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FRBSF Weekly Letter

Why Gold?

The present decade, which was dubbed at its inception the "Soaring Seventies," ironically is ending on just one spectacular note — the soaring price of gold. The decade began with gold still priced officially at $35 an ounce, but between January and October 1979, gold's price climbed from $220 to nearly $450 an ounce. This 1979 increase, which ranks with the 1933 revaluation as the sharpest gold-price rise of this century, has surprised even jaundiced economic observers. "Gold bugs" see the ascent as further proof of the need to restore gold to its rightful dominance in the international monetary system. But to many skeptics, the 1979 experience confirms their belief that a speculative fever, rather than sound economic principles, rules the peculiar market for this metal.

Few public officials can have welcomed the return of gold to the top of the financial pages. In principle, gold became just another commodity in the early 1970's when the U.S. stopped pegging its price, and certainly after 1974, when the U.S. authorized private ownership of gold again. But officials have had difficulty maintaining their stance of benign neglect in the face of the recent price upsurge, especially since that upsurge can be interpreted as an adverse verdict on the ability of governments to contain inflation. Officials, no less than private investors, thus wonder about what has caused the rise in gold prices, and what policy measures are available to deal with it.

Gold's value

Gold derives value from its intrinsic usefulness, from its durability, and from its relative scarcity. People prize it for its artistic, decorative, and industrial uses — essentially as a consumption good. But people also value it as an investment asset, because it can be stored without deterioration and in convenient, portable, and transferable forms. Gold's employment for both consumption and investment purposes is illustrated by its current uses. Of the 56 million ounces of gold which became newly available to private users last year, 40 million ounces went into artistic and industrial uses (primarily jewelry-making) and the rest went into coins, medals and bars. Of course, diamonds, silver, art objects and other durable goods similarly can be used for both investment and consumption — and in many cases their prices also have risen sharply in recent years.

As with any commodity, the price of gold is determined by the amount demanded relative to its supply. But on the supply side, the picture is complicated by the fact that gold can be supplied from existing stocks as well as from new production. Indeed, gold stocks are many times larger than annual production, with perhaps 1.5 billion ounces in private holdings and another 1.2 billion ounces potentially available from public holdings. And on the demand side, fluctuations in investment demand similarly may be many times the size of annual production or industrial demand. Consequently, gold's price normally is determined primarily by investment considerations, being dependent on investors' anticipations about its future value relative to that of alternative assets. In this respect, the gold market is more similar to the stock market than to the market for a non-durable commodity such as wheat.

Because the total value of privately held gold — no more than $600 billion at today's prices — is only a small fraction of the world's total wealth, the shifting of other assets into gold could have pronounced effects on the price of gold. Total GNP of all non-communist nations was roughly $8 trillion last year, and the land and capital stock required to produce this output was several times greater. Alternatively, last year's gold production — valued at about $9 billion — was only a modest fraction of U.S. individuals' net savings, not to mention the savings of individuals elsewhere. Obviously, from either standpoint, people around the world need shift only a small portion of their wealth into gold — buy a few gold coins — to bring about a drastic rise in its price. But by the same token, even a slight decline in gold's attractiveness can cause its price to tumble, so that gold is also a potentially risky investment.

Why would individuals want to invest in gold? Partly, they use gold as protection against losses on other investments. Traditionally, people throughout the world have held gold against panics, wars, and other upheavals that have often sharply degraded the value of stocks and other financial assets. More recently, many investors have found that holding gold reduces the risk that their wealth will be eroded by an unforeseen acceleration in inflation. This insurance characteristic has made gold attractive as an investment asset even in periods when its purchasing power was declining in terms of commodities.

Recently, of course, gold's purchasing power has been rising, making it a very attractive (although still risky) hedge against inflation. This has not always been true; indeed, for most of the post-World War II period, gold's price was pegged to the dollar, and its purchasing power declined with inflation. Investment in virtually any other asset — stocks, silver, or even savings bonds — would have yielded a higher return during that period. Since 1971, however, gold has risen faster in price than have commodities generally, despite sharp short-term price fluctuations which brought losses to some gold investors.

Gold's rise

Still, gold's upward march has been neither steady nor uninterrupted (see chart). Gold prices surged in 1971, roughly in line with the first devaluation of the dollar, and they accelerated further in 1973 and 1974, with the rise of world inflation and the adoption of floating exchange rates. But gold prices then fell nearly one-third in the 1975-76 period, with the temporary weakening of inflationary pressures — only to rise even more spectacularly this year as U.S. inflation accelerated again.

These shifting gold-price trends reflect changing sentiments about national currencies. Prior to the 1970's, the purchasing powers of individual national currencies were linked, at least loosely, through the mechanism of fixed exchange rates. The dollar served as a widely accepted and fairly stable international asset. Gold's utility as an investment was accordingly limited, particularly as it was linked to the dollar for most of that period. But then, with the acceleration and divergence of national inflation rates, fixed exchange rates became impossible to maintain any longer. As a result, the purchasing powers of alternative currencies have often diverged sharply and unpredictably. However, the considerable ups and downs in currency values of the 1973-79 period have made investment in any single national currency a risky endeavor. Not surprisingly, then, gold has increased in attractiveness as a hedge against the uncertain prospects for individual currencies, as well as against currencies collectively. For this reason, gold has been especially sensitive to the inflation outlook, its price rising or falling with the waxing or waning of inflation fears.

Nonetheless, we can detect differences between the situation in 1977-78 and the situation this year. Much of the 1977-78 run-up in gold prices can be attributed to U.S. inflation and the resulting decline in the value of the dollar, especially against "harder" currencies such as the Swiss franc. The dollar price of gold rose 68 percent over that two-year period — but the dollar price of the Swiss franc and the yen each rose about 50 percent, while the dollar price of the mark increased 23 percent. These currencies — if not quite "as good as gold" — were at least considerably superior to the dollar as inflation hedges.

In 1979, however, the situation apparently has changed drastically. Since last January, gold has risen more than 80 percent against the dollar — and by nearly as much against the yen, the mark and the Swiss franc, reflecting a shift in inflation prospects throughout the entire industrial world. Inflation has speeded up in Germany, Japan and Switzerland, brought about (at least in Germany and Switzerland) by a monetary acceleration which was caused in part by their heavy market intervention in support of the dollar. Also, around midyear, fears of further inflation were fanned by the sharp increase in oil prices announced at that time. Altogether, the upsurge in gold prices reflects the perception by investors that the inflation prospects of the major industrial countries are more closely — and adversely — linked than they had been previously.

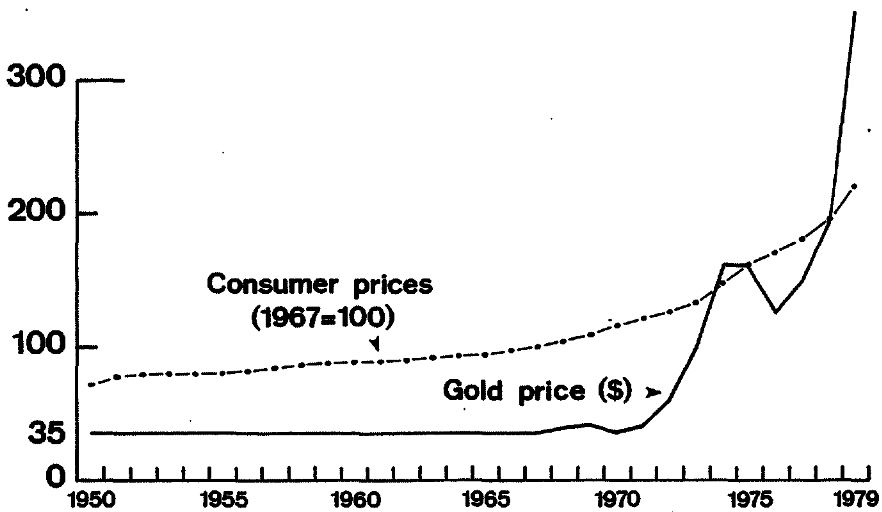
Gold — and policy

Public officials feel pressured to "do something" about gold — understandably so, in view of its high visibility and past monetary role. Increased gold sales by the U.S. and the International Monetary Fund could help dampen the rise in gold prices. But even if sales were (say) doubled, they would remain small compared to the stock now in private hands, and thus, would be unlikely to reverse the upward price trend. Indeed, expanded sales could backfire if they were perceived as a substitute for tighter domestic economic policies. Again, any attempt to restrict private purchases of gold could also backfire, because investors might then turn back to "strong" currencies such as the mark and Swiss franc, putting further pressure on the dollar.

More importantly, recent events have shown that gold's rise is a symptom, not a cause, of the uncertainty and pessimism about future economic conditions that at other times have led to fluctuations in land values, in stock prices, and in exchange rates. Investors have learned, often painfully, to switch among a variety of assets in response to their changing perceptions of the future state of the national and international economies. As a result, we have experienced frequent and often precipitous changes in the prices of such assets.

Thus, in the last analysis, effective anti-inflation policies are likely to be the most effective gold policy in the period ahead. The tighter monetary-policy package adopted last weekend has promising implications on this score; indeed, gold's price fell to $375 an ounce this Monday from last week's peak of $444 an ounce. There are also signs that monetary policy is tightening abroad as well. These developments suggest that, with the containment of inflation pressures, gold's price could continue to fall as it did in 1975-76, because investors then would feel more secure in putting their money back into other assets.

Charles Pigott



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

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/26/79	Change from 9/19/79	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	133,731	− 135	+ 18,663	+ 16.22
Loans (gross, adjusted) — total#	110,550	− 243	+ 18,069	+ 19.54
Commercial and industrial	31,673	− 203	+ 4,359	+ 15.96
Real estate	40,619	128	+ 8,300	+ 25.68
Loans to individuals	22,673	97	NA	NA
Securities loans	2,219	− 49	NA	NA
U.S. Treasury securities*	7,643	44	− 1,404	− 15.52
Other securities*	15,538	64	+ 1,998	+ 14.76
Demand deposits — total#	42,785	− 1,633	+ 2,590	+ 6.44
Demand deposits — adjusted	30,182	− 155	+ 834	+ 2.84
Savings deposits — total	30,078	− 165	− 644	− 2.10
Time deposits — total#	54,743	576	+ 6,881	+ 14.38
Individuals, part. & corp.	46,424	583	+ 8,525	+ 22.49
(Large negotiable CD's)	20,541	203	+ 1,081	+ 5.55

Weekly Averages of Daily Figures	Week ended 9/26/79	Week ended 9/19/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	− 1	68	66
Borrowings	15	226	86
Net free reserves (+)/Net borrowed(−)	− 16	− 158	− 20
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	− 453	+ 562	− 947
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	− 77	− 234	+ 503

* Excludes trading account securities.
# Includes items not shown separately.
@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.