The Surge in Gold Prices

Gerald H. Anderson

In the past several months the price of gold has soared to unprecedented heights, creating a maelstrom of activity in the gold market. This **Commentary** *discusses reasons for the price surge, sources and uses of gold, the relationship of gold to U.S. money, the impact of gold prices on inflation and economic activity, and the suitability of gold as an investment.*

Gold prices have more than quadrupled since July 1978, in contrast to the substantial stability they have exhibited for over a century. The price of gold was $20.67 per ounce during most of the period from 1834 to 1933; in 1934 it was raised to $35.00 per ounce.[1] The price remained at $35.00 until 1968, when the governments of the United States and several other nations terminated their efforts to peg the price. Gold prices then rose slowly, first reaching $100 in May 1973 and $200 in July 1978. Since then the price rise has accelerated, reaching $300 in July 1979, $400 in October 1979, $500 in December 1979, and $800 in January 1980. On January 18, 1980, gold sold in the London market for $835 per ounce (see chart 1).

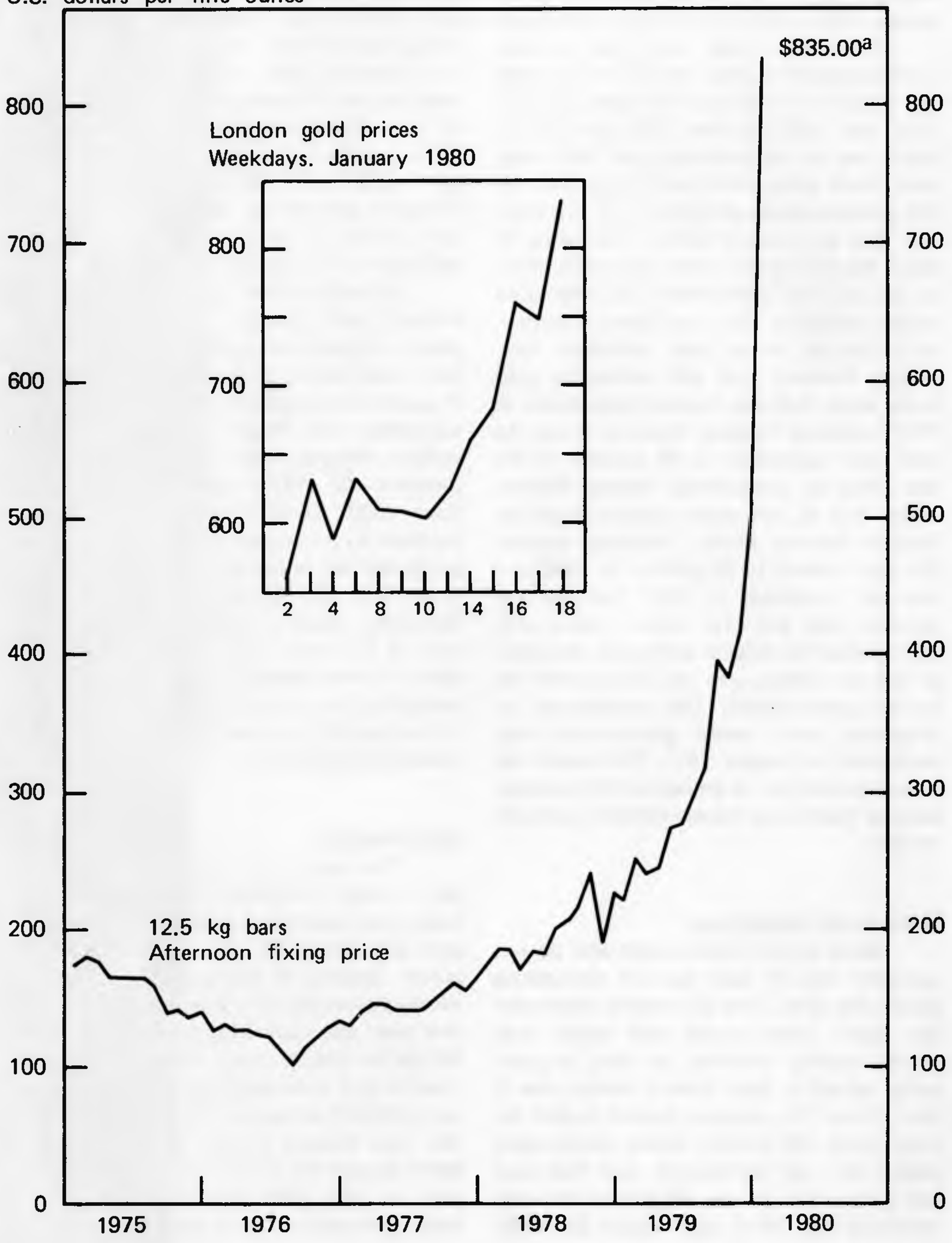
Causes of the Sudden Price Rise

Most observers of climbing gold prices seem to agree that the sudden price surge stems primarily from an increase in demand, although there also appears to be a reduction in supply. Normal demand for gold probably has been greatly augmented by purchasers seeking a hedge against inflation in the last year or two, a period in which the rate of inflation has risen in many nations, including the United States. What is truly sobering about this hedging is that it suggests a great reduction in confidence that soaring inflation can soon be brought under control.

Other buyers, mainly in the Middle East and Asia, are perhaps fearful of war or revolution. Since gold can easily be hidden and transported, it often is used to store wealth in turbulent times. There have always been gold buyers seeking to protect their wealth in periods of inflation, war, and revolution; recent political developments probably have exacerbated such hoarding. Added to normal demand and faced with a steady or reduced supply of gold, increased hoarding has caused gold prices to soar. Attracted by the rising prices, speculators also are buying gold, intending to sell it later at a profit.

1. The price did deviate from $20.67 on some occasions, such as during and following the Civil War, when the Treasury was unwilling to sell gold at that price.

Chart 1 Price of Gold in London
End of month
U.S. dollars per fine ounce



a. Afternoon figure for January 18, 1980.

Table 1 World Production of Gold
Metric tons

	1978	1977	1976	1975
Republic of South Africa	706.4	700.0	713.4	713.4
Canada	51.7	53.1	52.4	51.4
Latin America	47.0	47.0	45.1	38.7
United States	30.2	34.2	32.6	32.7
Papua/New Guinea	23.5	22.8	19.8	19.0
Other African nations	23.0	26.3	25.6	25.6
Australia	20.7	19.4	15.5	16.4
Philippines	19.1	17.4	15.6	15.6
Europe	18.0	19.0	19.0	14.0
Ghana	14.2	16.9	16.6	16.3
Other Asian/Oceanic nations	14.0	14.1	13.9	13.1
Total (excluding U.S.S.R.)	968.0	970.0	969.0	956.0

SOURCE: Samuel Montagu & Co., *Annual Bullion Review*, 1978.

Sources and Uses of Gold

Gold becomes available for private use from new production and from sales out of government stockpiles. In 1978, about 968 metric tons of gold was mined in non-Communist nations (see table 1). Approximately 73 percent of this was produced in South Africa, 5 percent in Canada, and 3 percent in the United States. The U.S.S.R., a major gold producer, does not divulge its production data, so its gold sales are used as a proxy for its gold production. In 1978, the U.S.S.R. sold 430 tons of gold.

Sales from government stockpiles in 1978 added significantly to gold availability, as the U.S. Treasury sold 126 tons and foreign governments sold 89 tons. In addition, the International Monetary Fund (IMF) sold 184 tons of its gold in 1978. Altogether, 1,797 metric tons of gold was made available for private use in 1978 (see table 2).

Although current supply data are not yet available, there are some indications that supply may have fallen. The U.S. Treasury has not sold gold since November 1, 1979, and IMF gold sales are scheduled to end in May 1980. Some press reports suggest that gold sales by the U.S.S.R. may have fallen. The main source of supply—newly mined gold from non-Communist nations—is probably about normal.

Table 2 Estimates of Market Supplies in 1978
Metric tons

New production	968
U.S.S.R. sales	430
IMF sales[a]	184
U.S. Treasury sales	126
Other sales by monetary authorities	89
Total	1,797

SOURCE: Samuel Montagu & Co., *Annual Bullion Review*, 1978.

a. The IMF sold an additional 43 tons to central banks of developing nations.

Gold is used for jewelry, dentistry, and in some industrial products, such as electronic equipment. It is also hoarded as coins and bullion. In 1978, the U.S. public absorbed 292 tons of gold—120 tons in coins and 172 tons in other forms. U.S. consumption totaled about 16% of the world's supply of gold made newly available for private use that year.

Treasury Holdings and Sales

The U.S. Treasury sales of 126 tons of gold in 1978 provided about 7 percent of the gold that became available for private use that year. Since the U.S. government owns about 8,200 tons of gold, it could, if it chose to do so, continue sales comparable to the 1978 figure for another 65 years.

The U.S. Treasury held monthly auctions of gold from May 1978 to November 1979, selling a total of 491 tons in 19 auctions. Gold sales are intended to help the U.S. trade balance in order to strengthen the dollar. The Treasury announced in October 1979 that its auctions henceforth would be held at irregular intervals, rather than monthly. The latest auction was on November 1; a subsequent auction has not yet been announced.

Most of the Treasury's gold is held at Fort Knox, Kentucky, with additional amounts at the Denver and Philadelphia mints and the U.S. assay offices in San Francisco and New York City. Approximately 11,000 tons of gold is stored at the Federal Reserve Bank of New York. This cache of gold, the largest in the world, does not belong to the U.S. government; it is largely owned by foreign governments and international agencies that have placed their gold for safekeeping in this country.

Impact of the Price Rise

The U.S. government is a major beneficiary of rising gold prices, at least in terms of unrealized profits. Its gold was worth only $46 billion two years ago, when the market price was $175 per ounce; it would have been worth $221 billion on January 18, 1980, when the market price was $835 per ounce. Of course, if the Treasury tried to sell all of its gold quickly, the market price would probably fall sharply.

Many people are concerned about the impact of rising gold prices on inflation and economic activity. In general, it appears that the impact on both is miniscule. Gold plays a very small role in U.S. economic activity. As stated earlier, 1978 consumption of gold by industry and hoarders in the United States totaled about 292 tons. Assuming that the price of gold averaged $200 per ounce that year, the total value of gold absorbed by the nation was about $1.9 billion. This figure represents less than one-thousandth of the 1978 gross national product of $2,128 billion. Moreover, since gold remains readily available, although at much higher prices, scarcity problems do not seem likely to hamper economic activity seriously.

The impact of rising gold prices on inflation is also likely to be very small because of the relative unimportance of gold in economic activity. The price of gold is not included separately in the well-known price indexes. In the Producers Intermediate Materials Price Index, jewelers' materials, of which gold is only a part, has a weight of approximately 0.2 percent. Gold's weight in the Consumer Price Index, which is indirect through its contribution to the prices of jewelry, dentistry, and perhaps consumer electronic equipment, is also miniscule.

Although the rise in gold prices reduces the dollar's purchasing power over gold and products made with gold, it has no direct effect on the dollar's purchasing power over other goods and services. One exception to this rests on the possibility that speculation in gold, if it appears to be profitable, could encourage speculation in other commodities that are more important to the economy, such as copper or plywood. If speculation were to drive up the prices of other commodities, inflation would be exacerbated. It can be argued, however, that any speculation in other commodities is caused not by the rising price of gold but by the same forces that have caused speculation in gold. Moreover, speculation that proves to be unsupported by other fundamental economic factors is likely to be short-lived in its impact.

For many years gold had a legal relationship with money, but this relationship was broken in at least three stages between 1933 and 1971. Before 1933 the United States was on an unlimited gold coin standard. Gold coins circulated freely, and the U.S. government would redeem U.S. currency with gold at a price of $20.67 per ounce. In 1933, the U.S. government required citizens to sell to the government all their gold bullion and coins. The use of gold as money, or in lieu of money, was forbidden. U.S. money, however, was still backed by gold in the sense that the Federal Reserve Act of 1913 required Federal Reserve Banks to hold gold equivalent to 40 percent of the face value of outstanding Federal Reserve notes, that is, the paper money issued by Federal Reserve Banks. Congress reduced this requirement to 25 percent in 1945 and removed it entirely in 1968. The last link between gold and U.S. money was a U.S. commitment to redeem with gold, at a ratio of $35 per ounce, any U.S. dollars held by foreign governments. The redemption arrangement with world governments was terminated in August 1971. The recent rise in gold prices has no impact on U.S. money, because there is no linkage between gold and money.

Gold as an Investment

Many pitfalls face people who do not normally deal in gold but are considering purchasing gold. Such purchasers rationalize that gold's value would hold better than money during inflation, or that a quick profit would be made from a further rise in gold prices. The primary hazard is that the price could fall sharply, which would make gold a very bad investment. Just five years ago gold prices fell by 48 percent between December 30, 1974, and August 25, 1976. Although the price has since recovered, the recovery is of little solace to those who bought high and sold low. Amateur investors also face the hazards of loss through fraud or theft. In addition, if the price of gold fails to rise, even though it does not fall, the purchaser foregoes the interest that investment in a financial asset could have yielded; in addition, he will have out-of-pocket expenses for gold safekeeping and insurance. Because of the possibility of large loss as well as large gain, gold ownership perhaps should be termed a speculation rather than an investment. It may be wise to purchase gold only with money that one can afford to lose.

Individuals can buy gold coins, gold bullion, gold jewelry, gold futures, and shares in gold-mining firms. It has always been legal for Americans to purchase shares in gold-mining companies, even when gold ownership was illegal. Ownership of gold bullion became legal for Americans on December 31, 1974, having been forbidden since 1933. Gold futures, which became available to Americans in the 1970s, can be purchased on organized exchanges in New York City and Chicago. Labor costs for fashioning jewelry represent a significant part of its price. Even if its gold content falls in price, however, jewelry can still be enjoyed as an adornment (unless the sight of it is a painful reminder to its owner of an investment gone sour).

Gold Mania

The current run up in gold prices is not without precedent. A boom in gold prices also occurred a century ago. In 1869, gold was selling for more than $20.67 per ounce, because of excessive issue of paper money during the Civil War. In September of that year, speculators bid up the price from $27.54 to $28.39 over a three-week period. Then in just three days, they drove the price up to $33.59 per ounce. On September 24, a day that became known as Black Friday, panic caused the price to plummet 18 percent in less than one hour, completely erasing the previous price advance.

What goes up, sometimes comes back down.

January 28, 1980

ECONOMIC COMMENTARY

In this issue:

The Surge in Gold Prices

Research Department
Federal Reserve Bank of Cleveland
Post Office Box 6387
Cleveland, Ohio 44101