THE GOLD AGREEMENT AND THE FUTURE OF GOLD

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THE recent agreement between South Africa and the International Monetary Fund (I.M.F.) on the sale of gold, concludes an episode of international monetary relations that goes back to November, 1967 when sterling devalued. The sterling devaluation exacerbated tensions within the international monetary system. In particular it reinforced doubts held until 1959-60 about the ability of the United States (U.S.) to maintain the price of gold at $35 dollars per fine ounce.

In terms of its association with the I.M.F. the U.S. is willing to exchange gold for dollars on presentation by official foreign monetary authorities. In October 1960, official and private speculation in gold sent the free market price as high as $40 per ounce. To stabilise the price at about the official level the U.S. organised seven major central banks to pool their gold reserves. The pool was designed to prevent temporary market disturbances. It was expected that the pool countries would acquire surplus gold on balance over time to add to their gold reserves. Until 1966 this was indeed the case. Additions to the western world's monetary stocks of gold averaged $544m per annum between 1961 and 1967 out of newly available gold, including Russian supplies that averaged $1731m. for the same period. In 1966, 1967 and 1968 however, monetary stocks of gold decreased by $45m., $1580m. and $710m. respectively[1] For the six months October 1967 to March 1968 gold-pool sales on the gold market, to stabilise the price, totalled $2720 million.[2]

[1] International Monetary Fund 1969 Annual Report Table 40, p. 131.
[2] Bank for International Settlements Annual Report 1969, p. 105.

in the remarks Dr. Diederichs made to the Annual Meeting of the I.M.F. Board of Governors held in Washington during September-October 1968. It seems worth while to repeat at some length part of this speech:

'The two-tier system has, as I said, at least the virtue that it checks the drain on monetary gold. But to the extent that the system in its extreme form, i.e., the two-circuit system, seeks to prevent the entry of newly mined gold into monetary reserves, it not only provides no basic solution to the world's monetary problems but, I submit, tends to aggravate them. Do we really believe that the present stock of monetary gold is sufficient and should now be sealed off hermetically? Surely some continuing increase in official gold reserves would be more conducive to international monetary stability than a scheme which expressly attempts to make such an increase impossible. It is worth recalling that the whole philosophy of the Articles of Agreement, as well as the Fund's policy since its inception, are directed toward the channelling of gold into monetary reserves. The Fund has, in fact, impressed upon members that a 'sound gold and exchange policy . . . continues to require that to the maximum extent practicable, gold should be held in official reserves rather than go into private hoards'. The two-circuit system would involve a complete *volte-face*.

The question is: what does the two-circuit scheme imply for the future? Unless the balance of payments deficits of the main reserve currency countries can be genuinely eliminated, this system must lead to a further decline in the relative gold component of total reserves and an increase in the currency component. Countries which, like South Africa, prefer to hold the major portion of their reserves in gold would be forced to distort the composition of their reserves increasingly against their wishes. Can we really bring ourselves to believe that in this world in which we live such a development would promote genuine exchange stability? In my view, it would have the opposite effect. Furthermore, many countries do not wish to increase the relative currency component of their reserves and thereby increase their dependence, economic and political, on the key currency countries.

In general, I would submit that nothing which seeks to discredit gold or to reduce its rôle as an unconditionally acceptable means of international payment can possibly add to confidence and monetary stability. I was therefore pleased to hear the Managing Director state categorically that '. . . it is important at this stage to do nothing to undermine, and to do whatever is possible to strengthen, the traditional reserve components. The new (SDR) facility is intended, when the need arises, to supplement, not to supplant, gold

unsettle the present monetary system. Under the two-price system, we would normally in our own interests sell a portion of our gold output on the free market as and when our balance of payments requires it. But in our view it is neither reasonable nor in the interests of world monetary stability to expect South Africa under all conditions to sell all its newly mined gold on the free market.

Nevertheless, having said that, I wish to reiterate that, in regard to the question of gold, my country stands ready to make its contribution and to confer with interested parties with a view to solving the difficult questions with which the world's monetary authorities are confronted'.[4]

As is indicated above South Africa normally accumulates Balance of Payments surpluses and hence her monetary reserves in gold. The Reserve Bank acquires the South African gold production from the Chamber of Mines. In turn the Bank sells sufficient gold for foreign exchange to finance the normal deficit in all other categories of the South African balance of payments. During 1968 South Africa's balance of payments was highly favourable due mainly to an inflow of foreign capital for investment on the Johannesburg Stock Exchange. The inflow was induced by the prospect of a higher gold price and as a result South African sales of gold could be kept to a minimum over the period.

Another effect of the inflow of capital was a rapid increase in the internal money supply during a period when inflation was already a problem. The South African monetary authorities did not neutralize the influence of the capital inflow on the money supply. A partial attempt was made in this direction through a build up of the Exchequer balance with the Reserve Bank. Relieving import and exchange controls originally imposed to protect weak balance of payments positions could have been an alternative method of offsetting the increase in the money supply. However, South Africa retained these controls to avoid selling additional gold given the unsettled situation regarding gold sales and the monetary rôle of gold. Also presumably to take tactical advantage of a high free market price.

Again to avoid selling gold, but perhaps more particularly to emphasize the nature of the rôle of gold in the international monetary system, South Africa attempted to exercise what she took as some of her drawing rights with the I.M.F. When a member of the I.M.F. has a deficit on its balance of payments it may purchase convertible currencies and repay in gold. The Fund management would appear to have been put under considerable pressure to deny this facility to South Africa on a regular basis. It is presumed that the I.M.F. were able to avoid

[4] Summary Proceedings Annual Meeting 1968, p. 197-200.

fall in terms of the psychology of speculation. To recall briefly, gold fluctuated quite widely between 37 and 42½ dollars a fine ounce up to December 1968. Between January and the first weeks of May 1969 fluctuations were more narrowly in the 42 to 43 dollar range. From June to October 1969 the price varied between 41 and 42 dollars. In October 1969 the price declined rapidly falling by as much as four dollars in the following month to $36. Since then the free market price has been about, and sometimes below, the official price of $35.

Perhaps the most fundamental factors responsible for the fall in price was the relative calm in the world currency markets following the devaluation of the French franc in June 1969, and the up-valuation of the German mark in September. Both these steps were taken reluctantly but very obviously in the right direction. In addition, there has been the much improved British balance of payments. Another factor has been the expense of holding gold when three-monthly Euro-dollar deposits were yielding 10% p.a. and above. American banks trying to avoid a very severe shortage of cash reserves have been borrowing Euro-dollars thus forcing rates up to unprecedently high levels, at the same time, of course, reversing the short term flow of dollars and improving the U.S. balance of payments.

The inception of the S.D.R. scheme on the 1st January 1970 at a rate equivalent to $3,500 million per annum has also reduced tensions in the international monetary system. It has done so by postponing any immediate necessity for American balance of payments adjustments. One suspects that SDR's in these quantities would not have been forthcoming nor monetary relations so relaxed had France's very weak balance of payments not eliminated the most powerful member of the gold lobby.

There were also larger South African sales of gold on the free market in 1969. The inward flow of capital had diminished and import and export control relieved as anti-inflationary with the prospect of a gold settlement. However, supplies of South African gold are small relative to the huge stocks of gold held for speculation and hedging. The price of gold on the free markets will be determined primarily by what these gold hoarders believe the price will be. In these circumstances South Africa has very little control of the price despite being a monopoly producer.

Any estimates of the value of these gold stocks are extremely uncertain. Newly available gold is accumulated in monetary reserves and absorbed in industrial and artistic uses. The balance is hoarded either as a traditional form of saving where it remains and will not be tempted out by prices on distant markets or held by sophisticated speculators. The only accurate statistics is for changes in monetary stocks. Reliable

hold on to their speculative gold purchases in the expectation of a longer-term price increase'.[8]

It remains for the central bankers to show by their portfolio preferences how relatively important the future monetary rôles of gold, dollars and SDR's will be. The new agreement suggests that the monetary authorities will be glad to augment their gold reserves at $35 an ounce through the channels of the I.M.F. In terms of the new agreement the most advantageous outcome for the anti-gold lobby would be for the state of the private market in gold to be so weak as to ensure a sufficient supply of monetary gold through the I.M.F. to satisfy central bankers' preferences for the metal. Alternatively, if supplies are insufficient surplus countries may again turn in excess dollars for gold at the U.S. Treasury.

Despite its clumsiness and high cost of production compared with credit substitutes, gold retains important advantages in a world where national sovereignity is held to be important. The supply of gold is dependent on many complex factors that make it beyond the control of any one country. Dealings in gold provide a greater degree of anonymity and holdings of gold permit more autonomy in the exercise of economic policy. The indication is that gold will retain a monetary rôle until countries are prepared to delegate a very important part of their economic policy to a supra-national central bank.

The monetary authorities will clearly not be stampeded into changing the dollar parity. SDR's give them more elbow room to resist the force of private speculation. However, they cannot be expected continuously to finance American balance of payments deficits of the order of the last few years. If, however, SDR's become more and dollars less important components of international reserves, SDR's may facilitate an orderly adjustment of the dollar parity if the need for it continues to be emphasized.

More international liquidity can at best merely postpone the necessity for real balance of payments adjustment. The need for such adjustment will remain. The major weakness of the international monetary system is still the absence of a smoothly functioning mechanism by which countries adjust in a mutually compatible way to balance of payments surpluses and deficits. The pre-1914 international gold standard was such a mechanism. Surplus countries accumulated gold, and inflated deficit countries lost gold and deflated, thus assisting each other in the adjustment process. Today deficit countries are reluctant to deflate because deflation, given wage and price rigidities, means unemployment and is politically intolerable. Surplus countries in turn attempt to avoid

[8] Johnson, op. cit., p. 346.