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Gold Policy: The Thirties and The Seventies

By Kurt Dew

The gold policy of the United States during the twentieth century has been marked by two distinct shifts. The first shift in the 1930's was characterized by expropriation—with citizens turning their private holdings over to the U.S. Treasury—and by a rise in the price of gold in terms of the U.S. dollar. This policy was conducted during a period of unprecedented economic weakness, evidenced by a rise in the value of the dollar in terms of domestic goods and services, that is, deflation.

A second change in U.S. gold policy began in 1968 with the establishment of a two-market gold-trading system—one for the public, one for central banks. This shift was continued with the closing of the gold window in 1971, and it culminated in the legalization of private holdings of gold on December 31, 1974. The rationale for these actions was the termination of the role of gold in U.S. monetary dealings. As in the Thirties, this policy is being conducted during a period of economic weakness—but a period marked this time by a rapid fall in the value of the dollar, that is, inflation.

Three questions may be asked about these seemingly quite different policies. First, could we reasonably expect them to produce the results for which they were intended? Secondly, could external actions cause these policies to result in detrimental side effects capable of overpowering the intended beneficial effects? Finally, was gold itself in either case a useful vehicle for the attainment of national economic welfare?

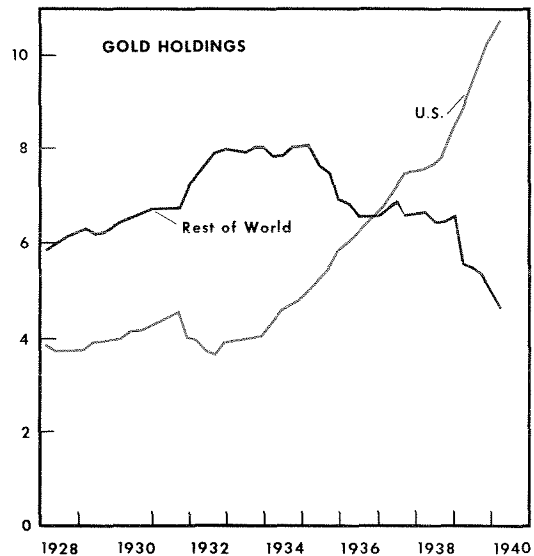
The Thirties

In the earlier case, the evidence suggests that the first two questions can be answered in the affirmative, and the last, in the negative. In the Thirties, the basic intent of President Roosevelt's gold policy was originally ill-defined, but it evolved gradually into an attempt to influence food prices. The gold decisions of that era had their genesis in Roosevelt's inaugural speech, where he affirmed his intention to subordinate international interests to those of the United States. The exact means of accomplishing this were unclear at first, possibly even unclear to himself. However, the form of his commitment became clearer at the International Monetary Conference of 1933.

This conference had been called to explore the possibility of a return to the gold standard and a reduction in the tariff and quota restrictions which were hampering international-trade flows. Advocates of these goals hoped that the United States would take a leading role in a successful outcome; in fact, Cordell Hull, a firm internationalist, headed the U.S. delegation. But Roosevelt sounded the death knell of the conference with his statement: "Let me be frank in saying that the United States seeks the kind of dollar which a generation hence will have the same purchasing and debt-paying power as the dollar value we hope to attain in the near future. That objective means more to the good

of other nations than a fixed ratio for a month or two in terms of the pound or franc." In other words, while we were still tied in 1933 to fixed-exchange rates between the dollar and other currencies, there was no firm commitment to a continuation of that policy.

After the conference, the dollar prices of goods—especially agricultural goods—continued to fall, further exacerbating an already serious farm situation. Professor George Warren of Cornell suggested a solution —a dollar devaluation *vis-a-vis* gold— on the basis of the close relationship he had observed between weekly agricultural prices and gold prices in terms of the pound sterling. The President bought the idea as a way to help the farmers, and raised the gold price from $20.67 per ounce on September 8, 1933, to its final level of $35 an ounce on February 1, 1934. The prices of a large range of commodities (including agricultural ones) rose on international markets, and Roosevelt's goal was largely achieved. The answer to the question, "Did he achieve his purpose?" is yes.



Note: Does not adjust for change in price of official gold

Yet the increase in farm prices was in many ways a Pyrrhic victory, primarily because of the lack of coordination between the Administration's gold policy and the policies of two other governmental entities, one foreign, one domestic. Consider first the behavior of the foreign entity, the gold bloc.

The first effect of the higher dollar price of gold was an inflow of gold to the U.S. Treasury. This inflow was naturally associated with an outflow of gold elsewhere, most importantly from the gold bloc, the group of European nations determined to maintain a fixed price of their currencies in terms of gold. When the United States raised the dollar price of gold, private holders of these foreign currencies (and of gold) had an incentive to exchange their holdings for dollars. This phenomenon was damaging to the gold bloc in the short run, but it need not have had the long-lasting detrimental effect upon them that it eventually had. Initially the devaluation of the dollar followed the classic pattern of a currency devaluation in a gold-standard world. The dollar remained a gold-backed currency throughout this period — at least in the minds of most citizens, economists, and government officials — and thus the total U.S. money stock increased as gold flowed into the country.

In principle, the growth in the money stock should have helped to raise both U.S. income and U.S. export demand, potentially in sufficient amounts to reverse the inflow into this country and to return the gold-bloc economies to their pre-devaluation level of prosperity. However, reality failed to coincide with principle. France and several other European countries had remained on the gold standard in 1934 with insufficient gold reserves, and holders of these gold-bloc currencies hence suspected that devaluation was inevitable. This suspicion further increased private incentives to trade for dollars, and the ensuing run on gold-bloc currencies reduced their domestic money stocks and brought about a deeper depression. The adverse primary effects of gold-bloc decisions upon their own economies had adverse secondary effects upon the U.S. economy as well, by sharply reducing the demand for internationally traded goods produced in this country. Had the gold-bloc countries devalued at the same time as the United States, they would not have suffered severe gold outflows. If they had raised the price of gold in terms of their own currencies, they could have avoided the problem of insufficient gold reserves.

On the home front, the expansionary effects of the Administration's gold policy were partly offset in the late Thirties by a tightening of Federal Reserve policy. Money expanded in line with the post-1933 gold inflows, thereby helping to stimulate the economy. But the monetary authorities became concerned about the large quantities of excess reserves building up in the banking system. They responded in late 1936 by doubling bank reserve requirements within a six-month period. This action sterilized a large share of bank reserves, which induced a reduction in loans and in the gold-backed supply of money, and thus helped create the recession in 1937.

Yet the fundamental flaw — the thing that turned a potentially beneficial policy into a disaster — was the tendency of both the United States and the gold-bloc countries to follow gold policies rather than monetary policies. President Roosevelt's mistake was in assuming the increase in the price of agricultural goods to be mystically related to the dollar-price of gold — in failing to realize that the economic source of this relationship was the monetary expansion which had been induced by the higher dollar-price of gold.

The Administration need not have purchased gold at all to achieve its aims, but instead, could have purchased labor, bridges, dams, and other useful resources rather than gold for storage in Fort Knox. Sale of the resulting debt to the Federal Reserve would have provided the same base for monetary expansion as did gold, without any damage to the gold-bloc countries. For their part, these countries viewed devaluation as almost immoral, a move to be made only under compulsion. Their policy, ironically, became the source of their desperate situation. Had they not been so intent on linking their currencies to gold, the outflow of gold they suffered would not have affected their money supplies. This experience suggests that gold was not a beneficial vehicle for the provision of economic welfare in the 1930's.

The Seventies

The same questions may be asked about the gold policy of the Seventies as were asked about the Thirties. First, will the current Administration's goals be fulfilled? Secondly, will these actions have repercussions, at home or abroad, that would make these intended aims more difficult to achieve? Finally, is gold beneficial for the conduct of economic policy in the 1970's?

The first question may be answered in the affirmative. The Administration's intention is to relegate gold to the same status as that of any other commodity, rather than to continue gold's historical role as a constraint upon the decisions of the monetary authorities. It is clear that this objective is being realized. With private gold purchases and sales legalized in this country, gold has become more like all the other items traded in the commodity markets. Also, since the closing of the gold window, the monetary authorities have not been substantially affected in their decisions by the price of gold or the shifting of gold across international boundaries. This is largely because we are now operating in a world of flexible exchange rates, where the link between money and gold has been effectively broken, despite gold's continued role as a major reserve asset.

The second and more interesting question concerns the factors which could offset the effects of the current gold policy. To limit the discussion, we should make two basic assumption. These are (1) that the American public has been well-informed enough about gold that it will not operate irrationally with its new found freedom, and (2) that all current gold agreements among nations will be honored. These two assumptions, if correct, put firm limits on the possible detrimental side effects of the new gold policy.

The public at large and, indeed, some economists believe that the whole issue is rather simple — namely, that legalization of private gold ownership is part of the U.S. Government's covenant with its citizens to provide a maximum of

individual freedom consistent with general welfare. Yet, while legalization demonstrably increases freedom of choice, some analysts question its benefits for the general welfare. They raise the question — if a substantial number of investors choose to buy gold, what assets will they sell in order to do so? As the price of gold and/or the quantity held by private citizens increase, the price of the assets sold and/or the quantity of these assets held by private citizens will go down. The economy could be adversely affected if investors sold substantial amounts of two types of assets: first, time deposits of banks and thrift institutions; and, second, corporate equity and debt liabilities.

In the first situation, such sales would represent a decision by large groups of relatively small investors that the yield on gold would be higher than the yield on savings deposits. This would be reasonable if the price of gold were to increase so rapidly as to make its yield greater than the 7.75-percent maximum yield available from savings-and-loan deposits. But this possibility appears rather remote, since the price of gold would have to rise 30 percent just to make it possible for the small investor to break even after paying commissions plus storage and assay costs. The investor might also choose gold if he believed that thrift institutions were going to collapse and the government default on its insurance, but this of course would happen only in a period of complete economic and social chaos.

A second posibility is that holders of corporate stocks and bonds transfer their holdings into gold. These investors are primarily large institutions with portfolios controlled by quite sophisticated financial managers. To assume that they would now shift into gold, we must first suppose that they have not been able to do so in the past — a dubious assumption in their case, especially since it has been quite legal to own equities of corporations that produce gold. Second, we must suppose that these financial managers believe an asset whose chief virtue lies in its fixed supply is preferable to an asset whose value depends upon the productivity of American capital — again an unlikely assumption in the absence of an actual decline in the effective stock of capital, as would happen only in the case of confiscatory taxation or physical destruction of assets. Thus, for either small individual investors or large institutional investors, the potential demand for gold should be relatively small.

Is it possible that other government actions might offset the benefits of the recent Treasury decision, repeating the experience of the Thirties? Again, this seems unlikely. First, in view of the U.S.-French agreement regarding the official valuation of gold at free-market value, the Administration may have achieved the international cooperation that its predecessor so signally failed to achieve a generation ago. If the major national holders of gold have agreed not to be net purchasers, any increase in the gold price will be the result of private decisions. This is the type of accord that could have helped forestall the serious difficulties of the 1930's.

But on the domestic scene, what if the monetary authorities should feel compelled to adopt a course of excessive monetary expansion, say, to forestall a deepening recession? Most projections of the effects of monetary expansion are based upon experience prior to the legalization of gold trading. These projections, utilizing the quantity equation $MV=PT$, assume that an increase in money balances (M) held by the public will initially result in an increase in real economic growth (T), because velocity (V) is relatively constant over long periods of time, and because the price level (P) does not change as rapidly as real economic growth in view of the high cost to the market place of changing P. But there are two factors that can act to reduce the cost of changing P — first, inflation, and second, the existence of close substitutes for currency.

Now, consider the case of an overly rapid monetary expansion in today's situation, with the legalization of the closest of money substitutes — gold. Sophisticated investors with large portfolios, realizing the implications of excessive money growth for the rate of future inflation, and uncertain of the future course of monetary policy, might switch to gold, or more importantly, debt and credit instruments payable in terms of gold. But inflation would have to be rapid enough to make such an expensive institutional change profitable. In particular, pervasive substitution of gold for money by small traders would be entirely unlikely without

a hyperinflation, simply because money is legal tender, while gold is not.

In the inflationary case, where the transition from cash to gold is profitable for trading purposes, the excess supply created by monetary expansion would be rapidly soaked up by a corresponding excess demand for gold. In response, the relative prices of gold and other "real" commodities (those not denominated in dollars) would rise more rapidly than they usually do in response to a given monetary expansion. The pass-through of easy money into inflation would be more rapid than before, leaving the economy with less real growth and higher unemployment than expected.

Judging from the experience of other industrial nations, it is somewhat unlikely that there could be an extensive substitution of gold for currency. But a dilemma could be created for monetary policy if such substitution should occur. It would be dangerous to assume that a greater increase in nominal money balances would have the same impact on real growth that it had in the past, for such an hypothesis ignores the presence of major changes in the economic environment. It would be better to recognize that rapid inflation in the presence of close currency substitutes, such as gold, is tantamount to a self-imposed reduction in influence of monetary actions upon the behavior of real economic variables.

Finally, as in the Thirties, there are fiscal implications to the current policy. Treasury sales of gold could make possible the attainment of such objectives as tax reductions, increased public-service jobs, or reduced deficits. The monetary expansion of the Thirties could have been accomplished — but was not — by the purchase of things other than gold. The current Administration has learned that lesson well, as it showed with its recent gold auction.

Perhaps the most important conclusion to be drawn from this comparison of the 1930's and the 1970's is the necessity for understanding and cooperation among government policymakers at home and abroad. Otherwise, the consequence of a given decision can be quite different from the planned result. The recent monetary agreement with the French Government suggests that we have learned from our earlier experience.

A second lesson from the Thirties concerns the differential impact of the gold policy of that period—beneficial for the United States but disastrous for the gold bloc. The benefits of that policy in no way stemmed from any intrinsic property of gold itself. If the reasons for this beneficial effect had been correctly understood, we might have conducted a superior policy without resorting to gold purchases—a policy that would have been better for us without wreaking havoc abroad. However, our early-1975 sale of gold suggests that that lesson of the Thirties has also been learned.