"Has Gold Lost Its Monetary Role?"*

by Milton Friedman

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A real, honest-to-God gold standard has many advantages. If such a standard could exist, it would be one in which gold was literally money, and money literally gold, under which transactions would literally be made in terms either of the yellow metal itself, or of pieces of paper that were 100 per cent warehouse certificates for gold. Under a gold standard of that kind, or even a slight modification of it, governments would have very little leeway with respect to monetary policies they could adopt.

Under a system of that kind governments would have to accept the discipline of gold; they could not engage in irresponsible monetary policy and produce runaway inflation. Unfortunately, however, that kind of a real, honest-to-God gold standard has seldom, if ever, existed. The actual kinds of gold standards that have existed over the past two thousand or more years have been of a very different variety. Perhaps the closest approximation to a gold standard of this type was during the 19th century and early 20th century, in the period before World War I. That was a period during which governments were playing a small role in economic affairs. It was a period when government spending was low. At the time of Queen Victoria's Jubilee, when Great Britain was at the height of its economic and its political power, total government spending in Great Britain, both central and local, amounted to roughly 10 per cent of the national income.

In the United States at that time, and during the whole of the period of the 19th century except only in the period of the Civil War, government spending again amounted to less than 10 per cent of the national income. Governments were following a generally *laissez-faire* policy. Of the 10 per cent of the national income that was being spent by government in the United States, two-thirds was being spent by state and local government and only one-third by the federal government, so the total federal spending amounted to about 3 per cent of the national income. The only real interventions on the part of the federal government of any importance were tariffs and some measure of regulation over the national banking system. Under those circumstances, it was possible for governments to submit themselves to the discipline of the gold standard, to let their monetary policy be dictated by the necessities of the balance of payments.

But even under those circumstances, when on the whole gold played a very important and very healthy role, the gold standard was very far from the kind of panacea that has been painted by the more ardent advocates of gold. Over the past two thousand years, the use of specie, of metal, of silver or gold as money has not prevented, for most of the period, governments from depreciating the currency, from engaging in inflation as a means of extracting the income of the people for governmental purposes. In the early days of specie standards the methods were somewhat different. Before the invention of paper money the method by which governments depreciated their currencies was by mixing the precious metals with alloys of much less value. There is the famous example of the Roman Empire, which started out with its chief coin, the denarius, which was essentially a pure silver coin. By the time of Diocletian the historians of the coinage of the

Roman Empires were saying that the once proud denarius was little more than a copper coin with a thin wash of silver.

The 19th century was the best of these experiences because during that century we had relatively little of this kind of depreciation via the deterioration of the coinage. Yet, even during the 19th century, prices were very far from stable. For the period from 1800 to 1914, price indices reached a peak three times as high as their trough. Prices under a pure gold standard were thus far from stable, ranging over a scale of 3:1. Of course that is a lot better than the kind of ranges of 10, 20, 30, 40, 50 and even 1 000 and more, that have been experienced under some kinds of paper standards, and that is why I say that, on the whole, there are many advantages to a gold standard.

In addition to the fact that prices varied widely, the 19th century was not lacking in other economics disturbances. There were repeated economic recessions, banking panics and the like.

Whatever may have been true of the gold standard before 1914 the gold standard that emerged after World War I was a very different animal. This is not, I may say, a judgment that is peculiar to myself. While I have been here in South Africa, I have been reading a book on the history of the Oppenheimers and I ran across a quote from Sir Ernest Oppenheimer, in the early 1930's, in which he made the point more strongly than I can. He said, and I quote: "The gold system as it was before the war, and as it is now, is as different as chalk from cheese."

Now that was Sir Ernest Oppenheimer in the early 30's when he was campaigning in favour of South Africa going off the gold standard. And he was right in his view. The gold standard that emerged after World War I was much weaker than it had been before and it became even more so after 1934. It was much weaker because governments were becoming much different creatures. From being minor elements in the economy, with small budgets, and little intervention, governments were increasingly playing a major role in the economy and accepting greater and greater responsibility for the course of events.

We shifted from a real gold standard or, at least, an approximation to one, to a system that I have called a pseudo-gold standard, a fake gold standard, a system in which, instead of gold being money and thereby determining the policy of the country, gold was a commodity whose price was fixed by governments. Instead of allowing the inflows and outflows of gold to dominate domestic monetary policies it was domestic monetary policy that now determined what happened to the gold price and to gold inflows and outflows.

The demise of the gold standard was assured in 1933 when Franklin Roosevelt, as part of his policy after the Great Contraction, prohibited the private ownership of gold by citizens of the United States. From that point on, it was only a question of time until the gold standard was going to disappear from the world. There is no way in which the mythology of gold can be maintained if gold becomes simply something which is used by governmental agencies, central banks or monetary authorities, as a symbol of their policy. In order to retain its mythology, gold must be something which is used by private people in day-to-day transactions and which is held and owned by private people. It is only in countries like France, where private people have in fact been able to own or hold gold, where anything like the old mythology of gold has been able to keep its hold.

It is worth noting that the Great Contraction from 1929 to 1933 in the United States itself occurred under what was supposed to be a gold standard. Sir Ernest Oppenheimer was in favour of South Africa going off the gold standard so that South Africa could free itself from the depression that had originated in the United States and which had spread throughout the rest of the world via the existence of a gold standard.

The occurrence of the Great Contraction while we were supposedly on the gold standard is another example that the gold standard is not a panacea.

Let us return to the main lines of the story: First – President Roosevelt prohibited the ownership of gold and trading in gold by private individuals. Second – he raised the official price of gold to $35 an ounce.

It took a long time for gold to disappear from the market as a monetary medium but, thereafter, it was pre-ordained. Since 1933, the world has been going through a series of withdrawal pains from the attachment to gold. The question that you will ask, and the question that is asked over and over again is this: Given this historical development, is it possible to return to a real honest-to-God gold standard? The other night, at a talk in Durban, one of the gentlemen asked a very good question: "In the 1890's and the 1900's, governments played a very small role. There was discipline on government monetary authority, and it was because there was a real gold standard. Does that not mean that if we could only establish the real gold standard again, we could again have the disciplines of gold?"

The answer is that you have to put the horse before the cart and not the other way around. If you could re-establish a world in which governments budgets accounted for 10 per cent of the national income, in which *laissez-faire* reigned, in which governments did not interfere with economic activities and in which full employment policies had been relegated to the dustbin, in such a world you might be able to restore a real gold standard. But by trying to restore the symbol of a gold standard you are not going to restore the substance. In my opinion, there is next to no chance whatsoever that, under present circumstances, it will be feasible or possible or even desirable to re-establish a gold standard of the kind that prevailed in the 19th century. Indeed, few modern-day advocates of what they call a gold standard are in favour of restoring a **REAL** gold standard. The most vocal advocates of a supposed gold standard today are simply in favour of government price-fixing of gold at a higher price rather than at a lower price.

A real honest-to-God gold standard is not feasible because there is essentially no government in the world today that is willing to surrender control over its domestic monetary policy. No people in the world, in any of our major countries, including South Africa, is willing to exert its influence on the government in order to force the government to follow a gold standard policy, where it adapts its monetary policy to that end. And for that reason, in my opinion, there is essentially no chance of the re-emergence of a world gold standard.

What then is the future of gold?

The many years in which gold has been used as a monetary medium have left two heritages. One is the world-wide belief in gold as a store of value. That heritage makes for a demand for gold for private hoarding, which is very substantial and will last a long time and is not irrational in any way. Certainly there are circumstances in which gold may prove a useful store of value. For example, the Indians who were driven out of Uganda could not take with them their buildings or their homes because their government, like yours in South Africa, had exchange control, which meant they could not convert those assets into foreign currency. But if they had a couple of bars of gold, they probably could stick those in their pockets or suitcases and get out with them.

The other major heritage of the gold standard era is the enormous stock of gold which is held in governmental hands in central banks around the world. The total stock of gold in the central banks of the world amounts to something like 30 years of the world's annual production of gold. That stock of gold has the opposite effect of private hoarding on the future of gold. It is an overhang on the market that sooner or later will have to be disposed of because it serves no function for governments to tie up so large a volume of their assets in gold when gold is not playing a fundamental monetary role. While governments may protest, as France has protested, its willingness to acquire additional gold, I would suggest that you give more weight to what they do, than to what they say, and I shall be very surprised indeed if France is willing to add substantially to its hoard of gold.

As every country gets into difficulty at some time or other, the temptation for each will be strong to dispose of some of its gold as a means of financing its expenditures. Recent cases in point are the offering of gold as collateral for loans by Portugal, South Africa and Italy.

Ultimately, albeit in the distant future, the price of gold will reflect use for private hoarding and for private industrial purposes. But that time will only come when the overhang of gold has one way or another been worked off.

A valid question is this: If you view gold solely as a commodity, what is a reasonable price for it? One of the arguments that is made for gold as a store of value is that it is a hedge against inflation. Over the past fifty years, that has not been the case. Gold has not in fact proved a very good hedge. I once made the calculation that if somebody had bought gold in 1929, and had simply held it until today, paying something like 3 per cent per year for both carrying costs and loss of interest – after all a very modest allowance – he would today have something like a total purchasing power equal to about one-fifth of the amount he started out with. Anybody who held it only from 1929 to 1934 could have done pretty well, thanks to the U.S. rise in the price of gold to $35 an ounce. Anybody who held it from 1968 to 1974 would have done very well; but throughout the rest of that period anybody who held it continuously would have done very badly. Historically, gold has not proved a very effective hedge against inflation.

To return to the question: What current price of gold would correspond to earlier prices, allowing for inflation? That calculation is made very easily. The price of gold in 1929 was $20.67 an ounce. From 1929 to now, the price level has roughly tripled, so that the $20.67 of 1929 would today be above $60.00 an ounce. In 1934 Franklin Roosevelt raised the price to $35.00 an ounce and, because of the decline in prices during the Great Contraction, the price level today is roughly four times as high as the price level was in 1934, giving a current price of $140.00 as the outside upper limit of a price that could be justified by inflation. Both those limits are too high because, in 1929, half of the total world's output was being absorbed for monetary purposes whereas we are now talking of a future situation in which essentially none will be going into monetary reserves. In addition, there is no doubt that in 1934 the $35.00 an ounce was well above the true market price of gold because it produced an unprecedented flood of gold into the American coffers, a sure indication that the price was pegged above the market price.

I am not making any predictions about what is going to happen to the price of gold in the short run. I am only trying to look at the various factors entering into it and the plain fact of the matter is that, as of today, gold is a highly speculative commodity whose price may go anywhere depending upon speculation. If you want to get some time perspective about what the course of gold in the future is going to be, I think that it is useful to look back on the history of the other great monetary metal, silver.

Before the 19th century, silver was overwhelmingly the most important monetary metal. Gold was not the main money, silver was. Gold was too valuable to serve as money and, in fact, in many societies you had brass and copper serving as small change money, silver as the large change, and gold only for the super-large transactions.

The demonetization of silver took place largely in the 1870's when, for example, the U.S., after its Civil War experience of being on a floating exchange rate system, went back to gold in 1879, in a way that essentially demonetized silver which had served as its monetary standard before the Civil War.

In the 1870's the Latin Monetary Union, consisting mainly of France, Spain and Italy, shifted from a silver standard to a gold standard, and by the end of the century silver was essentially demonetized everywhere except for its usage as fractional coinage in which it was really circulating as a token currency rather than for the value of its specie content.

The monetary price of silver in the United States was $1.44 an ounce in 1879. By 1932, which is toward the close of the period during which the transition away from silver took place, the price of silver was 25 cents an ounce. In 1933, the United States made the great mistake of embarking on a silver purchase programme. It raised the price of silver at first to 70 cents an ounce, later higher, the effect of which was to complete the demonetization of silver.

By raising the price of silver, the United States drove China off the silver standard. It is an arguable proposition that one of the most important reasons why China is Communist today is that the United States Government in 1933/34, in order to get the votes of two Senators from Nevada, embarked on a silver purchase programme which raised the price of silver, drained silver from China forcing China into a deeper depression than it had ever experienced before and ultimately resulted in China going off the silver standard and onto a paper standard, which fostered the hyperinflation which was the final blow to Chiang Kai-shek.

From the point of view of our present story this rise in the price of silver in the 1930's was a temporary phenomenon.

It, too, produced a flood of silver into the U.S. coffers but then, as the price of silver was held down, as more world-wide inflation occurred, it became lower than the effective market price. Silver stocks were depleted but not until the 1950's was the process, begun 75 years earlier, of really demonetizing silver, completed. At that point, monetary stocks were more or less exhausted and the bulk of silver had gone into commercial and industrial use. Today, silver has risen back up again to $4.00 an ounce. The whole process took about 85 years.

The world proceeds faster today than it did then, so perhaps the process of demonetization of gold, and the distribution of the stocks of gold held by central banks, will proceed faster under present circumstances. This remains to be seen. I repeat that the one thing you have to keep in mind in looking at the future of gold is that it is a highly speculative commodity. It is a speculative commodity with two special features about it. The one is that there are two countries in the world which are the primary producers of gold, South Africa and Russia, and they will of course have a strong incentive to try to act in such a way as to hold up the price of gold. The other special feature is that there is an overhang in governmental stocks of 30 years' annual production, a substantial amount of which can at any time come pouring onto the market and cause a sharp decline in the price.

As a result, the prospect is that in the future, as in the past few years, the price of gold will fluctuate widely.

From the long run point of view, stability can only be expected when essentially the bulk of the output of gold can be used for industrial purposes, for jewelry and for private hoarding. Until that day comes, the course of the price of gold is very uncertain.

Notes

* An address to 300 Johannesburg businessmen, April 2, 1976.

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