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**Article — Digitized Version**

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Intereconomics

*Suggested Citation:* Emminger, Otmar (1968) : The two-tier gold system—A permanent solution?, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 03, Iss. 9, pp. 258-262, <https://doi.org/10.1007/BF02930024>

This Version is available at:

<https://hdl.handle.net/10419/138020>

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## Recovery of the Monetary System

The Sterling devaluation, the dollar crisis and the gold speculation provoked a so far unique activity of the monetary authorities in recent months. The most important results thereof are the decisions for Special Drawing Rights and the Division of the Gold Price. The dangers for the monetary order have, however, by no means been removed as a result. A shortage of international liquidity still threatens, since the Special Drawing Rights will hardly be introduced before 1969, and it appears that Great Britain has definitely relinquished its role as a reserve currency country following the most recent taking of a new credit. A joint currency of the EEC countries would have a good chance to assume the functions of a reserve currency.

## The Two-Tier Gold System—A Permanent Solution?

by Dr Otmar Emminger, Frankfurt (Main)

In March 1968, under the pressure of the gold crisis which followed the devaluation of sterling, the central banks of the seven gold pool members—United States, United Kingdom, Switzerland, Italy, Germany, Belgium and the Netherlands—ceased to intervene in the London gold market. From November 1967 to March 1968 they had sold more than \$3 billion worth of monetary gold to this market, in order to prevent the London

market price from rising above \$35.20 per ounce. At a conference hurriedly convened in Washington on March 17 the governors of the cooperating seven central banks announced their belief "that henceforth officially-held gold should be used only to effect transfers among monetary authorities" and they therefore decided "no longer to supply gold to the London gold market or any other gold market". By this decision, the policy of pegging the London market price of gold which had been started in 1961 by the then eight gold pool central banks, was discontinued and the free market price was separated from the fixed gold price for monetary transactions.

The fixed monetary price of \$35 per ounce of gold is the official parity of the dollar and the basis of all the other currency parities in the International Monetary Fund. It is the price at which the American Treasury "buys and sells gold in transactions with other monetary authorities"; this was expressly re-affirmed by the Unit-

ed States government in the Washington communiqué of March 17, 1968.

The market price, which now results from the free play of supply and demand in non-monetary transactions, has fluctuated since the middle of March between \$37 and somewhat more than \$42 per ounce, if the no longer entirely free gold market in Paris is disregarded and only the major markets in London and Zurich are taken into account. For some time the price seemed to settle at around \$41, later at around \$39; towards the middle of July it had temporarily slipped back to \$38 and even somewhat below.

The cessation of central bank intervention in the gold market, together with the ensuing price rise, closed off the almost riskless "one-way street for gold speculators"; this has very quickly put a damper on the speculative gold rush. Thus it was mostly greeted with relief. The Italian central bank in its latest Annual Report published in May 1968 makes the point

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that from the monetary point of view the London gold pool had not performed any useful function so that its suspension had become overdue. Other quarters, however, mainly South Africa and other interested parties, consider the separation of the two gold prices as being a mere "gimmick" which they do not believe will last for very long. Thus the first question is: Will the separation of the two gold prices be only temporary or will it be of a permanent nature? And in this context the more fundamental question arises: Is the setting free of the market price for gold a step forward on the long road of gradually demonetising gold and what future role is gold likely to have in the international monetary system?

### **Return to Price Pegging Unlikely**

At first many observers were inclined to think that such a two-tier price system could not be maintained for very long and that natural forces would exert pressures for an eventual re-unification of the two prices.

On a closer analysis, however, the opposite view becomes much more plausible. No convincing reasons can be found why the present dual price system could not be maintained indefinitely. It can last as long as the leading central banks have sufficient confidence in the present gold parity of the dollar and in the readiness of the US Treasury to convert foreign official dollar holdings into gold at this parity. On the other hand, a re-unification of the two prices—in the sense that the central banks again assume responsibility for pegging the free gold price not far from the official price, as they did from 1961 to 1967—seems highly unlikely in the foreseeable future.

Indeed, it is hard to imagine any circumstances under which the central banks would again commit themselves and their prestige to keeping the free gold price pegged regardless of the cost involved. Even if the commercial price of gold should temporarily drop to \$35 or lower—and this can by no means be excluded—there would

always exist the possibility of new monetary or political crises accompanied by a revival of large-scale speculative gold hoarding. Therefore the central banks in their Washington communiqué of March 1968, rightly rejected any future commitment with regard to the free gold market.

Some people, and in particular the gold lobby, would, of course, suggest that a new linking of the two gold prices might become feasible if the official price of gold were to be sufficiently increased. But how large would such an increase have to be so as to enable the central banks to re-assume the responsibility for a stabilisation of the free gold price at the new level? It would have to be so ample as to guarantee an oversupply in the commercial gold market for an unlimited period, even during periods in which monetary or political crises would again generate a large hoarding demand. Only under such conditions could the central banks be sure of being permanent "residual buyers" in the gold market, as they used to be formerly. Only then would their official buying price under all circumstances determine the gold price in the free market.

### **Objections Against Increase in Official Gold Price**

□ **First**, a sudden revaluation of the \$40 billion worth of gold presently held in official reserves would create "with a stroke of the pen" a huge quantity of additional reserves and thereby a dangerous inflationary potential (even if one attempted to neutralise the counterpart in national currencies created by such action). Large-scale dis- hoarding of gold, probably unavoidable after a very big increase in the official price of gold, would greatly reinforce this inflationary potential.

□ **Second**, the additional international liquidity created by a substantial gold price increase would be very inappropriately and inequitably distributed over the world since about 85 per cent of the total monetary gold stock are concentrated in the hands of

the members of the Group of Ten and of Switzerland.

□ **Third**, after such a change in the price of gold it would be difficult to prevent, after a certain interval, a resurgence of gold price speculation unless the new price were so high as to produce an oversupply in the market for a very long time ahead.

□ **Fourth**, altering the gold parity of the dollar would put the United States into a difficult situation vis-à-vis the dollar-holding countries in view of the unequivocal pledge of its government not to change the present dollar parity.

From a monetary point of view, an increase in the price of gold, in view of its unavoidable excess and its manifold inequities would, as a method for creating international liquidity, be very much inferior to a cautious and gradual distribution of additional reserve drawing rights adjusted to the slowly rising reserve needs of the world, in the form of Special Drawing Rights in the IMF.

The dual nature of gold, which is at the same time a commodity subject to speculation and a monetary reserve asset, exposes us to an obvious dilemma: The monetary and the free gold price could be permanently re-united only by greatly raising the official as well as the commercial gold price so as to make sure of an oversupply in the free market under all conceivable circumstances. On the other hand, however, this would bring about an excessive rise in the value of existing official gold stocks (and private gold hoards as well). A re-unification of the two gold prices could thus be achieved only by artificially distorting the free gold market and—what is much more important—by a dangerous and inappropriate monetary decision as to the global supply of reserves.

In view of the strong objections against an—unavoidably excessive—increase in the price of gold, I doubt whether any responsible monetary expert would recommend such a move for the sole purpose of eliminating the alleged incon-

sistency of the two-tier gold price system.

### **Difficulties Are Surmountable**

In comparison with the difficulties involved in re-uniting the two gold prices the difficulties and dangers of preserving the present two-tier price system seem by far less weighty. What do they consist of?

First, it is feared that a substantially higher market price for gold might tempt some monetary authorities to sell monetary gold in the market and to replace it later on with gold obtained at the lower official price from the US Treasury. To prevent this the gold pool countries in their Washington communiqué expressly agreed "that henceforth they will not sell gold to monetary authorities to replace gold sold in private markets". Most of the other monetary authorities have in the meantime made known their concurrence with the objectives of the Washington communiqué. It is difficult to imagine that central banks will sell monetary gold in the private market if by doing so they will lose access to monetary gold at the official price. Besides, minor gold leakages arising from evasions by smaller countries could hardly amount to a volume which would decisively affect the overall picture.

Second, it is feared—and these fears were emphasised in the latest Annual Report of the Bank for International Settlements (BIS)—that a wider discrepancy between the free and the official gold price might "freeze" the gold stocks of central banks, as these could be disposed of only at the lower official price, and thus lead to an immobilisation of liquidity that would be dangerous for the world economy. Experience has in the meantime shown that such an immobilisation of the official gold reserves is hardly to be feared. It is several years since gold transactions between monetary authorities have been seen on the scale of recent months. Even a country like France, which perhaps still entertains hopes for an increase in the official price of gold, did not hesitate to make use of its gold

reserves when this proved to be necessary. The example of France moreover demonstrates that a country with high gold reserves can "mobilise" them quite easily by using them as a backing for foreign balance-of-payments loans.

Third, some people fear that a large spread between the official and the free gold price might foster monetary uncertainty and distrust. In fact, the relationship is just the reverse: Whenever important countries are, over extended periods, not capable of maintaining order in their external accounts and as a consequence monetary anxieties develop, rising private demand for gold and a higher gold price will be the result. Thus the higher gold price is a consequence and symptom, not a cause of the monetary unrest. If, however, the major currencies, especially the US dollar, are in a strong position, a spread between the official and the free gold price need not cause any alarm. In this respect the experience of the years immediately following World War II is instructive: between 1946 and 1953 the price of gold in the free markets of the world fluctuated greatly and sometimes rose to as much as \$ 50 or above. But as the dollar was very strong and in heavy demand, these fluctuations of the free gold price did no harm to the international monetary system.

At any rate, the durability of the present two-tier system is much less dependent on the size of the spread between the free and the official price of gold than on confidence in the present gold parity of the dollar. Should this confidence be severely impaired, not only would speculation on a rise in the gold price be revived and the gold price once again be pushed up but the consequences could be much more serious: central banks might then want to convert their dollar holdings into gold with the US Treasury. Should the United States, under the impact of such a crisis, feel compelled to slap on a gold embargo, the present gold price system might indeed break down. The consequence would certainly not be a new official gold

price but rather an acceleration of the demonetisation of gold, and that in a way which would run counter to the interests of the world economy as a whole and to European interests in particular.

Whether the present two-tier price system will last or disintegrate will therefore depend not on the size of the disparity between the two gold prices but rather on the major central banks' confidence in the ability of the United States to defend the present gold parity of the dollar.

### **The Problem of South African Gold**

It is not at all certain that the free gold price will in future stay substantially above the official gold price of \$ 35, especially if the recent resurgence of confidence in the dollar and sterling should gain further strength. If the additional private demand for gold which up to now has been caused by monetary fears should one day cease, or should larger quantities of gold come onto the market out of the huge private gold hoards or out of Russian gold stocks, a sizeable oversupply may emerge in the commercial gold market. At any rate, under normal conditions the commercial gold market should be more or less in fundamental equilibrium provided, however, that all newly-mined gold or at least a substantial part of it is offered in this market. Normal demand for gold, i.e. the requirements of industry and the arts and the traditional hoarding demand from India and some Arabian and African countries, should at present hardly be much more than \$ 1 billion annually; the annual gold production of the western world, however, amounts to \$ 1.4 billion.

In this context, the recently much discussed problem of the South African gold cannot be left unmentioned. South Africa, which last year accounted for more than 75 per cent of the total western gold production, is the decisive factor on the supply side of the free gold market. At present it seems to be South Africa's main objective to obtain the right to

sell gold at the fixed official price to the IMF at its own discretion. If this privilege were granted to South Africa it could decide at will what share of its newly-mined gold to sell on the free market and what share at the fixed official price. As a monopolist it could thus reap the highest possible profit. Much more important, and objectionable from a monetary point of view, would be the possibility for South Africa, by manipulating its sales of gold on the free market in an erratic way, to keep the gold market in a state of constant unrest and thus make the gold price a subject of permanent discussion and speculation. South Africa's request to the IMF to convert its gold at the official price into convertible currencies has not yet been decided upon. It is controversial whether the IMF is under an obligation to accept without limits not only monetary but also newly-mined gold, and the latter even at a time when it could fetch a better price in the free market. It can be assumed that this controversy will eventually be decided on the basis of the general task of the IMF to safeguard the stability of the international monetary system.

#### **Possible Conflicts in the Treatment of New Gold**

It should not be too difficult to find a satisfactory solution to this problem. The interest of the international monetary system as concerns newly-mined gold may, depending on the varying circumstances, take two opposite and conflicting forms: on the one hand it may be desirable to channel part of the newly-mined gold into the official reserves in order to increase the monetary gold stock of the world; on the other hand it may be advisable to sell as much of it as possible in the free market in order to prevent the spread between the official and the free price from becoming excessive. In the years immediately following World War II the first of these two considerations prevailed. At that time the IMF used its influence to direct as much newly-mined gold as possible into official reserves

regardless of the repercussions on the free market price of gold. Today, and for the foreseeable future, it is in the interest of international monetary stability to bring as much newly-mined gold as possible onto the free market, at least so long as the free gold price is higher than the official one of \$35. In their Washington communiqué of March 1968 the central banks of the gold pool countries have explicitly stated that "they no longer feel it necessary to buy gold from the market as the existing stock of monetary gold is sufficient in view of the prospective establishment of the facility for Special Drawing Rights".

#### **The Demands of Gold Producers**

The gold producers, especially South Africa, are of course interested in a substantial increase of the official gold price (and consequently also of the minimum price in the commercial market). The request for a higher official gold price has been a standard item in South African statements at the Annual Meetings of the IMF Governors. Apart from this more ambitious goal, gold producers are interested in selling their commodity at the free market price so long as it is above \$35, but at the same time being protected against the possibility of the free price being pushed below \$35 by an oversupply in the commercial market. For these reasons the South African request for a substantial increase in the official gold price cannot be met. But one might well envisage a system in which gold producers would be assured of a minimum price of \$35 (or \$35 less a small transactions fee), provided they were willing to channel newly-mined gold in an orderly way into the free market whenever the price in this market was higher than \$35. The minimum price could be guaranteed by an assurance on the part of the IMF to purchase gold from South Africa and other gold producers at the official price whenever the free market price drops (or threatens to drop) below \$35 over a certain minimum period. Such a guaranteed minimum price for newly-mined gold would

by no means automatically imply the same minimum price for other sellers in the free market; the commercial gold price might very well drop below \$35 if large gold supplies from other sources, whether from private hoards or from Eastern bloc countries, should weigh on the market. The IMF in turn could use the newly-mined gold it has purchased either to replenish its own gold stock or to acquire, in case of need, scarce currencies, thereby directing gold to those countries where it belongs according to the basic rules for the international distribution of gold reserves.

#### **A Step Toward the Demonetisation of Gold?**

South Africa and the other gold producing countries, too, should be interested in strengthening the international monetary system and especially in preserving the position of gold within this system by cooperating closely with the major countries. South Africa alone cannot compel the rest of the world to make a massive increase in the official price of gold. But by deliberately provoking wide fluctuations in the gold markets it may well further discredit gold as a monetary asset and thereby accelerate its gradual demonetisation.

It cannot be denied that the events of the last twelve months in the gold market have already considerably discredited gold as the supreme measure of values and as the basis of the present monetary system. The myth of the "immutable" and "impartial" value of gold has been badly shaken since it has been demonstrated to the world at large that the free market price of gold is arbitrarily tossed up and down by private speculative forces. Moreover, it has increasingly been recognised that the non-speculative forces of supply and demand in the gold market, such as gold discoveries and improvements in mining techniques or the fluctuating demand for industrial and artistic gold, also cannot be accepted as the determining factors for the monetary price of gold and the value of the

monetary gold stock of the world. After the spectacle of the last twelve months, it will be difficult to accept the idea that the supply of reserves to the world should depend on the ups and downs of private gold speculation and on the above-mentioned non-speculative factors. With the approval of the Special Drawing Rights scheme the principle has been accepted that the provision of global monetary reserves should be deliberately managed—by analogy with the deliberate management of the domestic money supply.

### Gold Cannot Be Replaced

Nevertheless gold cannot be easily dispensed with in the present monetary system. Monetary gold stocks are still by far the most important part of the world's monetary reserves, accounting for nearly three fifths of the total; nobody can be interested in depreciating this block of reserves worth roughly \$40 billion. Gold is the common measure for fixing the relationships between currencies

within the IMF and it is also to be the measure for the new Special Drawing Rights vis-à-vis national currencies. The present gold exchange standard, despite its imperfections, is still preferable to a system without gold. The commitment, inherent in the gold exchange standard, to convert the key currency on request into gold is a means, albeit an imperfect one, of imposing some monetary discipline. Were gold to be removed from its present universal role the world economy would either have to fall back on a pure foreign exchange standard, i.e. a pure dollar standard, or it would disintegrate into several currency blocs.

The gold pool countries' decision of March 1968 to withdraw from the free gold market was taken under the pressure of a concrete critical situation. The additional decision, however, not to expect any significant reserve contribution from gold in the future demonstrates that a further step was taken in the direction of detaching our system from an irrational gold

myth. The Italian central bank expressed this idea in its latest Annual Report in the following way: "The Washington decisions ... form part of the evolutionary process which has reduced the monetary functions of gold, first inside countries and then internationally".

In this sense, the separation of the commercial from the official gold price may be considered a landmark in the process of gradually diminishing the role of gold. But the repercussions of this price splitting on the evolution of the world economy should not be overrated. In this respect the setting free of the commercial gold market is likely to be of only secondary importance. For the stability of the world economy in the period ahead, the development of the American balance of payments and of confidence in the dollar are of far greater importance than the ups and downs of the commercial gold price, notwithstanding the widespread publicity which the latter have received up till now.

## SDR Will Rationalise the World's Currency System

by Dr Wilhelm Hankel, Bonn

A few months of an unseasonably torrid spring and summer scorching the world of international currencies have been sufficient to revise judgment upon the Special Drawing Rights (SDR) in their intended function as a new reserve instrument. It is not very long ago that most commentators looked down their noses at this new child of eager consultations and discussions, giving it the slightly abusive name of "paper gold", or suspecting it to be a more or less inflationary homunculus bred in the monetary alchemists' retort whose "native hue of resolution is sicklied o'er with the pale cast of thought", but there is hardly an expert left today, and none of the people bearing actual responsibility, who had not, in the thick of the monetary battles, longed for the arrival

of SDR openly or secretly, quite as keenly as the Duke of Wellington longed for the Prussians' arrival on the hills of Waterloo.

### A Constructive New Development

Special Drawing Rights, as they exist today, have been developed by gradual steps at successive currency conferences at The Hague (June 25, 1966), Luxembourg (September 12, '66), Munich (April 17, '67), London (August 26, '67), Rio de Janeiro (September 25, '67), and Stockholm (March 29 and 30, '68). Work on them was started at a time when people had long realised the many weak spots of the traditional gold currency standard but when, in the absence of an actual crisis, distant sheet-lightning produced the misleading feeling that

there was still much time left for a "true" reform of the system. Only when the storm broke, it became possible, in the light of its thunder-flashes, to recognise the truly constructive value of the new design.

What is the new system all about? Special Drawing Rights may transform the present currency system, which is based on dollar and gold holdings, into a multi-currency standard using as its basis all the most important national currencies, but they need not do it. Using SDR, countries will in future be entitled to draw any required currency directly against another one, which means that currencies will become directly convertible at fixed rates of exchange. Looking at SDR from this angle, and in the long term, they