successfully defended. In that case, there might be quite a bit of selling even before the United States fixes the price, tending to push down

the market price at the time of fixing. There might be further selling once the price had been fixed and the doubters had become convinced that it would be defended successfully. In that case, the United States would have to buy that gold to prevent the price from being driven down.

Investors who did not expect any kind of rate of return and held gold only as protection against the risks of investment, or of life in the 20th century in general, would have no reason to take any particular action. Indeed, to the extent that they believe that the price will remain reliably fixed, they might feel more confident about their nestegg and perhaps even increase their holdings.

Looking at these possible attitudes from another point of view, one might conclude that if the price of gold did not come down once the intention to fix it had become known to the market, this would be prima facie evidence that the market was skeptical of the chances of the price being defended successfully.

<u>Attitudes concerning a return to the gold standard</u>. In the United States, there are widely different attitudes concerning the advisability of returning to a gold standard, leaving aside for the moment the specifics of an arrangement that clearly means very different things to different people. The proponents of a gold standard, who probably are a small minority, point out that historically it has contributed to long-term stability of prices and exchange rates. They point to the severe inflation of recent years and claim that it could not have happened under a firmly maintained gold standard. Basically, they are skeptical of the ability of the world's leaders to manage

the world's financial affairs, and recent experience surely does provide them with some support. The discipline of the gold standard, in their view, is just what politicians and central bankers need.

The opponents, especially among economists, see the gold standard as a straightjacket, which historically has contributed to severe crises from time to time, and has by no means kept prices stable from year to year. It appears to them as a wholly irrational restriction on the use of discretion in fine tuning monetary and fiscal policy in pursuit of full employment (if they are Keynesians) or as an inferior alternative to another form of disciplining politicians and central bankers, through an unchangeable money-supply target (if they are monetarists). Keynesians and monetarists, therefore, for opposite reasons, join hands in their dislike of the gold standard. Many Americans, and probably the great majority of economists, would subscribe to Keynes' description of gold as a "barbarous relic."

One may wonder, however, about the appropriateness of this intellectual arrogance with respect to the gold standard. It is very widespread, because the present generation of older economists was trained during the depression of the 1930's, to which the gold standard made a considerable contribution and during which it collapsed. In the course of that depression abandonment of the gold standard came to be seen as part of the cure. Few economists of the younger generation have heard much good about the gold standard during their period of training. Indeed, majority opinion among economists for a long time kept moving farther in the direction of abandoning even temporarily fixed exchange rates and going on to a system of free floating.

Events have not dealt too kindly with any of these improvements in economic theory and policy. Fine tuning for full employment through monetary and fiscal policy seemed to work well for a while but has ended up with high unemployment and inflation. The doctrine of a rigid money-supply target was undermined by the development of money substitutes and the increasingly unstable relation between money and the economy. Its principal remaining validity is reduced to the proposition that less money is probably less inflationary than more money over the long run. And faith in the virtues of floating exchange rates was in good part disappointed by wide fluctuations in exchange rates and reduced to the commonplace that, with high inflation in most countries, there was simply no way of maintaining permanently fixed rates.

Thus, the simple arrogance of saying that the gold standard is ridiculous and not worth talking about is not supported by any superior performance of alternative methods of regulating our monetary affairs. A negative view of the gold standard, which I believe to be justified, must be based on the assumption that in the future we can handle our affairs better than we have in the past. Or alternatively, one might oppose the gold standard on the grounds that the disturbed condition of the times simply makes it unworkable.

Gold and the Dollar Without a Gold Standard

If there is no return to the gold standard, what is likely to be the future role of gold? During the Bretton Woods years, when the gold standard increasingly changed to a dollar standard, gold and the dollar to a degree were rivals. The strength of the dollar was perceived to diminish as foreign claims against U.S. gold reserves mounted. Much effort was directed toward protecting the dollar against the consequences of these claims being exercised. After the gold window had been closed in 1971, and even more after generalized floating began in 1973, all of which seemed to relegate gold to a sort of limbo, the United States continued its efforts to prevent a return of gold as the primary reserve asset. Central banks made agreements not to increase the world's monetary gold stock, thereby narrowing but not quite closing the door to gold purchases by any of them. Finally, gold was read out of the international monetary system by the second amendment to the Articles of Agreement of the International Monetary Fund.

Since that time, the United States has been far less protective about the dollar. It has become obvious that, at least under a floating system, the United States did not gain much from the dollar's role as a reserve currency, while potential adverse effects from worldwide ownership of dollars were considerable. The advance of other reserve currencies, and the possible substitution of SDRs for dollars through a substitution account, came to be viewed with equanimity. The only actions affecting the dollar-gold relationship that could be viewed as protective of the dollar were the gold auctions of the U.S. Treasury which disposed of about 5 percent of the U.S. gold stock.

These auctions drew attention to the question why monetary authorities should continue to hold gold in a world in which there was no intention of returning to a gold standard. Moreover, even if the United States were to return to the gold standard, the analysis set forth above would suggest that the price of gold would decline before the United States decided at what level to fix it. Official holders along with private then would see the value of their holdings reduced. Would not that argue in favor of precautionary sales?

Such a line of thought, I believe, would be unrealistic. Nobody may know exactly what to do with official gold today. But many, I believe, can find persuasive reasons for holding on to it. One reason, to be sure not closely related to any rationale of monetary policy, is that gold holdings have been enormously profitable for monetary authorities. Central banks are not in business for profit, but they need not turn profit aside when it happens to come. Any disposal of gold at a profit, moreover, would tend to raise troublesome questions about what to do with that profit. Suggestions would not be lacking to relieve the central bank of its holdings of government securities, to pay off other parts of the public debt, or simply to spend the money on deserving budgetary purposes. Each of these courses of action would be inflationary, directly or indirectly. The possibility that some day, advisedly or not, the world en masse might decide to go back to a gold standard can never completely be ruled out. It calls for a husbanding of gold reserves. In a more mundane vein, gold does represent a reserve, and for some countries a very large one, even though it lacks liquidity. The ability to borrow against gold has already proved the usefulness of gold as a last-ditch reserve. Such borrowing has also revealed the reluctance of monetary authorities to part permanently with any of their holdings.

In the past, there has been concern from time to time with excessive world liquidity. Historically, sudden increases in the world's gold reserves, such as during the Californian, Australian, and South African gold finds, have been followed by rising world price levels. The enormous multiplication in the price of existing official gold stocks might be supposed to have a similar effect.

But while concern about international liquidity continues to be relevant, the sense of urgency seems to have diminished. Unlike the relation between domestic money supply and prices, the supply of international reserves today seems to be only a minor causal factor in the ongoing world inflation. Under a floating system, in any event, the supply of reserves is open-ended since any country can acquire reserves by purchasing foreign exchange in the market, if it is prepared to accept some depreciation of its currency. Moreover, any country can increase its gross reserves by borrowing, although that does not increase its net reserves after allowing for the indebtedness. Whatever the need for control of international liquidity, it seems to have moved out of our reach for the time being and only marginal increases seem possible. Reduction in official reserves through gold sales would not fundamentally change the openendedness of reserves. In the matter of official gold holdings, therefore, the course of wisdom for once seems to be to do exactly nothing.

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