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*“The Euro, the Dollar and Gold”*

# The relationships between currencies and gold

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**1.** "If a gold standard had never existed, it might be necessary to invent something of the kind". This quotation from a monograph by Dennis Robertson (*Money*, 1928, p. 122) refers to one of the positive aspects of the gold standard: that of shielding central bankers from pressures to increase the money supply. After the First World War the return to gold was in fact the overriding objective of economic policymakers, in order to ensure monetary stability.

The economic disequilibria produced by the war were so pronounced, however, that they made it hard to re-establish the gold standard. The cost, in terms of welfare, imposed by inflation, rising public debt and war reparations was so high that it prevented the rapid return to gold.

The Genoa conference of April 1922 laid the foundations for an important innovation: the creation of the gold exchange standard, under which gold was flanked by convertible currencies and central banks were granted greater autonomy; this was to be used to stabilize the value of gold, through international cooperation. However, the new system did not enjoy the same credibility as the earlier regime and, at the same time, failed to leave the monetary authorities sufficient room for manoeuvre. Culturally still under the influence of the gold standard, the monetary authorities were in any case little inclined to cooperate and tended to accumulate gold reserves, thereby exerting powerful deflationary pressure on the economy.

The monetary disorder of the thirties created the need for a new reform, which was implemented after the Second World War with the Bretton Woods agreements.

The suspension of the dollar's convertibility on 15 August 1971 officially cut the link between legal tender and gold — an epochal change after more than two thousand five hundred years during which money had always been based explicitly or implicitly on a precious metal, prevalently gold.

**2.** The abandonment of a monetary system hinging directly or indirectly on gold was a consequence of the severe economic disequilibria that developed between the two world wars. The advances made in monetary theory also exerted a powerful influence.

Ricardo provides us with a clear indication of the main objective of the gold standard: “To secure the public against any other variations in the value of currency than those to which the standard itself is subject, and, at the same time, to carry on the circulation with a medium the least expensive ... ”. He also noted that: “Experience, however, shews, that neither a State nor a Bank ever had the unrestricted power of issuing paper money, without abusing that power: in all States, therefore, the issue of paper money ought to be under some check and controul; and none seems so proper for that purpose, as that of subjecting the issuers of paper money to the obligation of paying their notes, either in gold coin or bullion.” The same concepts are to be found some hundred years later in Irving Fisher.

The success of the gold standard was due, among other things, to the broad consensus on metallism and the classical model; one of the latter’s key features is the self-adjusting ability of the economy.

The restoration rule, which required the gold parity to be re-established after a period of suspension due to exceptional circumstances, was an essential part of the gold standard. Short suspensions of convertibility made it possible to overcome temporary difficulties. The system allowed discretion to be exercised only within very rigid limits. Gold acted as an anchor both for the monetary system and for the economic system by making maintenance of the parity a constraint on economic policy.

A commodity standard, however, is not without its weaknesses, owing to the impossibility of controlling the money stock in the face of exogenous fluctuations in the quantity of metal. Given the short-run non-neutrality of money, countries suffered substantial welfare costs in deflationary periods, as in the closing decades of the nineteenth century. During the heyday of the gold standard several proposals were put forward to overcome this difficulty: Jevons's revival of the tabular standard, Marshall's symmetallism and Fisher's compensated dollar. Wicksell even suggested cutting the link with precious metals altogether, thus anticipating by a quarter of a century Keynes's radical approach in the *Tract on Monetary Reform* (1923).

England's ephemeral return to gold in the first half of the twenties and, just a few years later, the terrible impact of the Great Depression greatly affected economic and political thinking.

The discussion on monetary reform ceased to be confined to the purely academic domain. The advocates of reform (including, albeit with different approaches, economists such as Keynes, Fisher, Hawtrey and Robertson) focused primarily on the "artificialness" of the value of gold: demand for the metal depended crucially, among other things, on the conventions that governed the monetary systems of the various countries. While Keynes held that gold had exhausted its monetary role, other economists, such as Fisher and Hawtrey, continued to assign it a leading part, although they envisaged that central banks would neutralize the variations in its value — with the result that gold itself would be anchored.

Keynes's once heterodox view became widely accepted, since the malfunctioning of the monetary system was seen as one of the main causes of the propagation of the Depression.

On the eve of the Second World War, the need to reform the monetary system faced economists with an intellectual challenge. For the first time in history, experts designed a new monetary "order", to use Professor Mundell's expression.

The Bretton Woods architects set themselves the objective of re-establishing a fixed exchange regime and allowing each country to pursue a full-employment policy by means of capital controls. Parity changes were to be permitted only in the event of "fundamental disequilibrium", which was not defined.

In practice the system turned into a fixed-rate dollar standard. The importance attributed to domestic targets in the economic policy of the United States undermined the coherence and operation of the system, thereby preparing the ground for the abandonment of the link with gold and the move to floating exchange rates.

**3.** In the decade immediately following the breakdown of the Bretton Woods regime, the world economy became prey to high and variable inflation. This tendency was subsequently halted when, after absorbing the effects of the real shocks of the seventies, monetary policies were directed with greater determination to restoring price stability. Floating exchange rates proved highly volatile.

In the last thirty years the international monetary system has come to find itself in a position where the expansion of credit and the creation of money have not been constrained, at the global level, by binding rules. After the about-turn in the monetary policy of the Federal Reserve at the end of the seventies, the restrictions imposed on the stock of money in the leading countries put a brake on monetary growth. Nonetheless, the combination of fiat money and the possibility of short-term capital movements between the different parts of the world has led to a system which does not permit the expansion of credit to be closely controlled and which is inherently unstable.

In this context price stability is ensured in the leading countries; to some extent their behaviour then influences that of the world economy.

Economic theory has taught us, rigorously (consider, for example, the analysis put forward by Patinkin), that even with fiat money the price level can be determinate when the central bank exercises control over the nominal quantity of money.

The creation of important monetary areas — that of the euro alongside those of the dollar and the yen — contributes to the stability of the world economy, even though many countries remain outside these areas.

The expansion of credit at the international level is closely connected with the operation and stability of banking systems and capital markets.

Important steps are being taken to subject countries outside the main monetary areas to standards of banking supervision that help to ensure the orderly expansion of credit and money.

**4.** In the absence of rigorous control over the quantity of money at world level, the last two decades have seen crises that, despite their occurring in just a part of the globe, have triggered a combination of inflation and deflation, with the destruction of some of the savings accumulated in banking systems and slowdowns in the growth of economies. The crises have become more frequent in the last five years and their effects more far-reaching as a consequence of contagion.

The enormous advances made in data processing and telecommunications have fostered a growth in international monetary flows and total financial assets that has far exceeded the expansion of the world economy. This has undoubtedly contributed to the growth in productive investment at the global level in a period marked by low inflation, attributable in part to the increased competition in trade in goods and services and especially raw materials.

The last five years have been marked by very rapid growth in the stock of financial assets made up of public and private-sector securities and bank deposits. The expansion began in 1995 at the time of the decision to carry out massive interventions in the foreign exchange markets in order to correct the pricing distortions between the dollar and other weak currencies on the one hand and the yen and other strong currencies on the other. On that occasion sales of yen against dollars amounting to several tens of billions of dollars were made; at the same time, a policy was adopted aimed at reducing yen interest rates until they were close to zero.

The expansion of yen-denominated liquidity enabled the dollar and other weak currencies, including the lira, the peseta and sterling, to strengthen. The global market saw the start of bond and share purchases by highly-leveraged intermediaries; the latter borrowed funds at low cost and then invested in financial markets, making substantial use of derivative instruments.

The parallel growth of the New Economy in the United States, consisting essentially in an increase in the productivity of capital and labour connected with the large-scale application of information technology to production, led to a flow of capital to the United States and a continuous rise in share prices, which, in five years, roughly tripled.

The ratio of financial wealth — shares, bonds and the money stock — to annual GDP at current prices rose from 240 to 360 per cent.

The growth of derivatives makes it possible to carry out transactions with very high leverage, increases the velocity of circulation of the money balances used for financial transactions.

Interest rates and the cost of capital have decreased. The recovery of the world economy, under way since 1999, is connected with these developments.

The American economy, performing as a high-growth component of the global economy, attracts capital while simultaneously helping to sustain economic activity in the rest of the world with its imports.

The low cost of capital is helping the expansion of investment in Europe and other parts of the globe. These developments can be said to have constituted an application on an international scale of the process, theorized in the past by Tobin, of monetary expansion increasing the value of the existing capital stock and thereby stimulating investment.

The process up to now has followed a virtuous course, without excessive inflationary pressures thanks to heightened competition and productivity gains in the United States. Its Achilles' heel is the rise in the prices of raw materials and energy products.

**5.** The gold reserves of the central banks today amount to some 32,000 tons, about one quarter of the world stock.

Like other real assets, gold can appreciate when there is widespread inflation, which remains a threat.

Gold's importance as a monetary anchor came to an end with the emergence of more rigorous monetary policies in the eighties and especially the nineties. But in periods of crisis gold can constitute a sort of reserve or guarantee "of last resort" for a country, as Italy demonstrated during the seventies.

This view appears to be shared by the central banks of the leading industrial countries; when they signed the September 1999 agreement, they stated that gold continued to have an important role to play in the management of global reserves.

It is up to economists to analyze whether and to what extent, in an international monetary system that has surely not yet become fully consistent in many of its parts, reference to gold, which performed a monetary function for thousands of years, can still contribute, in the decades ahead, to preserving that fundamental condition for orderly economic activity — price stability.

The experience of the period following the Second World War shows that macroeconomic stabilization has always provided the basis for the growth of the most successful economies. Conserving this stability and the soundness of economies' fundamentals is one of the principal tasks of governments and central banks.