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The Official Price of Gold

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Whether or not the United States should raise the official price of gold has been widely discussed throughout the postwar period. The subject has received particular attention during the past year as a result of the announced intention of the United Kingdom and the other countries of Western Europe to progress as rapidly as possible toward currency convertibility and relaxation of restrictions on trade. Significant progress toward these objectives is usually regarded as requiring an increase in the gold and dollar reserves as well as in the dollar earnings of these countries; the proposal for a higher gold price is frequently presented as a means of fulfilling both these prerequisites. In general, the various arguments in favor of a higher gold price fall into two principal categories: (1) the need for greater international liquidity and (2) the need to increase the dollar earnings of the rest of the world.

This paper will appraise the major economic arguments which have been advanced in various quarters for an increase in the official price of gold. It is assumed here, as in most discussions of the subject, that what is under consideration is a uniform increase in the price of gold by all countries; that is, on a given date every country would raise the official price of gold in terms of its currency by the same percentage. As a result, exchange rates would remain unchanged throughout the world. Such a uniform change in the price of gold is provided for in Article IV, Section 7 of the Articles of Agreement of the International Monetary Fund. Agreement by the United States to such a measure would require an act of Congress, in accordance with the provisions of the Bretton Woods Agreements Act.

It should be noted at the outset that the possible inflationary effects of increasing the price of gold will not be dealt with in detail in this paper. In the non-gold producing countries, the principal danger in this regard would arise from the expenditure by governments of gold revaluation "profits". If these were used indiscriminately to finance increases in government expenditures (or to permit reductions in taxation) serious inflationary dangers might result. Although it is certainly within the power of governments and central banks to prevent such effects, as is argued by the proponents of an increase in the price of gold, it might be politically difficult if not impossible to do so in many countries. The sudden acquisition by governments of the financial resources represented by the revaluation profits would undoubtedly lead to pressures for new expenditures or tax reliefs which would not have been forthcoming in the absence of such new financial resources. Since the advocates of gold revaluation recognize these dangers, the question resolves itself into a matter of judgment as to the ability of governments to resist such pressures. Nevertheless, for the purposes of analysis, in order to meet the proponents of a rise in the gold price on their own grounds, this paper will accept their contention that the inflationary impact (in non-gold producing countries) would be insignificant.

The price of gold and international liquidity

The argument in favor of a rise in the price of gold in order to achieve a higher level of gold reserves has several aspects. It is argued by some that the world supply of gold is insufficient to sustain continued growth in production at current prices. Money supplies have increased at a far greater rate than gold reserves and unless the gold shortage is relieved, severe deflation will be the result. The process whereby such deflationary tendencies would occur, while not always clearly elaborated, appears to involve either (1) deliberate deflationary fiscal and monetary policies to achieve balance of payments surpluses and therefore accretions to reserves or (2) restrictions on foreign trade and payments in order to limit potential claims on limited gold reserves. Such actions would spread cumulatively from country to country.1/ This argument, therefore, appears to resolve itself into the proposition that gold reserves are insufficient to permit a level of international trade consistent with full employment at current prices. A related argument states that countries with low gold reserves have less flexibility to pursue domestic economic objectives, since minor balance of payments fluctuations might seriously deplete gold reserves.2/ Most recently it has been argued by many observers that significant progress toward freer trade and currency convertibility requires that the reserves of many countries be increased markedly in order that they may be in a position to withstand the unpredictable reactions to the relaxation of trade and exchange restrictions.3/

Supporters of these views point out that a rise in the price of gold would not only raise the dollar value of gold reserves proportionately, but would also provide an incentive for increases in gold production. Consequently gold reserves would be augmented from this source as well. It is usually noted, in this respect, that world gold production (outside the U. S. S. R.) has declined from a dollar value of nearly $1.3 billion in 1940 to less than $850 million in 1951 (from about 37 to about 24 million ounces). A higher price, it is argued, might restore gold output to the 1940 level. While there may be merit to this argument, part of its force was removed by the devaluations of 1949, which raised the sterling price of gold by 44 per cent.

In evaluating the arguments concerning the inadequacy of reserves, it might first be pointed out that the concept of reserves need not be, and in most periods of modern history has not been, confined to gold. Dollar holdings, which are in any case freely convertible into gold by foreign monetary authorities, can also serve the purposes which the proponents of these arguments put forth as the functions of gold reserves.4/

1/ This argument may be found in W. J. Busschau, The Measure of Gold (1949), passim. and in R. F. Harrod, "Imbalance in International Payments", Staff Papers (International Monetary Fund) April 1953, p. 4.

2/ Busschau, op. cit., p. 2.

3/ See, for example, "Prospects for the Gold Price", The Economist, Dec. 6, 1952, p. 706.

4/ On this point, as well as others contained in this paper, see Miroslav A. Kriz, The Price of Gold, Essays in International Finance No. 15, Princeton University, July 1952.

The arguments for higher gold reserves are usually supported by comparisons of gold reserves with the value of foreign trade. Most computations of this sort compare the current ratio of gold reserves to trade with the ratio existing in 1938. In view of the large increase in the dollar price of gold which occurred in 1934 (69 per cent) and the corresponding increase in the dollar value of world gold reserves, whereas the value of world trade was depressed in 1938, it is not surprising that the comparison with 1938 should be highly unfavorable. It is desirable, therefore, to examine the data for a period prior to both the depression of the thirties and the gold revaluation of 1934. The year 1928, which fell in a period of prosperity and high levels of international trade, appears to be more comparable to the present period.

Table I

Ratio of Official Gold Reserves to Total Imports 1/

	(Per cent)		
	1928	1938	1951
Canada	7	24	20
Latin American Republics	40	45	26
United Kingdom	13	63	20
Other Sterling Countries	14	23	8
Continental EPU Countries	25	78	18
United States	85	592	191
World, excluding U. S.	23	60	18

1/ Omits members of Soviet bloc, and dependent territories of both United Kingdom and Continental EPU countries.

Source: -- The Adequacy of Monetary Reserves, International Monetary Fund, June 1953.

Table I presents data, compiled by the International Monetary Fund, on changes in official gold reserves as a percentage of imports between 1928, 1938 and 1951 for the principal countries and areas.

It may be seen that the ratio dropped sharply for all countries, including the United States, between 1938 and 1951. Comparison with 1928 shows a much more moderate decline in the ratio of gold reserves to trade. For the rest of the world, excluding the United States, the ratio fell from 23 per cent in 1928 to 18 per cent in 1951.1/ In the case of the United Kingdom, gold reserves as a percentage of annual imports rose from 13 in 1928 to 20 in 1951. For the sterling area as a whole, the figure was virtually the same in the two years.

There are, of course, a number of reasons why the comparison with 1928 is somewhat misleading. In the first place, gold circulated freely in 1928 whereas at present it is concentrated in official institutions in most countries.2/ Secondly, in the case of the United Kingdom, claims against the gold (and dollar) reserve have risen substantially since that time. Finally, it might be argued that the widespread use of trade restrictions at present, in contrast to the relative freedom of trade and payments in 1928, represses the current volume of trade.

On the other hand, it is easy to exaggerate the rise since 1928 in potential claims on the gold reserves of the United Kingdom. Although the sterling area has been formalized since 1939, even before that time most of the present members maintained exchange reserves largely in the form of balances in London. These balances were always convertible into gold. Thus the extent of the increase in actual or potential sterling claims which might require gold sales by the Bank of England (or now by Exchange Equalization Account) involves a difficult judgment. With respect to the volume of trade, it is arguable whether the relaxation of trade restrictions would have, under present circumstances, a significant effect on the over-all volume and value of international trade. In view of the achievement of internal financial stability in most, although not all, countries, it appears likely that such relaxation would affect the geographical distribution much more than the volume of trade. It is true, however, that an increase in trade with the dollar area, even if it were accompanied by a decline in trade with other countries, might be regarded by many countries as requiring higher gold and dollar reserves.

The preceding analysis does not indicate that the gold reserves of non-dollar countries are adequate. It does bring out the fact that by 1928 standards the deficiency is considerably less glaring than are indicated by the usual comparisons with 1938. Mr. Harrod, for example, states that for the countries other than the United States "to restore their reserves to their pre-war relation to trade, they would have to get all the gold out of Fort Knox, and long before that happened the United States would feel herself short. The plain fact of the matter is that, at the present valuation of gold in terms of goods, not all the gold in the world (including that in Fort Knox) is sufficient to provide nations with adequate reserves."3/ It is clear that so extreme a statement could not be based on comparisons with the twenties; by "pre-war" Mr. Harrod means 1937-38, but he fails to point out that in those years the relation of gold reserves to trade was unusually high.

1/ For the non-dollar world (the countries included in the IMF study except for the United States, Canada and the dollar countries of Latin America) the percentages for the three years are 25, 26, 17.

2/ It has been estimated in the case of the United Kingdom that monetary gold outside the Bank of England — that is, with other banks or in private hoards — amounted to $90 million in 1928 (Statistical Yearbook of the League of Nations, 1931-32, p. 268). If this sum is added to official gold reserves for 1928, the ratio to imports rises to just over 14 per cent.

3/ Op. cit., p. 4.

Increases since 1951 - The reserves of many countries have increased substantially since December 1951, the final date used in the International Monetary Fund study. The official reserves (gold and dollars) of the United Kingdom had just regained the end-of-1951 level by mid-1953, but those of the Continental EPU countries had risen by nearly $1.4 billion. The last column of the following table shows the increase in gold and dollar holdings of the Continental EPU countries between December 31, 1951 and June 30, 1953. Virtually all of the increase was in official reserves. This increase is compared, for each country, with the increment to reserves which would have resulted from a 50 per cent rise in the price of gold as of the end of December 1951. It appears justifiable to compare the latter (hypothetical) figures with the (actual) increases in gold and dollar reserves in view of the fact that the increments in dollar holdings are convertible into gold.

Table II

Gold and Dollar Holdings of Continental Western Europe
(In millions of dollars)

	Gold holdings December, 1951	Hypothetical increase from 50% rise in gold price	Actual increase in gold and dollar holdings Dec.51-June 53
Austria	50	25	65
Belgium-Lux.	624	312	59
Denmark	31	16	26
France	548	274	44
Germany, Fed. Republic	28	14	459
Greece	3	2	33
Italy	333	167	23
Netherlands	316	158	418
Norway	50	25	14
Portugal	265	133	75
Sweden	152	76	56
Switzerland	1,452	726	118
Turkey	151	76	-13
Total	4,003	2,004	1,377
Total, excluding Switzerland	2,551	1,278	1,259

Table II shows that the group of Continental EPU countries, excluding Switzerland, has gained nearly as much in gold and dollars since December 1951 as it would have gained at the end of 1951 from an increase in the price of gold to $52.50.1/ In other words, it has taken only a year and one-half for Continental

1/ It is assumed, perhaps unrealistically, that anticipations of the rise in the gold price would not have led to large-scale conversions of dollar holdings into gold by foreign monetary authorities before December 31, 1951.

Western Europe, excluding Switzerland, to gain from balance of payments improvement plus American aid what would have been gained from a 50 per cent rise in the price of gold.1/

The additions to reserves which did occur were more equally distributed than those which would have resulted from a gold revaluation. In particular the large absolute increases which would have accrued, under an assumed rise in the price of gold, to countries whose gold reserves were already relatively high (Switzerland and Belgium) were avoided. Instead a number of countries whose reserves were small at the end of 1951 have added substantial amounts to their gold and dollar holdings.

The adequacy of reserves - The data in Table I, especially when supplemented by the information in Table II regarding increases in gold and dollar holdings since 1951, hardly support the fears that a world-wide deflation might be precipitated as a result of inadequate reserves. On the other hand, reserves might very well be inadequate, in the case of a number of countries, to support significant relaxations of trade and exchange restrictions. In particular, the reserves of the United Kingdom are not regarded by the British authorities as adequate for convertibility. It is questionable, however, whether it is either desirable or necessary to increase them by raising the price of gold. The resources of the International Monetary Fund (its gold and dollar assets amount to about $3 billion) and perhaps other sources for stabilization loans might be sufficient to supplement British reserves. Such resources can be loaned selectively, in contrast to the general effects on reserves of a uniform increase in gold prices.

The possibility must be considered that the increased reserves resulting from a gold revaluation might be used not only to finance normal fluctuations in balances of payments, as is assumed by the proponents of a rise in the price of gold, but also to finance deficits in some countries until reserves were again drawn down. In other words many countries might regard the increase in the dollar value of their gold reserves as a once-for-all resource to be utilized for the financing of development programs or other domestic requirements. While a flow of capital resources from the United States to underdeveloped countries is generally accepted as desirable, it is questionable whether its geographical distribution ought to be based on the size of the present gold reserves and the disposition among these countries to spend increases in such reserves. This objection has particular force in a period of high economic activity in the United States and most other countries of the world.

1/ It is obvious that, if there had been no changes in world trade and payments or U. S. aid disbursements and the price of gold had been raised in December 1951, official reserves would have been considerably higher. But it is probably more realistic to assume that, if the gold price had been raised in December 1951, American aid would have been considerably smaller during the past eighteen months. (Between December 1951 and June 1953 disbursements of grants and loans by the Mutual Security Agency to Continental Western Europe amounted to somewhat over $1.5 billion.) On this basis, it is possible to regard the hypothetical increment to reserves shown in the table above as an alternative to the actual increase in gold and dollar reserves.

The price of gold and the dollar problem

The other set of arguments for an increase in the price of gold rests on the proposition that such an increase is necessary in order to permit the rest of the world to increase its earnings from the United States.1/ The resultant closing of the "dollar gap" would in turn permit the elimination of grant aid from the United States and also enable the rest of the world to relax discriminatory restrictions against dollar imports and to progress toward convertibility.2/

These arguments are usually supported by statistics showing that the price of gold has remained unchanged while commodity prices have risen by 100 per cent or more since pre-war. For the sterling area in particular, gold was the principal means of covering the dollar deficit during the thirties and the failure of the gold price to rise is frequently regarded as the main explanation for the dollar deficit of the post-war years.3/

Here again the comparison is with the thirties, the period immediately after the 69 per cent increase in the dollar price of gold. If, as in the case of gold reserves, the year 1928 is taken as a basis for comparison, it is found that U. S. wholesale commodity prices have risen 77 per cent while the price of gold has increased 69 per cent. While a disparity remains, it is so small that it can hardly be held chiefly responsible for the dollar gap of the post-war period.

Although the argument of the previous paragraph casts doubt on the claim that the constancy of the gold price is the chief explanation for the dollar difficulties of the post-war years, it does not dismiss the claim that an increase in the price of gold would be of great benefit in alleviating the dollar problem.

It may immediately be conceded that a rise in the gold price would relieve the dollar problem of South Africa. But the case is usually presented as a means whereby the United Kingdom and Continental Western Europe could increase their dollar earnings and as a result relinquish American aid and reduce their restrictions against dollar imports. It is not sufficient, therefore, merely to show that if the gold price had risen, world gold production would have been sufficient to cover the surplus in the U. S. balance of payments. It is also necessary to show that those countries which incurred dollar deficits would have been able to earn the (higher-valued) gold production.4/

1/ Although Mr. Harrod does not explicitly argue for an increase in the price of gold, he points to the contribution such an increase would make to eliminating the dollar gap; op. cit., p. 11.

2/ See, for example, "A Programme for the Commonwealth", The Banker, September 1952, pp. 131-133.

3/ See, for example, A. R. Conan, The Sterling Area, London (1952), pp. 76-77.

4/ An example of the omission of this step may be found in Mr. Harrod's demonstration that a rise in the gold price would have permitted the rest of the world to cover its deficit with the U. S. in 1950-52. He includes the gold production of Canada with that of the rest of the world; but surely an increase in the price of gold would not make it significantly easier than at present for other countries to earn gold from Canada.

Table III

World Gold Production in 1951
(In millions of dollars)

South Africa	403.1	
Rhodesia	17.0	
West Africa	22.9	
Australia	31.3	
India	7.9	
Belgian Congo	12.3	
Sub-total		494.5
United States	66.3	
Canada	153.7	
Mexico	13.8	
Colombia	15.1	
Chile	6.1	
Nicaragua	8.8	
Sub-total		263.8
Other		81.7
Total		840.0

Source: — Federal Reserve Bulletin

Since the United States, Canada, Mexico, Colombia and Nicaragua are "dollar countries", their gold production may be considered as of no value in meeting the dollar deficit of Europe, for the reason that exports to these countries are already payable in currencies which may be freely converted into gold by foreign monetary authorities. As may be seen in Table III, this leaves no more than about $580 million (valued at $35 per ounce) of gold production which, if valued at a higher price, might be of greater benefit to Western Europe. For the sake of discussion and analysis it is useful to pick a maximum figure for the value of this portion of world production under the twin assumption of a rise in the gold price and an increase in gold output. Assuming a doubling of the price and an increase in gold production by one-third, the maximum value of annual gold production which Europe might earn would amount to about $1.4 billion.1/ Of this sum, South Africa would account for almost 70 per cent.

The major question, therefore, is whether the United Kingdom and Continental Europe would be able to earn this amount of gold from South Africa

1/ It is also assumed that there is no disappearance into industrial uses or private hoards. In 1952 these factors accounted for over one-half of production outside the U. S. and U.S.S.R.; (Federal Reserve Bulletin, March 1953, p. 211).

more easily than they could earn dollars elsewhere. The answer to this question involves consideration of (1) the policies South Africa might be expected to follow with regard to discriminatory restrictions and (2) the ability of the United Kingdom and Continental Europe to compete with the United States in the South African market.

With regard to South Africa's trade policy, there appear to be no economic reasons why it should continue to discriminate against the United States in the event of an increase in the price of gold and the attendant large benefits to South Africa's real income and potential dollar earnings.1/ Earnings from gold exports financed over one-third of South Africa's merchandise imports in 1952. An increase in the price of gold by 50 per cent, even without a rise in gold production, would permit merchandise imports to be increased by more than 15 per cent at present prices. If the price of gold were doubled, South Africa could raise its imports by at least one-third. It seems reasonable to conclude that under the circumstances South Africa would abolish discriminatory restrictions, if not all quantitative restrictions on imports.

The question remains, therefore, whether the United Kingdom and Continental Europe could earn surpluses with South Africa in the face of competition from the United States. On the one hand, it might be argued that if the United Kingdom could compete successfully with the United States in South Africa, then it could also compete with the United States elsewhere, including the United States market itself; and if British goods are competitive with American goods, the United Kingdom's dollar problem can be solved without an increase in the price of gold, since it would permit greater direct earnings from the dollar area and greater earnings of dollars from non-dollar countries. On the other hand, however, it must be conceded to the proponents of a rise in the gold price that it is probably somewhat easier for the United Kingdom to compete with the United States in South Africa than in the Western Hemisphere, particularly in the United States. Long-standing business and cultural ties, the lower level of tariffs and, as a result of the gold revaluation, the rapid increase in real income in South Africa are among the reasons why British exports could be more easily sold in South Africa, even under conditions of non-discrimination, than in the United States or other countries of the Western Hemisphere.

A more precise formulation of this advantage to the United Kingdom is that its terms of trade, after a given increase in the dollar value of its exports, would be more favorable if the exports were sold to South Africa than if they were sold elsewhere for dollars. It is important to note that the benefit to the United Kingdom, and perhaps other countries of Western Europe, from a rise in the gold price is confined essentially to this factor; namely, the higher prices associated with exports to South Africa where real income would be growing rapidly, than to other

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1/ The notion that South Africa might agree to continue discriminating in favor of the United Kingdom in return for British support in persuading the United States and the International Monetary Fund to raise the price of gold is in rather direct conflict with one of the principal purposes of the proposed rise in the gold price; namely, that it would permit rapid progress toward a system of freer world trade and payments.

countries from which dollars might be earned.1/ The value of this benefit is difficult to assess. One can conceive of circumstances under which its value might increase; this would happen if, for example, American tariffs were raised relative to South African tariffs. Similarly, a recession in the United States greater than in South Africa would enhance the value of the benefit. On the other hand, its value would be reduced by an easing of American commercial policy.

If there were no costs to the United States resulting from a rise in the price of gold, it might be argued that even though the benefits to the United Kingdom and Continental Europe were not of major proportions, they were of sufficient importance to justify the revaluation. In fact the increase in the price of gold would be equivalent to a large improvement in the terms of trade of South Africa. The burden of the higher volume of imports thus permitted to South Africa would, in the final analysis, fall on the United States, whether South Africa sold its gold directly to the U. S. Treasury or used it to purchase goods from the United Kingdom which, in turn, sold it to the United States. This point may be seen more clearly if gold is regarded as a commodity. The United Kingdom would be importing this commodity from South Africa and re-exporting it to the United States. As a result the terms of trade of the United Kingdom would be unaffected by the increase in the price of gold, while the terms of trade of the United States, the final importer of the gold, would deteriorate.

Now it might turn out that the current account surplus of the United States would be no greater than in recent years when it has been financed by foreign aid. In that case, the real burden on this economy would not increase. It has always been assumed, however, that the foreign aid burden was a temporary one. Furthermore the substitution of higher gold imports for foreign aid suffers from the disadvantage of replacing the political and economic criteria governing the distribution of foreign aid by a system based upon the accidents of geology.2/ In view of the announced intention of the European aid-receiving countries to dispense with aid as soon as possible, it is somewhat questionable whether it ought to be replaced by another burden on the American economy, from which the United Kingdom and Continental Europe would derive only a minor share of the benefits.

1/ Two additional but less important benefits would be (1) the increase in earnings on British investments in South African mines and other enterprises whose incomes would rise and (2) the higher value of gold production in the colonies which would be more certain to accrue to the mother countries. On the other hand, an increased flow of capital from the U. K. to South African gold mines and other enterprises would probably offset, in the short run at least, the higher investment earnings.

2/ In addition it is more inflationary to finance the current account surplus in the U. S. balance of payments by gold imports than by government grants. If expansionary policies were to become desirable, from the viewpoint of the U.S. economy, there are other ways to achieve them.

In compensation for this real cost to the American economy, the gold so acquired would have a higher value as a claim on goods abroad. However the balance of payments argument for gold revaluation regards gold imports as a more or less long-term means of financing the current account surplus in the U. S. balance of payments. It follows that the United States is expected to continue to accumulate, rather than to use, these higher-valued claims on foreign goods and services. If, on the other hand, it is argued that the United States could utilize the gold by taking various measures to raise imports, the force behind the gold revaluation argument disappears, since such measures would in themselves increase the dollar earnings of the rest of the world.

Under present circumstances most countries of the world are experiencing rapid reductions in their dollar deficits (or increases in their surpluses). Between March 1952 and June 1953, the gold and dollar holdings of foreign countries increased by more than $2-1/2 billion. Of this amount, the United Kingdom has accounted for about one-fifth. It is impossible to predict how long these tendencies will continue or whether they will be reversed. But as long as they do continue, it is difficult to accept the claim that, for balance of payments reasons, an increase in the price of gold is an essential condition for a solution of the "dollar problem" or for progress toward freer world trade and payments.

Conclusions

Current arguments favoring an increase in the official price of gold advance the proposal as a means of facilitating progress by the United Kingdom and other countries of Western Europe toward the elimination of trade restrictions and the achievement of convertibility.1/ The proposal is put forth as a way, on the one hand, of augmenting the value in terms of goods of the gold reserves of these countries and, on the other, of increasing their dollar earnings.

There are of course no fixed criteria for judging the adequacy of gold reserves. Most observers would agree, however, that the gold (and dollar) reserves of the United Kingdom are probably not sufficient to support sterling convertibility under present circumstances. The extent of this insufficiency has frequently been overstated as a result of comparisons with the immediate pre-war period, when the ratio of gold reserves to foreign trade was abnormally high. Furthermore the gold and dollar reserves of the United Kingdom and many other countries have been rising rapidly in the recent past and this movement is continuing. It is therefore suggested that other methods of augmenting reserves, for countries which need such assistance, might be found. The resources of the International Monetary Fund can be used selectively in support of significant measures in the direction of freer trade and payments. In addition, stabilization credits from other sources might be used to supplement the reserves of particular countries in the same way.

1/ One observer has deduced that the Commonwealth Economic Conference of last December received favorably South Africa's plea for a joint Commonwealth appeal to the United States regarding a uniform increase in the price of gold; C. Gordon Tether, "New Phase in the Gold Price Controversy?" The Banker, February 1953, p. 90.

The argument for a higher gold price is even less convincing when it is presented as a means of increasing the dollar earnings of the United Kingdom and Continental Europe. It is demonstrated above that the benefit to the latter countries in this respect would not be as great as is sometimes assumed. That benefit is measured by the greater ease in developing an export surplus with South Africa than with other countries from which dollars might be earned. The major benefit would accrue to South Africa and the major cost, in real terms, would be borne by the United States. Under the circumstances, therefore, the case for a rise in the official price of gold has little to recommend it.