Research Department
Federal Reserve
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Gold—Quo Vadis?

The U.S. Government held its second gold auction of the year on June 30, and to the surprise of many, this time it was a winner. The General Services Administration put up a half-million ounces for sale, and was swamped by a total of 758 bids for about 4 million ounces of gold. All but 500 ounces was sold at a uniform price of $165.05 per ounce. At the January auction, in contrast, the GSA received only 209 bids, and sold only 754,000 of the 2 million ounces offered, at prices ranging from $153 to $185 per ounce.

The success of the June auction was no doubt attributable to the use of a "Dutch auction" procedure, whereby each successful bidder paid the lowest accepted bid—viz. $165.05 per ounce—regardless of his own bid price. This method reduced the bidding risks for high bidders, who might otherwise have found themselves at a competitive disadvantage against low bidders when they wanted to resell their gold.

Why the auction?

Last month's auction was held, according to the Treasury's explanation, for the purpose of reducing U.S. gold imports from abroad. The announcement was made just ten days before the June 10-11 meeting in Paris of the Interim Committee of the Board of Governors of the International Monetary Fund. The timing of the announcement thus led many observers to speculate that the U.S. also wanted to underscore its determination to dethrone gold in the international monetary system and to dissuade foreign governments from attempting to restore gold to its former exalted position. The pundits noted that this presumed policy was in conflict with the French adherence to gold as a store of value and with the French attempt to keep gold as a means of international settlement. They noted also that, largely as a result of Franco-American differences, the IMF committee meeting ended with no agreement on the future role of gold in the international monetary system. It should be emphasized, however, that the Treasury disagreed with this interpretation of its actions.

At first glance, the success of the June auction appeared to vindicate those who saw it as evidence of an undiminished popular support of gold in the face of U.S. pressure for demonetization. After an initial setback following the auction announcement, the London gold price recovered strongly in June to reach about $165 per ounce, the level around which it had fluctuated during the preceding two months. Significantly, the bidding at the auction was dominated by eight large dealers from Zurich, London, and New York, who together accounted for 95 percent of the total amount sold. The high bids submitted by these sophisticated international dealers were interpreted as indications of a general atmosphere of bullishness in the gold market. The impression arose that the gold price was indeed

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supported by a buoyant private-market demand, strong enough to override government decisions.

Why the high price?

However, this impression may be illusory, and the recent buoyancy in demand may be only transitory. The phenomenal rise in the price of gold in the past two years can be attributed largely to speculation induced by worldwide inflation and monetary turmoil. In this situation, investors have fled from national currencies to gold on account of its historical role as a store of value. In fact, however, circumstances have changed; what was once true in the historical past is no longer true today. The monetary demand for gold—that is, the demand by national monetary authorities—has actually turned negative. Moreover, with the rapid rise in price, the industrial demand for gold has fallen sharply. Speculative demand alone continues to hold up the price of the metal. In the meantime, new production continues to pour gold onto the market in excess of total industrial and monetary demand.

If the price of gold remains high, it may be only because of continued increases in speculative demand, fed by sustained monetary expansion and heightened expectations of more inflation and more monetary turmoil. Whether or not the future holds this fate in store for us is anybody's guess. According to present indications, however, the worst is about over, and world inflation is gradually coming under control. Thus, although reasonable persons may disagree about this subject, it is well for the astute investor to examine some market fundamentals before dashing for that sack of gold.

Changing role

Foremost among the fundamentals is the changing role of gold in the international monetary system. Even to this day, long after the historical gold standard has been dead and buried, many people hold tenaciously to the idea that gold is needed to support national currencies. But they fail to perceive that, even during the 19th-century heyday of the gold standard, it was generally national currencies that supported gold, not the other way around.

Whenever the market price of gold treatened to fall below the official support price—as happened in the case of major gold discoveries and technological breakthroughs in gold refining during the periods 1849-72 and 1893-1913—the world's monetary authorities bought up all the excess gold supply. Even during the leaner supply years of 1873-92, newly

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mined gold continued to pour into official reserves. This suggests that the market-equilibrium price of gold in the absence of official support would have fallen consistently below the official price between 1849 and 1913. A similar phenomenon occured in the 1930's when the United States raised its official support price from $20.67 to $35 per ounce, thereby setting off a gigantic flood of gold into its monetary reserves.

Changing times

All that is changed now. No government in the world still stands ready to buy gold at an official price, either in the open market or from other national monetary authorities. The United States has officially proclaimed its intention to demonetize gold. Even France, the arch-supporter of gold, which last January revalued its monetary gold stock to $170.40 per ounce, has neither bought nor sold gold at that price, or indeed at any price. Although the IMF committee meeting failed to reach agreement last month on all the issues it set out to discuss, it did agree to abolish the official price of gold and to abrogate the obligation to use gold in payments between the IMF and its members. In short, the official support of gold is practically dead. No national or international monetary authority seems likely to maintain the price of gold, should it start falling.

Additionally, the industrial demand for gold in jewelry, electronics, dentistry and other uses is far below the level of a few years ago, and also far below the level of current production. Last year's industrial demand—about 496 metric tons—was 63 percent below the comparable figure for 1971.

In the meantime, gold supply to the open market in 1974 totaled 1,180 metric tons—including 985 tons of new production from non-Communist nations, 150 tons of sales from Communist nations, and 45 tons of sales from Western official gold stocks. Both gold production and total market supply were 20 percent below 1971 levels last year. Even so, there was enough metal available to supply a private speculative demand of 684 metric tons, which at the 1974 average price of $150 per ounce was valued at about $3.3 billion.

Several questions thus come to mind. How much further can supply be held back? How many more tons of gold can investors and speculators add to their holdings? How many more tons of gold will be sold from the world official holdings, estimated now to total nearly 37,000 metric tons? These are some of the fundamental factors that will determine the future price of gold.

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

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/02/75	Change from 6/25/75	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	85,355	+ 187	+ 1,595	+ 1.90
Loans (gross, adjusted)—total	64,435	+ 191	– 1,205	– 1.84
Security loans	1,091	+ 69	– 103	– 8.63
Commercial and industrial	23,375	+ 81	– 138	– 0.59
Real estate	19,577	– 8	+ 34	+ 0.17
Consumer instalment	9,870	+ 35	+ 425	+ 4.50
U.S. Treasury securities	8,557	+ 83	+ 3,569	+ 71.55
Other securities	12,363	– 87	– 769	– 5.86
Deposits (less cash items)—total*	85,854	+ 579	+ 6,839	+ 8.66
Demand deposits (adjusted)	23,850	+ 757	+ 2,106	+ 9.69
U.S. Government deposits	274	– 171	– 966	– 77.90
Time deposits—total*	60,170	– 171	+ 5,762	+ 10.59
States and political subdivisions	6,646	– 258	+ 244	+ 3.81
Savings deposits	20,489	+ 213	+ 2,452	+ 13.59
Other time deposits‡	29,101	– 298	+ 1,988	+ 7.33
Large negotiable CD's	16,005	– 45	+ 2,085	+ 14.98

Weekly Averages of Daily Figures	Week ended 7/02/75	Week ended 6/25/75	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	88	55	48
Borrowings	264	0	247
Net free (+) / Net borrowed (–)	– 176	+ 55	– 199
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+) / Net sales (–)	+ 859.3	+ 1,475.8	+ 1,427.7
Transactions of U.S. security dealers			
Net loans (+) / Net borrowings (–)	+ 354.7	+ 490.3	+ 171.6

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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