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Roy Harrod on the Role of Gold Today — 8 pages

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J. Herbert Furth.

For many years Mr. Harrod has been one of the most vocal advocates of an increase in the price of gold. In a paper given appropriately at the University of the Witwatersrand in Johannesburg, Union of South Africa, on January 8, 1958, 1/ he repeats his arguments and undertakes to bring them up to date.

Mr. Harrod believes that an increase in the price of gold would benefit the world for two reasons: first, because it would improve the current-account position of non-dollar countries by raising their exports; and second, because it would improve the reserve position of all countries, within and outside of the non-dollar area.

Improvement in current-account position

Mr. Harrod reminds his audience that as early as 1952 he came to the conclusion "that the biggest single cause of change in the international pattern of payments was the great shrinkage in the value of shipments of newly mined gold. . . . If this displacement in the value of gold shipments had not occurred, the imbalance of the rest of the world in 1950-52, and particularly of the Western European countries, with the United States would have been of quite manageable proportions" (p. 3).

Even today, "the changed position of newly mined gold in the over-all pattern remains a main cause of the chronic difficulties of Europe on her dollar account. . . . She has by manful efforts increased her exports to the dollar area, but not by enough to compensate for the diminished value of the annual supply of newly mined gold becoming available for monetary use." Because of "the diminished relative value of the yearly gold output . . ., the continuation of some discriminatory restrictions on United States imports has been necessary" (p. 4). The failure to increase the value of gold has been particularly troublesome for the European countries because it was "superimposed on a deterioration of their over-all balances of payments with the rest of the world as a whole, owing to the loss of investment income and worsened 'terms of trade'" (p. 5).

This argument is based on two assumptions: first, that Western Europe as a whole has "continuing dollar difficulties" (p. 4); and second, that an increase in the price of gold, raising not only the value but also the volume of gold produced in the free world, would be sufficient to iron out these difficulties. It will be shown that both assumptions are unjustified.

Europe's "continuing dollar difficulties" -- If Europe really had suffered from "chronic difficulties on her dollar account" since 1950, European gold and dollar holdings since that time would presumably have been reduced, or at least not greatly increased. Actually, they rose between December 1949 and March 1958 (latest available date) from $8.3 billion to $18.9 billion -- hardly a symptom of an aggregate "unmanageable" dollar deficit. It is true that within the European area several countries

1/ The South African Journal of Economics, March 1958.

occasionally suffered from dollar deficits; however, in view of the experience of the area as a whole, it seems reasonable to conclude that individual deficits were attributable more to developments within the countries affected than to a problem common to the area as a whole.

Moreover, if Europe's trade had been hampered by "continuing dollar difficulties", European imports would either have been prevented from rising, or would have risen in conjunction with increasingly severe discriminatory restrictions against the dollar area. Actually, these restrictions have been continually relaxed until those European countries that still use them at all might be forced to confess that they are doing so primarily as an excuse to protect individual domestic industries rather than as a means to avoid a balance-of-payments deficit. Simultaneously, European imports have risen from $24.9 billion in 1950 to $48.2 billion in 1957, a rate of increase slightly higher than that of the rest of the free world. These developments, particularly when viewed in the light of the great increase in Europe's gold and dollar holdings, do not indicate any shortage of international means of payments.

The lack of realism in Mr. Harrod's presentation is evident by his mention of "worsened terms of trade". It is true that the terms of trade (export prices divided by import prices) worsened between 1937 and 1950 for Continental Europe from 107 to 99 and for the United Kingdom from 115 to 100 (1953 = 100). However, they also worsened for the United States from 131 to 100; if the terms of trade were decisive for a country's balance of payments, the United States would have been worse off than Europe. Moreover, since 1950 the terms of trade have improved for Continental Europe to 101 and for the United Kingdom to 104; therefore, for the period after 1950 -- when the lagging price of gold allegedly started to play its sinister role -- it would be misleading to speak of "worsened terms of trade."

Role of gold shipments -- The foregoing data show that Europe's reserve position has greatly improved since 1950, that its foreign trade has greatly expanded, and that it therefore has not needed an increase in the price of gold in order to be rescued from non-existent "chronic" difficulties. Moreover, if Europe had been in such need, it will be shown that an increase in the price of gold would have been of no help.

Mr. Harrod chooses the year 1937 as a basis for his comparisons of pre-war and post-war situations. This choice -- usual with advocates of an increase in the price of gold -- is questionable, to say the least. In 1937, the after-effects of the great depression, on the one hand, and of the recent rise in the dollar and sterling prices of gold on the other, made for a very low level of foreign trade, a very high level of gold reserves, and thus for an abnormally high ratio of reserves to world trade.

Moreover, as will be demonstrated, not even the choice of such a questionable base year suffices to validate Mr. Harrod's findings. It is true that gold production outside of the United States and Canada fell from

$917 million in 1937 to $820 million in 1957. And indeed, if we assume that a doubling of the price of gold would have kept production in 1957 at the level of 1937, the value of gold output in 1957 would have been about $1 billion higher than it actually was. Mr. Harrod himself assumes, in addition, that the entire difference would have been available to Europe as a net addition to its exports to the dollar area, and he also assumes that this difference would have vitally affected the trade balance between Europe and the dollar area.

It is quite true, of course, that an increase in the price of gold would have benefited the gold producing countries and -- assuming that they had sufficient idle factors of production available to increase the volume of gold production without reducing the volume of other outputs -- would have enabled them to import about $1 billion more goods and services per year than they actually did. This effect on the gold producing countries would have been identical with the effect on copper producing countries of an increase in the price of copper, and on banana producing countries of an increase in the price of bananas. And similarly, the effects on the rest of the world would have been identical in the three instances: just as countries that do not produce copper and bananas are not directly benefited by an increase in the price of copper and bananas, so countries that do not produce gold would not be directly benefited by an increase in the price of gold. There might be an indirect benefit, through the "foreign trade multiplier", which might help countries with idle resources to expand economic activity in consequence of their increased exports to the gold producing countries. However, this foreign trade multiplier could not be expected to raise the level of total world trade by more than the original additional trade of the gold producing countries, or drastically to change the trade balances of non-gold producing countries.

Actually, the gold producing countries would presumably have used their additional gold exports to import goods and services not only from Europe but also from other countries; it would therefore have been extremely unlikely that Europe would have got hold of anything like the entire amount of the additional gold produced.

Even if Europe had succeeded in doing so, it would have been extremely unlikely that it could have produced the necessary additional exports to the gold producing countries as a net addition to its actual output, since virtually all European countries had virtually full employment between 1950 and 1957. Most or all of the additional exports would have had to be taken either from domestic consumption and investment, or from exports to other countries. Since in that period most European countries tried to keep domestic consumption down as much as possible, a further reduction in consumption would have been all but impossible; and since these countries also wished to encourage investment as much as possible, a reduction in investment would have been contrary to public policy. It seems therefore certain that most or all of the exports needed to acquire the additional gold would have been diverted from other exports. In consequence, the net international trade position of the European countries would probably not have improved at all.

Finally, even if the European countries had been able to export that additional gold to the dollar area, the net effect of that addition would have been relatively small. Between 1937 and 1957, exports of the free world outside of the United States and Canada rose from $19.8 billion to $74.0 billion; the injection of an additional $1 billion in 1957 would obviously have been insignificant. In the same period, exports of European countries rose from $10.6 billion to $41.4 billion; exports to the United States and Canada from Europe represented in both years about one-tenth of the total. Considering that at best a fraction of $1 billion would have been available to Europe as an additional net export to the dollar area, the impact could not possibly have had the effects envisaged by Mr. Harrod.

Improvement in reserve position

Mr. Harrod maintains that "ample reserves are useful in making deflation during a slump postponable," although he concedes an element of truth in the argument "that they will have an opposite and harmful effect in inflationary phases". However, he dismisses this argument except for "a limited number of relatively backward countries", stating that "the main countries of importance in world trade" had too great a "sense of responsibility" to "let an unbalanced position continue" (p. 6). Considering the experience of France and the United Kingdom itself -- both of which are mentioned by Mr. Harrod -- it is difficult to share Mr. Harrod's optimism.

Mr. Harrod realizes that it would be possible to increase inadequate reserves by "substitutes for the holding of a gold reserve," including holdings of international currencies (sterling and dollars), and drawing rights on international financial institutions, especially the International Monetary Fund and the European Payments Union (p. 7). Mr. Harrod believes, however, that none of these substitutes can fully replace gold. The countries issuing international currencies cannot let foreign holdings of those currencies increase without limit, because the world is apt "to look at their net position"; he cites as "a striking instance . . . the present position of Britain," stating that "at the centre of her difficulties is the sense of her own vulnerability owing to the large externally held 'sterling balances'". The exchange crisis of 1957 would not have happened if Britain had had "a larger gold reserve". According to Mr. Harrod the United States so far is not in the same position, but its "state of affairs is precarious". He computes the United States "net reserve" (gold holdings minus net foreign liabilities) at only $10.5 billion, as compared with $19.6 billion in 1948, and believes "that if the net figure fell very much more, there would begin to be anxiety, and even agitation, in the United States. For instance, if the net United States position declined by as much during the eight years after 1956 as it did in the eight years before, it would be almost down to zero. Can anyone doubt that troubles would then arise?" (p. 8).

Mr. Harrod points out that the large increase in foreign reserves since the second World War has been possible only by "the great pile-up of sterling balances" and the willingness of the United States "to see a great pile-up of her external sight liabilities with equanimity." This process could not "continue indefinitely . . . . There just cannot be an addition to dollar balances or to sterling balances of a magnitude comparable with those which occurred in the last 18 years" (p. 10).

Drawing rights on the International Monetary Fund, although "a real contribution", are not "so large a contribution to liquidity" as the addition of an equivalent sum to the stock of monetary gold, because of the obligation to repay the drawings. The only possible solution of the problem is thus "an increase in the dollar price of gold."

Role of sterling and dollar balances -- Mr. Harrod is right in stating, first, that the increase in foreign reserves since the Second World War has largely been in the form of dollar and sterling holdings, and second, that the increase in foreign holdings of such balances cannot continue indefinitely. At the end of 1957, the gold and foreign exchange holdings of countries outside of the United States and Canada amounted to $33.2 billion, of which $13.8 billion was in gold, $12.8 billion in United States dollars (short-term assets and long-term United States Government securities), and $6.6 billion equivalent in sterling balances. The importance of dollar and sterling holdings is therefore beyond doubt.

It should be emphasized, however, that the sterling crisis of 1957 had little if anyting to do with the volume of the foreign-held sterling balances. The amount actually withdrawn from the United Kingdom was a small fraction of those balances, and could have been withdrawn even if the volume of these balances had been not more than one-tenth of the present figure and the United Kingdom had had considerable positive "net reserves." The reason for the run on sterling was not the fear that sterling balances would cease to be transferable or convertible, but the fear that the United Kingdom would have to let sterling depreciate in relation to some other currencies because of unfavorable developments in price and cost relations. These fears were thus concerned exclusively with uncertainties about the competitiveness of British industry primarily in relation to Germany, rather than with the volume of British gross or net reserves. Moreover, the fact that the pound sterling was able to survive this crisis not only without weakening, but actually with increased strength, indicates that, given the determination to follow correct policies, the British reserves (plus existing international credit facilities) were quite sufficient. The outcome of the exchange crisis of 1957 is thus a strong argument against the plea for an immediate need of increases in reserves.

It makes little sense, moreover, to compute the "net reserves" of either the United Kingdom or the United States by deducting foreign liabilities from their own gold and foreign exchange holdings. From this point of view, the United Kingdom would still have considerable negative "net reserves" if its present substantial gold and dollar holdings were doubled. Even some of the more cautious statements with respect to the conditions necessary for the establishment of formal convertibility of the pound sterling have suggested that such convertibility would be feasible (assuming correct policies) if British gross reserves were raised to, say, $5 billion; even these observers would thus consider negative net reserves of $1-1/2 billion not alarming. Under these circumstances it is difficult to see why United States positive net reserves of $10 billion should be deemed "precarious" and why a reduction of these arithmetical "net reserves" to zero should be disastrous. No bank finds it necessary to cover its liabilities a full 100 per cent by cash assets; if it did, it would cease to be a bank, and would become simply the equivalent of a safe-deposit vault. The same principle applies to the United States as a world banker.

For the immediate future, the problem of a further increase in foreign-held dollar balances should therefore not be considered alarming. It may be conceded, however, that at some indefinite future time a point may be reached at which a further increase in foreign-held dollar balances might cause apprehension. It is therefore legitimate to inquire into other methods of increasing foreign reserves.

Effectiveness of an increase in gold price -- Before pointing to workable substitutes for a further increase in foreign-held sterling and dollar balances, the question should be examined whether or not an increase in the price of gold would necessarily result in an increase in the total of international reserves.

The answer is not as simple as Mr. Harrod would make it appear. The dollar and the pound sterling act today as near-perfect substitutes for gold in large part because the stability of their value in terms of gold is taken for granted; as soon as serious doubts arise on that score (as was temporarily the case in relation to sterling in the summer of 1957), these currencies might cease to be treated as substitutes for gold. An increase in the price of gold might therefore result in a tendency to hold international reserves only in gold rather than in gold, dollars, and sterling. If it became known that the price increase was not a one-time step, but would be repeated as soon as international reserves again were considered "inadequate," dollar and sterling might permanently lose their function as international currencies. The consequence would be a simple problem of arithmetic: if the price of gold were doubled, gold reserves held by countries outside of the United States and Canada would increase in value from $13.8 billion to $27.6 billion; but if at the same time dollar and sterling balances totaling the equivalent of $19.4 billion ceased to be considered as reserves, international reserves would be reduced from the present $33.2 billion to $27.6 billion. This would be a peculiar way to increase international liquidity.

Moreover, from that time on any addition to international liquidity really might depend exclusively on newly mined gold (and Soviet gold sales); such a state of affairs might indeed tend to make international liquidity inadequate every few years, provided that world trade continued to expand at the present rate. There is no need to confine the argument against raising the price of gold to the inflationary dangers of that step, to the extremely inequitable way in which the reserves of foreign countries would be affected by such a move, and to the fact that (apart from South Africa) the Soviet Union would be the main beneficiary of such a step -- since the action in itself might have a harmful rather than a beneficial effect on world liquidity.

Other ways to increase world liquidity -- Since the expansion of foreign-held dollar and sterling balances in relation to the gold base must ultimately be limited, and since an increase in the price of gold would be dangerous and might be ineffective, the continued increase in international liquidity to match the expansion of world trade should be accomplished by the third factor discussed by Mr. Harrod, the increase in resources of international institutions, and especially of the International Monetary Fund. Mr. Harrod's objection, that the need to repay drawings on these resources makes them imperfect substitutes for gold, is invalid. A country can hope to preserve its international financial liquidity only if periods of deficits are followed by periods of surpluses. A continual deficit must inevitably lead to the destruction of the domestic currency. The need to achieve a surplus in order to repay drawings on international institutions, far from being harmful, is a useful means of discipline for the deficit economy. If present arrangements concerning the "repurchase" of Fund drawings are suspected of being too strict or too rigid -- although such a suspicion would have to be justified by a detailed supporting argument -- they could easily be made as flexible as needed.

A great advantage of increasing the resources of international institutions, and especially of the International Monetary Fund, lies in the fact that it would put the burden of financing temporary deficits not merely on the United States and the United Kingdom, but on all world trading economies with ample reserves. The basis of subscribing to quota increases in the Fund, for instance, could easily be readjusted so as to take into consideration current export and reserve positions rather than the inter-war data on which the original quotas were based.

Finally, an increase in such institutional resources would not need to be as large as an all-around increase in reserves, since drawing rights would be offered only to countries in actual need, and would not automatically and unnecessarily expand the reserves of surplus countries.

Conclusions

Mr. Harrod believes that an increase in the price of gold would permit the rest of the world "to adhere more fully to the principle of multilateral trade and non-discrimination" (page 11). This belief would be mistaken even if present international reserves were inadequate and if a rise in the price of gold were an effective remedy for such inadequacy.

A country is in danger of losing gold or dollars not if it has a bilateral deficit with the United States, but only if it has a global payments deficit. There have indeed been times when "regional disequilibria" could threaten a country's reserve position even in the case of an over-all surplus; but these times vanished when sterling and the currencies of the European Payments Union became de facto convertible. Over-all deficits however, cannot be eliminated by bilateralism and discrimination; in fact, since bilateralism and discrimination distort the optimum allocation of external resources, they tend to aggravate a deficit position.

However, without conjuring up the nightmare of a world-wide return to bilateralism and discrimination, it may be conceded that the problem of maintaining adequate international reserves is important for the future expansion of world trade. It is fortunate indeed that the free world has, in its international financial organizations, the tools to insure a continuing supply of international reserves, without needing to experiment with an increase in the price of gold.