GOLD, MONEY, INFLATION & DEFLATION

A Garland Series

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AMERICA WEIGHS HER GOLD

CHAPTER I

THE GOLD

AMONG the world's most sacred institutions in this period of its history is the gold standard. Selected and handed down to us from a distant past, it has come in time to be regarded as one of the laws of the Medes and Persians. Woe unto him who dares question either its perfection or its permanence.

Perforce abandoned or severely modified during the currency disturbances of the war and post-war years, by its general restoration it seems to have gained an added prestige. To its temporary suspension, the thinking public the world over tacitly attributed many of the serious difficulties of the recent inflation *régimes*. Hence, to its re-establishment—often at great cost—by most people, nothing but good was attached. Once more, upon it rest the monetary systems of almost the entire civilized world, and, to it, few indeed are yet willing to attribute any existing monetary evils. An understanding of this basic and generally accepted institution is essential to any discussion of the current gold problem.

Strange as it may seem, this time-honored standard which sets the *values* of the monetary units throughout the civilized world is no value-standard at all. On the contrary, the monetary units are defined as given weights of fine gold. To the vicissitudes of the values of these weights of one of the precious metals, used now as always primarily as a means of adornment, the value-standards of the world must continually adjust themselves. To these almost continuous and extraordinarily clumsy adjustments—forced by definition and left largely to chance and to manipulation—many of our present most serious economic difficulties can be traced. A brief discussion, however tedious it may be, of the outstanding features of the system is therefore necessary.

Under a gold standard, the monetary unit being defined as a given weight of fine gold, all gold brought to the mints, or to other governmental agencies, is freely coined. In turn, on the melting of the money thus coined, no practical restrictions are imposed. Besides, all other moneys of the country are in general redeemable in gold coins or bullion. It follows, therefore, that so long as the standard is maintained, the government undertakes not only to buy at a fixed price all gold brought to it, but likewise to sell at the same price all that is demanded. To the above provisions are added—though frequently revoked—those assuring the free import and the free export of the money metal.

Throughout the gold standard world, therefore, gold is the one international commodity with an unchanging price. At this price it is freely bought and sold in theoretically unlimited quantities. Partly as cause, partly as result, it follows that all international balances between such countries are ultimately paid in gold. Hence, to the extent of these outgoing and incoming balances, gold moves to one country or to another.

Since gold is thus connected with the monetary units, and they in turn with prices, it follows that gold and prices are likewise interconnected. These numerous and frequently debated interconnections form much of the subject matter of the voluminous tomes on monetary theory. For present purposes, it is enough to call attention to the fact that part of the existing stocks as well as of the annual new supplies from the mines are used in the arts, and part in money. Together these two parts make up the total demand for gold. Thus, on the basis of existing supplies, the value of gold relative to other things is largely determined. And since in gold standard countries gold and money are interchangeable, it follows that the value of money relative to other things is likewise thus measured. Moreover, while the use of elastic banking and monetary systems and of gold exchange standards modify greatly the monetary demand, and hence the total demand for gold; so long as the gold standard is maintained, this particular relation between gold and prices continues to hold. In any attempt, therefore, to visualize the gold situation and to interpret its possible effects on prices, it is important to consider, in connection with gold demands of all sorts, not only stocks and current production but their division into monetary and non-monetary uses. First will be considered the monetary gold needs.

A country on a gold standard must keep on hand a stock of the monetary metal for several well-defined but uncertain needs. To maintain the standard, an adequate supply must be held to meet at all times any demands which may appear for the redemption in gold of other moneys or of bank deposits. Under ordinary circumstances, the main source of such demands is from gold exporters, who, drawing upon their accounts at the central bank, may on any day require sudden large and unforeseeable amounts. In these days of huge international credits (to be discussed in detail later) such withdrawals may indeed reach disturbing proportions. To these demands are added those of the goldsmiths who in certain countries find it convenient to supply their needs for raw material directly from the government or from the central bank as its fiscal agent. Also, in periods of financial stress, when confidence either in the solvency of the government or in the safety of the monetary system has been shaken, other very large and unpredictable demands may come from the holders of paper currency, for various reasons of their own, bent on using their privilege of turning it into gold. Furthermore, a large gold reserve must be held by the central banks for more or less sentimental purposes. In certain countries—most notably perhaps in France—such hoards have come to occupy so important a place in the hearts of the people that substantial reductions can be accomplished only in the face of strong public disapproval. Finally, in the minds of many, remains the idea of an essential war-chest of gold.

Against these uncertain demands, varying amounts of gold are held. In most countries, in order that the amounts may under no circumstances become too small, statutory restrictions as to minimum reserves of the central banks have been imposed. While these restrictions very fortunately have in general been given a considerable degree of flexibility, they nevertheless serve to "tie up" and to hold completely unusable very large stocks of the money metal, for which the demand has thus been in like measure enhanced.

In spite, however, of all these restrictions and of the changing attitudes toward gold in one country or another, a certain automatic adjustment of supplies to needs—real or imaginary—has in time taken place. At any rate such has been the assumption. In the classical economic theory, gold shortages and gold surpluses were alike impossible. An oversupply of the money metal, according to that theory, led automatically to increases in the money and credit supplies. This increase soon resulted in a rise in prices which, unless accompanied by similar rises in other countries, led in turn to an increase in imports, a decrease in exports, and hence to a shipping away of the excess gold supplies. Conversely with shortages, the undersupply of gold, by reducing money and credit supplies, would reduce prices, increase exports, decrease imports, and hence in a short time lead to an inflow of the needed money metal sufficient to restore the international price equilibrium.

Prior to the sometimes sluggish price adjustments, international credits could be depended upon to relieve temporary excesses or deficits. The low interest rates almost sure to arise with oversupplies of the money metal would lead to a flow of funds to more favorable money markets, and gold would quickly follow in their train. The high rates in the countries of gold undersupply would, on the contrary, lead to prompt inflows of funds, imports of gold, and hence to speedy relief from monetary shortage.

In the post-war period, however, such speedy and automatic adjustments as had been anticipated by the classicists at least temporarily failed. After more than a decade of the most extraordinary currency phenomena the world has ever known, the distribution of the monetary gold stocks is as shown in the accompanying chart.[1]

For purposes of comparison are added similar data for 1913, along with changes in the gold holdings of central banks and of governments during the intervening period. Of especial significance are the gigantic increase in the share of the United States and the great reductions in those of England, of Russia, and of Germany. France appears to have gained relatively little, but, on account of very large French holdings in London and in New York of short-term credits immediately convertible into gold, her share is virtually much larger. The rest of the world as a whole has about held its own.

How, under the operations of our modern economic machinery, is this apparent maldistribution of the much-demanded yellow metal possible? Is it destined to continue? Why, in recent years, have the assumed corrections to such a situation broken down? What is the part played by the United States in the happenings of this period of continuous readjustment not yet ended? Finally, is there any vague evaluation of the effects of these extraordinary happenings on the economic life of the United States and of other parts of the world? Before even a tentative answer can be given to many of these questions, other aspects of the gold situation must be considered.

According to the estimates of the United States Bureau of Mines, considerably more than half the gold used by man in historical times has been brought out of the ground since 1900. Yet, in spite of this enormous recent production, it is entirely clear that certain of the more highly developed sections of the world are actually suffering from gold shortages. Moreover, the fact that these shortages are a mere counterpart of the maldistribution described above only intensifies rather than solves the extraordinary gold problem with which this generation is faced. It is therefore important to consider in some detail both the production and the consumption of the metal.

In gold-mining, unlike other industries, the operator finds two distinct markets but only one unchanging price for his product. So much of his output as is desired at the fixed price is taken by the manufacturers of gold articles of all sorts; the remainder goes automatically to the mints or to the bullion reserves of the gold-standard countries. As has been explained, the unique fixed price grows directly out of the provisions of the gold standard itself. In the United States, for example, fine gold always sells for $20.67 an ounce, for the simple reason that the Government, through its free-coinage provisions, agrees to pay exactly that price for all gold brought to its mints or to other designated agencies, while, by imposing no practical restriction upon the melting of its purposely full-weight gold coins—into which all other money is readily convertible—it virtually sells gold at the same price.

How much gold has been produced in recent years and how it has divided itself between monetary and industrial uses can be seen from the accompanying chart.[2]

Of the total production, perhaps the most notable features are the very great and continued increase in the twenty-five years just prior to the outbreak of the World War, the equally abrupt decline in the seven years, 1916–22, and the subsequent though gradually "damped" rise in the decade just ended. In the non-monetary demands, and hence in the residual supplies available for monetary purposes, the extraordinarily violent fluctuations are most noticeable. Both of these observations are of prime importance in any attempted understanding of the gold problem.

It has sometimes been assumed that gold, on account of its fixed price over a large part of the economically developed portion of the earth's surface, undergoes enlarged consumption and reduced production when prices in general are high; and conversely, reduced consumption and enlarged production when they are low. Indeed, some have gone so far as to contend that these influences will automatically and speedily correct any temporary shortage or surplus in the stock of the money metal. It should be profitable, therefore, to see whether this contention has been confirmed in the experience of the past forty years. Chart II will be of assistance.

While the great increase in gold production beginning in 1891 came after eighteen years of generally falling prices, and while the abrupt decline in production in 1900 occurred after three years of rising prices in the United States, the further rapidly increasing output was not halted until 1912 in spite of the fact that prices were rising almost continually throughout that period. With the abrupt rise in prices which began under war conditions in 1916, the output of gold likewise started an almost equally abrupt decline, and did not increase again for more than a year after the phenomenal fall in commodity prices that began in the middle of 1920. Since 1922, while the price level trend has very gradually declined, gold output has gradually increased.

It seems clear, therefore, that, while the pronounced movements of commodity prices in general have usually been accompanied or followed by reverse movements in the output of gold, the big and most significant movements in gold production must be attributed to other influences. At least the gigantic increases in the final decade of the last century and in the first of this can only be accounted for by the utilization of rich new deposits and by highly improved methods of mining operations, neither of which can be attributed directly to the price-level movements. So, in spite of the recent drastic declines in prices, it clearly cannot be assumed that—except accidentally—present gold shortages will be eliminated by early increases in production. In fact, both of the available estimates of future production to be discussed later indicate a downward rather than an upward trend.

The violent fluctuations in non-monetary demands have a much simpler, if a more extraordinary, explanation, which appears clearly when the takings of India, China, and Egypt are deducted from the totals. How much of these fluctuations can thus be laid at the doors of these three countries is evident from Chart II.

As is well known, India is the chief disturber. Apparently because of increased prosperity, on account of an unusual number of weddings, or for other materialistic or sentimental reasons, greatly enlarged demands suddenly make their appearance, continue for a variable length of time, and then disappear as suddenly and as mysteriously as they came.

With these eccentric demands eliminated, the more even industrial consumption of the rest of the world will be briefly considered. Obviously (see Chart II) it was little affected by price changes. While, in the period of moderately rising prices, 1896–1914, the western industrial consumption of gold likewise gradually increased, during the much more rapidly rising price period of the war years immediately following, its consumption was considerably curtailed, but rose again immediately after the War ended. With the drastic decline in the general price level again in 1921, this gold consumption likewise declined and continued reasonably nearly constant in the following period of relatively stable prices.

While it is clear therefore—due allowance being made for war conditions—that the western consumption of gold in the arts does in general vary in a predictable direction with big changes in the price level, perhaps its most noticeable feature is its high degree of constancy from year to year. Apparently one of the most primitive of all our savage urges, the love of adornment, maintains—at least in the civilized world—an extraordinarily persistent and unchanging level. When to this relatively constant demand is added the great and highly fluctuating ones of the peoples of the East, forecasts of total consumption become little more than guesses.

Nevertheless, in spite of all these difficulties, working estimates of future production and future consumption of gold for the next decade[3] have