Research Department
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What Future for Gold?

With appropriate fanfare, Congress passed a bill last week authorizing the lifting of the forty-year ban on gold ownership by U.S. citizens. This development came about a month after an agreement by the Group of Ten large industrial nations concerning gold holdings —an agreement to permit economically distressed countries to use gold stocks as collateral for international loans at prices close to the current market value, about three and a half times the official price of $42.22 an ounce. These two moves should substantially increase the freedom of both potential buyers and potential sellers to trade in gold.

It has been suggested, incorrectly, that these developments conflict with the stated U.S. desire to reduce the importance of gold in international finance. In fact, they are consistent with the gradual evolution of gold from a special legal role in the conduct of international transactions to a status equivalent to that of any other commodity. Gold was important in the past not because of any such trading freedom, but rather because of its prominent historical role as a means for settlement of international payments imbalances.

Shifting importance

For most of recorded history, gold and similar commodities, rather than government-issued paper, were the dominant types of money in circulation. Gold was a natural choice to use for money, partly because of its scarcity and consequent high value, and partly because of its pliability and ease of splitting into different denominations.

Buyers could never be sure that a piece of gold was as pure as the seller claimed, so governments entered the field to ensure some uniformity in monetary transactions. They did this by "coining" gold—putting the sovereign's seal on each piece—and in effect providing an assurance of the minimum gold content of the coin. As time passed it became clear that paper money, whether in check or currency form, was a more convenient medium for purposes of exchange, so that gold was often replaced by gold-backed paper. Once gold was removed from circulation, however, the importance of gold's physical properties declined.

In essence, nations with gold-backed currencies were constrained in the amount of money they could print by the amount of gold they held. In other words, gold provided a rule for determining the amount of money in circulation. Governments used gold to settle their debts to one another. Although governments eventually began to print more money than they held as gold, the role of gold in settling official international debts remained. Partly due to the lack of a sufficiently strong incentive to change the system, a modified form of the gold payments system remained a central feature of the international scene until 1971.

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Actually, gold had lost much of its significance even earlier. The transition period began in 1968, when the U.S. and other participating governments withdrew their support from the London gold market. This led to the establishment of a two-tier gold price, whereby private markets could set gold prices independently of the official $35-an-ounce figure.

The two-tier system broke down in August 1971, when some European governments wanted to exchange their massive dollar holdings for gold. In order to prevent enormous gold losses, the Administration suspended convertibility of the dollar into gold, and then (December) devalued the dollar by more than 8 percent against gold. Even this move was insufficient to correct U.S. balance-of-payments deficits, so it was followed in February 1973 by an additional 10-percent devaluation to $42.22 an ounce. Finally the entire fixed-exchange-rate concept was abandoned in March 1973, when most countries moved to a regime of flexible exchange rates.

Shifting role

Under the traditional gold standard, the relative value of national currencies was determined by the amount of gold that could be purchased by each unit of currency. International payments deficits and surpluses were settled by transfers of gold from debtor to creditor countries. In the case of a "pure" gold standard, individual nations tied their supply of money to the quantity of gold held by the government. A deficit in the balance of payments precipitated a reduction in the nation's money supply, followed eventually by deflation in the price level and a resulting shift in the payments balance back toward equilibrium. But since a reduction in the money supply tends to be followed by a reduction in economic activity and employment, the insurance against inflation provided by the gold standard was purchased at the cost of sporadic curtailment of economic growth and unemployment.

In recent decades, the role of the money supply in this international context has been greatly overshadowed by the money-supply role in influencing changes in real income, employment, and prices. But to a great degree, desires to stimulate real income through money-supply expansion have conflicted with desires to reduce balance-of-payments deficits through money-supply contraction. So the gold payments system became the casualty of national desires to conduct monetary policy independently of payments considerations.

Moreover, currency values recently have floated against each other as well as against gold. The benefits of a floating system of exchange rates, in comparison with a fixed-exchange-rate system, have been

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debated by economists for decades. However, many of the long-held fears of fixed-rate advocates have been overcome by recent experience. For example, uncertainty about the level of future exchange rates has failed to influence the volume of world trade significantly, while the U.S. payments position has greatly improved.

New responsibility

Allowing governments to sell gold at the market price makes gold a government-held inventory item like steel or wheat. Allowing the public to buy it makes gold no different legally from any other goods traded in this country. Gold may have some importance to individuals, but in view of the two developments cited at the outset, gold henceforth will have no more significance to the conduct of government business than any other precious metal.

The most important direct result of the dissolution of the fixed-exchange-rate system is the freedom to conduct an autonomous national monetary policy. Paradoxically, however, each nation's interest may in the end be more poorly served with floating rates than with a fixed-rate system, because of the disappearance of the discipline imposed by the old system. Although a money-supply increase can lead to a short-run increase in the rate of growth of real income, it can also create enough long-run inflation to reduce real-income growth. So, along with the freedom to control the growth rate of real income comes the responsibility to keep price-level increases within reasonable bounds. When individuals lose faith in the determination of governments to maintain the rate of inflation at a level that makes currency desirable to hold, they look for currency substitutes.

The 1973-74 boom in gold prices represents a public acknowledgement of just such a lack of determination to keep inflation rates at reasonable levels. It is no surprise that the increase in the price of gold in this recent period has outpaced the rate of inflation, since gold is widely regarded as the best commodity replacement for currency. Yet, if the current signs of multinational resolve to combat inflation are translated into appropriate action, we may well see a tumbling of gold prices from their current levels.

The traditional preference for a gold-payments system over a floating-rate system reflects a lack of faith in the ability of nations to provide for their own best interests—a belief that they must be protected from their own lack of responsibility by the discipline of gold. Such an attitude is at worst patronizing, and at best, indicative of a need for improved public education—but not for a return to an outdated gold standard.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/24/74	Change from 7/17/74	Change from year ago Dollar	Percent
Loans (gross) adjusted and investments*	83,141	− 561	+8,680	+ 11.66
Loans gross adjusted—	65,252	− 518	+8,143	+ 14.26
Securities loans	1,051	− 162	− 87	− 7.64
Commercial and industrial	23,451	+ 86	+3,228	+ 15.96
Real estate	19,644	+ 40	+2,735	+ 16.17
Consumer instalment	9,379	− 6	+ 756	+ 8.77
U.S. Treasury securities	4,739	− 75	− 645	− 11.98
Other Securities	13,150	+ 32	+1,182	+ 9.88
Deposits (less cash items)—total*	79,133	− 99	+6,901	+ 9.55
Demand deposits adjusted	22,090	− 256	+ 744	+ 3.49
U.S. Government deposits	403	− 24	− 426	− 51.39
Time deposits—total*	55,239	+ 211	+6,347	+ 12.98
Savings	17,906	− 31	− 150	− 0.83
Other time I.P.C.	28,111	+ 174	+6,457	+ 29.82
State and political subdivisions	6,196	− 35	− 318	− 4.88
(Large negotiable CD's)	14,916	+ 206	+4,394	+ 41.76

Weekly Averages of Daily Figures	Week ended 7/24/74	Week ended 7/17/74	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	79	− 41	50
Borrowings	317	177	189
Net free (+) / Net borrowed (−)	− 238	− 218	−139
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions Net purchases (+) / Net sales (−)	+1,400	+1,454	−151
Transactions: U.S. securities dealers Net loans (+) / Net borrowings (−)	+ 336	+ 55	− 11

*Includes items not shown separately.

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