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The Rules of the Game, from which this paper has been adapted, was chosen in 1984 to receive the American Society of International Law's certificate of merit for its preeminent contribution to creative scholarship.

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The Future of Gold

Kenneth W. Dam*

Changes in the international monetary system, whether by reform or evolution, are heavily influenced by political and economic developments. Those developments, by their nature, are difficult if not impossible to predict. Changes in the international monetary system are therefore also hard to foresee.

Only in retrospect can one detect a steady line of development from the gold standard to Bretton Woods to the current system. Even the international monetary events of a particular decade have seldom been anticipated by reigning opinion at the outset of that decade. Few would have predicted in 1910, the zenith of the international gold standard, that it would collapse four years later. In 1940 few would have foreseen that the Second World War would lead to a massive postwar planning exercise culminating in a scheme as ambitious as the Bretton Woods system and the International Monetary Fund. The end of the dollar shortage and the onset of the "dollar problem" in the 1950s were not generally recognized until after they had occurred. And although informed observers in 1970 realized that the U.S. commitment to sell gold at $35 per ounce might soon be abrogated, few anticipated either the 1973 move to generalized floating or the fundamental alterations in the world oil market that emerged during the ensuing decade.

Any discussion of issues concerning gold in the 1980s should make a sharp distinction between the role of gold in the international monetary system and the steps that might be taken with respect to the International Monetary Fund's holdings of gold. The latter is likely to be on the agenda even if, and perhaps especially if, gold is somehow actually phased out of the international monetary system.

The Fund's 100 odd million ounces of gold represent an enormous body of assets, especially at

*Harold J. and Marion F. Green Professor in International Legal Studies, currently on leave of absence from the Law School to serve as U.S. Deputy Secretary of State. This paper has been adapted from Mr. Dam's book *The Rules of the Game: Reform and Evolution in the International Monetary System*, chapter nine. The book, published in 1982 by the University of Chicago Press, was completed before Mr. Dam became U.S. Deputy Secretary of State. It is reprinted in revised form by permission.

the gold prices experienced in recent years. The fertile minds of Fund and national officials do not fail to consider ways of using those assets to remedy the limitations of the Fund and of other reserve assets.

Reform initiatives of one kind or another are likely to be successful in harnessing the financial power embodied in the Fund's gold. Whether the role of gold in the international monetary system will yield to such reform initiatives is a different question. Certainly U.S. and IMF officials seeking "to phase gold out of the system" found that incantation accomplished little, even when the Fund's Articles of Agreement were amended to replace gold formally with the Special Drawing Right.[1] As the manager of the Bank for International Settlements observed in 1980, "Gold may have no official status in the monetary system. But it is not unloved."[2]

Indeed, it is far from clear what objective indicators could be established to tell an observer whether, at any particular time, gold was becoming more or less important in the international monetary system. It is not even possible to say with any conviction whether gold was a more or less important factor at the end of the 1970s than it was, say, at the time generalized floating began in 1973. Although the Fund Articles of Agreement accorded it a less important role, its greatly increased price made it, when valued at market prices, a much larger portion of world reserves. The free market price of gold rose for the first time above $250 per ounce in 1979, reaching a peak of more than $800 per ounce in early 1980, and then returned to the $300–$700 range.[3] The effect on market price valuation of gold reserves was dramatic. By the end of 1979 official world gold reserves increased in market value to $485 billion, whereas nongold reserves totaled only $355 billion. Just three years earlier, at the end of 1976, the comparable figures had been $136 billion and $216 billion respectively. As a result, it has been

[1]The Report to Board of Governors by Committee of Twenty, 14 June 1974, declared that "the SDR should become the principal reserve asset, with the role of gold and of reserve currencies being reduced." IMF, *International Monetary Reform: Documents of the Committee of Twenty* (1974), p. 5.

[2]Rene Larre, quoted in David Marsh, "Gold Supplies Get Wise to a Surge in Demand," *Financial Times*, 7 July 1980.

[3]*Bank for International Settlements 49th Report* 1979, p. 152; *BIS 50th Report* 1980, pp. 147–48; *BIS 53rd Report* 1983, p. 154; Michael G. Martin, "The Changing Gold Market, 1978–80," *Finance and Development* 17 (December 1980): 40–43.

argued that by 1979 gold had "re-established its role as the principal reserve asset."[4]

The higher price was increasingly recognized in countries' calculation of their own reserves, as more and more countries adopted some market-related method of calculating the value of gold reserves and abandoned the use of the old official price.[5] The allocation of European Currency Units against gold, with gold valued at the London market price, provided a means of realizing on the higher price of gold without actually selling it. One of the questions about the significance of the higher price of gold is whether it could be sustained if monetary authorities actually supplied gold freely to the market in the same way they supplied dollars in times of payments deficits. Despite the resilience of the gold market in the face of sales by the IMF Trust Fund, the U. S. Treasury, and other monetary authorities, gold has remained "at the bottom of the pile" for most governments.[6] The issuance by the European Monetary System of European Currency Units against gold valued at the market price is, in this light, a potentially important way of remonetizing gold without disturbing its market price.[7] The contribution of the European Monetary System to a revitalized role for gold may in fact turn out to be one of its principal long-term effects.

A Return to the Gold Standard?

A possible return to the gold standard is a subject that attracts many popular writers on monetary

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[4]John Makinson, "Concealed Buffer for Central Banks," *Financial Times*, 30 July 1980, supplement on gold (hereafter cited Makinson). See also *IMF Annual Report* 1980, p. 59, table 14; gold accounted for 57 percent of the total value of world reserves in May 1980. By March 1983 its share had fallen to 52 percent. *IMF Annual Report* 1983, p. 68, table 14. See also *BIS 50th Report* 1980, p. 151. The BIS points out the difficulty of establishing "the actual increase in the effective value of gold reserves." Ibid. p. 150.

[5]Joseph Gold, *Floating Currencies, SDRs, and Gold: Futher Legal Developments* (IMF Pamphlet Series, no. 22, 1977), pp. 52-54; Joseph Gold, *SDRs, Gold and Currencies: Third Survey of New Legal Developments* (IMF Pamphlet Series, no. 26, 1979), pp. 33-34; Makinson surveys national gold pricing practices as of July 1980.

[6]Canada sold gold in 1980. *Bundesbank Annual Report* 1979, p. 58; "Canada To Sell More Gold from Reserves," *Financial Times*, 6 August 1980. IMF gold sales ceased in 1980. *IMF Annual Report* 1983, p. 88, table 22.

[7]On the effect of the use of gold market valuation of ECUs, see *IMF Annual Report* 1980, p. 60.

affairs and some economists as well. Interest in such a return rises when inflation seems most serious because the gold standard represents financial probity and price stability. But few advocates spell out exactly what they mean by "the" gold standard, apparently assuming that everyone understands by that term the perfectly automatic system that operated before World War I. This mythical gold standard is believed to have functioned without the aid of human hands, particularly those of central bankers and finance ministers. When examined more critically, it reveals itself as a form of sterling standard which exhibited many features that we normally think of as recent developments, such as floating exchange rates, intervention in exchange markets, and central bank lending and borrowing. Nonetheless, the myth of the self-regulating gold standard was widely believed at the time, or at least was hastily created after the demise of the gold standard at the onset of World War I.[8]

The increasing popularity of proposals for a return to the gold standard represents more an expression of lack of confidence in money and in the economic policies of contemporary governments than any concrete plan for a radical reform of the international monetary system.[9] Any specific proposal by a government for a return to the pre-World War I gold standard would be met by a host of practical objections. Proponents of a gold standard rarely make clear how, in democracies, voters and interest groups can be persuaded to abandon the insistence on government action—responsibility for employment, interest rate policy, social welfare transfers, and all of the other policy objectives that led to the abandonment of the interwar version of the gold standard in the 1930s. Political innocence about government spending and monetary policy was lost, and it is difficult to see how it can be reestablished.

Opponents of a gold standard proposal would surely point to the great volatility of the gold price in recent years as making gold a singularly inappropriate anchor to which to tie not only a new international monetary system but also the fate of each national economy. To meet this point it is

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[8]See Kenneth W. Dam, *The Rules of the Game: Reform and Evolution in the International Monetary System* (1982), pp. 14–40, especially pp. 15–17.

[9]See, however, the proposals in Arthur B. Laffer, *Reinstatement of the Dollar: The Blueprint,* Economic Study, A. B. Laffer Associates (29 February 1980), pp. 3–5.

often proposed that the principal central banks peg the price of gold.

The difficulties faced by the IMF's commodity stabilization and buffer stock plans suggest the difficulties that any gold-pegging plan might encounter. Such proposals confront two kinds of problems. The first is the economic problem of how to make such a pegging operation successful. Much of course would turn on the initial price chosen. Although the recent volatility of the gold price makes a correct choice difficult, the difficulties can be exaggerated. The price was successfully pegged throughout the Bretton Woods period. Governments have, in principle, an unlimited amount of their own currency available to support the price of gold, though they may have to pay inflationary consequences if they in effect print money to do so. Many have vast stocks of gold available for sale to prevent the gold price from rising. The Fund's gold might be used in support of such an agreement. A product in which reserve stocks are roughly forty times as large as annual production is obviously different from commodities like tin or coffee.

The second problem involved in pegging the gold price arises from the legal and institutional arrangements for sharing the burden of doing so. The United States unilaterally undertook that burden at Bretton Woods, even though it did not stand ready to buy and sell at the $35 per ounce price except in transactions with official institutions. Only later did burden sharing arise, and that was because the private market price was pegged. The Gold Pool of 1961 was the device through which this sharing was accomplished, though it broke down in 1968 when the two-tier system was adopted.[10]

The largest problem connected with burden sharing, and hence with any policy of gold price pegging, is the underlying exchange rate scheme. The greater the reliance on exchange rate changes and particularly on floating, the more complicated must be the arrangements for allocation of the responsibility for intervention and for risk of loss. Moreover, each exchange rate change becomes a gold price change in at least one country. Hence, the greater the volatility of exchange rates, the greater the opportunities for speculation in gold markets and the more often the resolve of the pegging central banks is likely to be tested.

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[10]On the Gold Pool, see Dam, *Rules of the Game,* pp. 137–38.

The pegging of the gold price, however successful, would not constitute a return to the gold standard. Accomplishment of the goals of many gold standard proponents would require some more direct link between national currencies and gold. A system in which countries can escape the discipline envisaged by gold standard advocates through repeated devaluations offers few advantages. Indeed, it would merely put the world back in the same position that all countries other than the United States were in during the Bretton Woods period. The pre-1914 gold standard involved redemption of currency in gold at the instance of private parties and the circulation of gold coin as well. And it also involved a direct link between the money supply, or at least the supply of currency, and the quantity of gold in the coffers of the monetary authorities. As Edward M. Bernstein has noted, "The significant characteristic of the classical gold standard was not that the currency was defined in terms of gold or even that it was redeemable (convertible) in gold, but that the expansion of the money supply was limited by the gold reserves."[11] It takes a considerable stretch of imagination to conceive of modern governments agreeing to accept any such constraints on their economic policies, and an even greater leap of faith to expect any such agreement to gain the credibility that would be necessary for long-run success. Who would believe that modern governments would continue to tie their hands with these gold standard obligations in the face of popular dissatisfaction and electoral opposition?

For these reasons it is unlikely that a return to a gold standard could be accomplished through technocratic reform, and especially through multilateral diplomatic negotiations. But a return by national action in one or two key countries is not inconceivable. It might become possible if unprecedentedly high rates of inflation were destroying the fabric of political life and creating a social revolution in even advanced industrialized countries. The conditions might then be created in which the government and the people would be willing to forgo the luxury of flexibility in fiscal and monetary policies and submit themselves to the external control of an arbitrary and unyielding external standard like gold for the sake of economic and social stability. The runaway German inflation of 1923 was

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[11] Edward M. Bernstein, "The History of the International Monetary Fund, 1966–71," *Finance and Development* 14 (December 1977): 17.

brought to a halt in part through the device of purportedly backing the currency with land; that it might not work or was at base legerdemain did not matter to the populace, which was ready to accept anything that might bring the juggernaut of inflation to a halt. Surely a gold standard is a more plausible and rational economic mechanism than the German rentenmark scheme.[12]

The fact that the gold standard developed at the national level and became an international system only through the interaction of separate national systems rather than through any international agreement lends some plausibility to the notion of a gold standard starting in one country and then, having proved itself there, spreading into an international system through emulation by other countries. Yet what country would be first? Any country so racked with inflation that it would be prepared to accept the rigors of the gold standard would surely long since have lost most of its reserves, unless it had previously refused to intervene to support its exchange rate. Certainly the United States would find it difficult to move to a gold standard in the pre-1914 sense since its reserves, measured net of external liabilities, are negative, even when gold is valued at the market price.[13] Thus, even the notion of a gold standard, spreading outward from one or two successful countries, is probably only a nostalgic fairy tale.

On the other hand, the nostalgia for a gold standard might be an important factor supporting a return to a fixed-rate system. Against the background of the floating period since 1973, a fixed-rate system with several governments willing to support their currencies through gold sales in addition to foreign exchange market intervention

[12]On the rentenmark scheme, see Leland B. Yeager, *International Monetary Relations: Theory, History and Policy,* 2d ed. (1976), p. 315; William Adams Brown, Jr., *The International Gold Standard Reinterpreted, 1914-1934* (1940), 1:362-65.

[13]In the first quarter of 1978, gross U. S. reserves (including gold valued at the official rate) were $19.2 billion; external liabilities were $207.2 billion. Even after valuing the gold component at a later market price figure of $500 per ounce, gross reserves amounted to no more than $146.2 billion, still less than external liabilities. IMF, *International Financial Statistics* 33 (July 1980): 402-3. By February 1982 (the most recent period for which *IFS* carries a figure for U. S. external liabilities) the disparity between reserves and external liabilities was even greater, for gold holdings had declined as had the market price. U.S. gross reserves, including gold valued at the official rate, were $30.1 billion, while external liabilities were $360.1 billion. IMF, *International Financial Statistics* 35 (August 1982):426-27.

could be presented under the gold standard banner. But it would be far from the pre-1914 model. Indeed, it is hard to imagine that a radical solution, either a return to the gold standard or a comprehensive reconstruction of the international monetary system, is a likely outcome for the 1980s. The more probable lines of development lie, as so often in the past, along the two competing paths of reform and evolution. Down the reform path lie further legal and institutional efforts to promote the Special Drawing Right, the IMF's reserve asset created in 1969, and to bring the IMF back to the center of the international monetary system by expanding its borrowing and lending power and perhaps its regulatory power. Down the evolutionary path might lie a movement toward a multiple reserve currency system, despite recent weakening of this trend.[14]

Progress along either path is likely to involve new levels of complexity in legal rules. The period since 1945 has shown that an international system of rules such as that formulated at Bretton Woods requires pragmatic, evolutionary interpretation as well as occasional constitutional reform. Some of the changes merely gave shape and meaning to existing rules, but others were of such originality that no one at the Bretton Woods negotiating table could have foreseen them. Attempts to adapt the system to changing circumstances and to incorporate the contributions of institutions and organizations legally external to it produced unprecedented and successful innovations such as the General Arrangements to Borrow and, for a time, the Gold Pool. Attempts at root-and-branch reform produced a new international financial instrument, the SDR. Neither evolution nor reform could prevent the breakdown of the Bretton Woods System in the early 1970s, but the arrival of floating exchange rates was accompanied by the intensive reform negotiations in the IMF and by development of an alternative European "system."[15] The changes and crises of the late 1970s and early 1980s have produced a host of proposals for new rules, but all are far from the self-adjusting system of the idealized gold standard in the legendary past.

[14] *IMF Annual Report* 1983, p. 72, table 16, and p. 73.

[15] On the IMF, see Dam, *Rules of the Game*, ch. 7, "Reform and the Committee of Twenty," pp. 211–52; on the European Monetary System, see ibid. pp. 328–38.

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