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THE CONTROVERSY OVER THE PRICE OF GOLD. 1974.

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THE CONTROVERSY OVER THE PRICE OF GOLD

The controversy over the price of gold was temporarily submerged on June 12, 1974 by informal agreement of the ten leading financial powers. The agreement helps to meet the urgent problem of providing additional financial resources for some of the countries -- notably, Italy -- with serious economic problems. But, it leaves many issues unsettled. The issues of the price of gold, the role of gold in the international monetary system, and, indeed, the nature of the reformed international system will be affected by how the unanswered questions on gold are resolved.

To highlight the issues involved it is useful to describe the recent agreement and several recent proposals on the treatment of gold.

The June 1974 Agreement

On June 12, the major industrial nations agreed to allow countries to expand their borrowing power by using official gold holdings as collateral for international loans. The value of the gold as collateral would be what was agreed by the creditor and debtor. Clearly, it would be well above the official price of $42 an ounce, though less than the $150 to $160 an ounce of the private market.

The new agreement -- or, more accurately, informal understanding -- may facilitate borrowing by some hard-pressed European countries with large gold reserves. But, the actual impact of the understanding can easily be overstated. Gold could have been used as collateral before, though, of course, the blessing of the ten largest industrial powers would make such action more acceptable. And, central banks cannot, under current

rules, call the collateral and use it in transactions with other central banks except at $42 an ounce.

The new understanding does not meet the full objectives of the Europeans. Indeed, despite general agreement that the role of gold in the international monetary system should be reduced, the United States and the European Community (EC) remain at odds on what to do about gold.

For official transactions among central banks, the price of gold stays at $42 an ounce, the point it reached as the result of the devaluation of the dollar in 1973. However, on the private market, the price of gold fluctuates widely and is roughly four times the official price.

Central banks may now sell gold to the private market at whatever the market will bear. But, they cannot buy gold from the private market and they cannot sell gold to each other at any price other than the official price of $42. [a/]

Consequently, gold held by central banks is not being used as monetary reserves -- as a practical matter they are frozen:

-- No government or central bank would sell gold at $42 an ounce as long as it thinks the price will quadruple.

-- And, central banks do not sell gold on the private market, as they can, because such sales would break the price. The market is very thin. For example, if Italy alone were to try to finance its current trade deficit by gold sales, it would have

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a/ The rules of the International Monetary Fund prohibit all sales of gold by central banks at less than the official price and purchases at above the official price (in each case within a small margin).

to sell one billion dollars of gold per month. The result would be a phenomenal increase in the amount being traded and the price would collapse.

Thus, at a time of great balance-of-payments stress, a large part[a/] of world monetary reserves are frozen; gold cannot be used to meet emergency situations, to perform its normal economic function of financing international deficits.

The Proposal of the European Community (EC)

The EC Finance Ministers proposed early in 1974 that the price of gold for official transactions -- i.e., for transactions among central banks -- be raised to something approximating the price in the private market. (In addition, the finance ministers proposed that central banks be permitted to buy gold from, as well as sell gold to, the private market so long as EC central banks as a group do not increase their total holdings of gold over a year's time.)

Their argument was that unless the official price of gold were raised, the enormous stock of gold now held by central banks would continue to be immobilized.

An additional objective of the Europeans was, and probably remains, to set a floor under the price of gold. Indeed, this was proposed by the EC finance ministers and by key officials of the Bank for International Settlements (BIS) at its annual meeting in early June 1974. They recommended that a range around the private market price be fixed for the price of gold; that when the price reached the top -- say \$170 an

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a/ Gold, valued at \$42 an ounce, accounts for almost one-quarter of world monetary reserves; valued at \$160 an ounce it would amount to almost 60 percent.

ounce -- the IMF sell gold to the private market; when the price fell to the bottom -- say, $150 an ounce -- the IMF would buy gold from the private market. This would put a limit on how low (and how high) the price of gold could go.

This is not true of the agreement to allow gold to be used as collateral for borrowing. The price of gold when used as collateral would be fixed by agreement for each transaction. There would be no floor. Of course, if there were a good possibility of gold being sold on the private market, the price would fall, as was suggested earlier. British bankers have suggested that the price of gold used as collateral today might run at $100 an ounce or less.

However, a recent -- and very rough - calculation of Citibank's Economics Department (see Citibank "Money International," May 1974) puts the value of gold for non-monetary uses -- i.e., the price at which the underlying supply would balance non-speculative demand -- between $118 and $135. Thus, a fall in the non-official price below $100 does not seem likely to persist in the absence of sales by central banks.

The desire to revalue gold to approximately the present price in the private market stems not simply from an abstract desire to unfreeze part of the world's monetary reserves, but from practical fact that at current market prices world monetary reserves would be almost doubled. As can be seen in the attached table, <u>total</u> official monetary reserves of the European Community would rise from $67 billion to $115 billion if the official price of gold were made equal to the price in the private market. Total Italian and French official reserves would

more than double, increasing by roughly $10 billion for each of these countries. And they are running abnormally high balance-of-payments deficits. (Indeed, in the first four months of 1974, Italy has been running a trade deficit equal to $13 billion for the year.)

United States Objections

While the U.S. would be the largest single gainer by far from an increase in the official price of gold, U.S. officials continue to oppose such an increase. (If gold were valued at current market prices, the U.S. would add over $30 billion to its total monetary reserves which now amount to less than $15 billion.) The U.S. arguments are as follows:

(1) A sharp increase in the price of gold could be inflationary. This is not because it would raise world liquidity and permit an expansion of the money supply in each country. Modern governments no longer base their monetary systems on gold. Rather, a gargantuan increase in monetary reserves would make it easy for some countries to finance their international deficits and would, consequently, ease the pressure on them to take effective anti-inflationary measures.

(2) More important in the eyes of American officials, an increase in the price of gold would be a retrograde step -- it would reinstate gold in the international monetary system.

The U.S. Government, most other governments with the notable and important exception of France under DeGaulle, and virtually all economists agree that an international monetary system cannot be based on gold. The IMF Committee of 20 endorsed this view in its report of June 14, 1974 when it agreed that "the role of gold... [in the international monetary system] will be reduced."

The same reasons which led all modern nations to abandon gold as the basis for their domestic monetary systems apply with equal force to gold as a basis for the international monetary system. The supply of gold for monetary purposes is inflexible and erratic, depending in large part on the accident of new discoveries and on the growing needs of the metal for industrial and artistic uses. Its supply cannot be regulated or adjusted to meet the changing financial needs of a national or the world economy. And, changes in the price of gold can have an inequitable effect on the distribution of income in the world.

These reasons explain why in 1969, after six years of negotiation, the International Monetary Fund agreed to create a new asset for use as an official monetary reserve asset to supplement and, eventually, to replace gold and national currencies as official reserves. The new asset goes by the inelegant name of Special Drawing Rights (SDRs), and some $9-1/2 billion of them were issued to IMF members from 1970 to 1973.

If the price of gold were raised significantly, it is unlikely that any SDRs would be created for some time. As can be seen in the attached table, world monetary reserves would rise by seventy percent if the official price of gold rose to the price on world markets. Such an increase would kill any remaining support for the creation of more SDRs in the foreseeable future. The result might well be the virtual demise of SDRs as a basic instrument for managing the world's monetary system.

Raising the price of gold would not only greatly increase total world monetary reserves, but it could result in gold continuing to be frozen in reserves if further significant increases in the price were expected.

(3) The United States objects to allowing central banks to buy gold from the private market because this would also support the price of gold and work toward keeping it as an important element in world monetary reserves. Sales without purchases, however, would see a gradual erosion of the position of gold in monetary reserves and require its replacement by another asset, presumably SDRs.

(4) At least as important as any of the other objections to an increased price of gold is that it would be inequitable. The major gainers would be the rich countries -- the United States and the European Common Market -- plus the gold producing countries -- the U.S.S.R. and South Africa. The poor countries of the world have little gold in their reserves and they would gain very little from an increase in its price.

SDRs, on the other hand, could be created to meet the problem of insufficient total world liquidity and could be distributed to less developed countries to help finance the huge increases in the costs of importing food, fuel and fertilizer. This proposal, usually known as the "link" (between development aid and world liquidity), is still under consideration in the IMF and is being resisted primarily by the United States and Germany.

(5) Despite assertions to the contrary, an increase in the official price of gold would do little to meet the very serious world balance-of-payments strains resulting from the four-fold rise in the price of oil.[a/]

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a/ For a full explanation of this important problem see:
Library of Congress. Congressional Research Service. The Impact of the Rise in the Price of Crude Oil On the World Economy: Prognosis and Policy Options, by Alfred Reifman. February 10, 1974. 13 p.
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Of course, it would greatly ease the immediate financing problem of individual countries in great need, notably Italy and France. But the financing problem of these countries could be met by arrangements with the IMF, the United States and their Common Market partners. The argument behind this conclusion is as follows:

-- The oil exporting countries do not seem to be interested in increased purchases of gold. If they were, they could get it on the private market.

-- The oil exporting countries either spend their increased earnings on foreign goods and services, in which case no balance-of-payments problem results (though a real burden is put on the oil importing countries); or the oil exporters leave their earnings abroad as short-term or long-term investments. In the latter case there is no immediate real burden -- it is postponed until the funds are used to buy imports -- and no balance-of-payments problem for the oil importers as a group.

-- Problems, of course, will arise for those individual countries whose imports rise faster than their exports plus their receipt of foreign capital funds. Some, indeed, perhaps much, of this shortfall will be made up as the financial markets cycle funds around. Any remaining shortfall can be met by loans from countries which receive a disproportionate share of the surplus funds of oil-exporters or by IMF loans. Indeed, at its June 14 meeting the IMF Committee of 20 recommended the "establishment of a facility in the Fund to assist members in meeting the initial impact of increased oil import costs."

-- The financing problem concerns merely money, not real goods,

so that it should be relatively easy to manage. This is not to say that it will be easily accomplished. The differences between borrowing from the IMF or another country for needed financing and getting it through an increase in the price of gold are real and important: The latter does not involve interest and amortization costs, a matter of some economic importance; moreover, an increase in the price of gold avoids forcing countries to request and negotiate international loans, a matter of some political importance.

A Possible Compromise

A number of areas for compromise between the two positions exist. For example, the following formulation might meet many of the objectives of the Europeans and the objections of the United States:

(1) Central banks would be allowed to trade in gold with each other at the current private market price for gold or at some new agreed price considerably above the present official price. This would unfreeze the gold now held in official reserves.

(2) Central banks, however, would not be permitted to buy gold from the private market and, consequently, to support the price of gold. (The EC finance ministers had a weaker version of this when they proposed that purchases from the private market be permitted with the understanding that there could be no net purchases over a year's time for the EC as a whole.) Since central banks can sell gold to the private market, over time the official gold stock would at most remain constant and probably decline. In either case the result would be a relative diminution of the role of gold in the world monetary system as the amount of other reserve assets, presumably SDRs, rose.

(3) To make the impact of the increase in the price of gold more equitable, some percentage of the increase in the value of a country's gold stock could be earmarked for a special account in the International Monetary Fund or the Bank for International Settlements. After joint consultation, these "windfall profits" could be used as aid for the "most seriously affected" less developed countries.

(4) There are two possible supplements to the above approach:

-- All, or a large percentage of, the increased value of the gold now held by the IMF -- if the $6.5 billion of IMF gold were valued at current market prices, the IMF's assets would rise by $18 billion -- be made available on easy terms to poor countries.

-- Gold held by central banks could be sold to the IMF at a discount, say 20 percent, from the private market price. The IMF could then, as it thought wise, sell gold to the private market, using the profits for aid to the developing countries.

The treatment of gold remains an issue between the United States and Europe. However, this issue is dwarfed by the pressing problem of working out means to finance the sharp increase in the cost of imported oil and to avoid having it limit economic expansion and yield restrictions on world trade and investment.

WORLD MONETARY RESERVES, March 1974
(billions of dollars)

	Total Reserves (with gold @ $42 an ounce)	Gold (with gold @ $42 an ounce)	Gold (if gold valued @ $155 an ounce)	Increase in Reserves (if gold valued @ $155 an ounce)
World *	$179.8	$49.6	$180	$130
International Monetary Fund	n. app.	6.5	25	18
United States	14.6	11.7	43	32
Japan	12.4	0.9	3	2
EC	66.9	17.8	66	48
United Kingdom	6.4	0.9	3	2
France	8.1	4.2	15	11
West Germany	32.9	5.0	19	14
Italy	6.7	3.5	13	9
Belgium	4.8	1.8	7	5
Netherlands	6.0	2.3	9	6
Switzerland	7.6	3.5	13	9
Less Developed Areas	45.7	3.8	14	10
Latin America	15.7	1.2	4	3
Middle East	12.1	1.2	4	3
Other Asia	10.5	0.8	3	2
Other Africa	7.2	0.5	2	1

* Excluding U.S.S.R. and other countries which are not members of the IMF.

n. app. not applicable.

Source: International Financial Statistics, May 1974.