
Fall of the Global Gold Exchange Standard and the Formation of the Contemporary Free Gold Market

Submitted 20/01/21, 1st revision 15/02/21, 2nd revision 03/03/21, accepted 20/03/21

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Abstract:

Purpose: The purpose of this paper is an explanation of the fall of the global gold exchange standard in the beginning of XXth century. Moreover, reasons of the cancellations of the U.S. dollar convertibility into gold according to the fixed parity in 1933 and 1971 are purposes of this paper. The final cancellation of the U.S. dollar gold convertibility was related to the establishment of the free gold market in 1968-1974. A lack of the gold standard and the free gold market are characteristic features of the contemporary world market system.

Design / Methodology / Approach: The design is finding the historical reasons of the fall of the global gold exchange standard and of the establishment of the free gold market in 1968-1974. The research method is a describing political-economic analysis based on statistical data. The approach covers the most important historical time periods connected with the transformation of the global market system including the changing role of the gold.

Findings: This paper analyses reasons of the fall of the gold exchange standard from the beginning of the XXth century to the establishment of the free gold market in 1968-1974. Author considers this problem including changes of the global political-economic situation in the analyzed period. The First World War and the recession (the great depression) in 1929-1933 disturbed the gold exchange standard and promoted the growing importance of fiat money in circulation. Moreover, a fall of the Bretton Woods agreement, i.e., of the re-establishments of the limited dollar convertibility into the gold, promoted the establishment of the U.S. free gold market.

Practical Implications: The practical result of this historical research is the background of the formation of the contemporary gold market. A knowledge of the analyzed facts can be helpful for long-term investments in gold.

Originality/Value: Original research paper.

Keywords: Gold exchange standard, the global system, Nixon shock, the free gold market.

JEL classifications: E26, E31, E39.

Paper type: Research article.

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1. Introduction

Gold is a strategic metal that played important role in the global monetary history. The gold-exchange system limited inflation and promoted stable exchange rates. This paper explains the reasons of the fall of the gold-exchange standard. Subject of the analysis is the global gold-exchange system and its disturbances before 1933. Moreover, author analyzes the attempt to restore the U.S. dollar gold convertibility in 1944 and its final collapse in 1971.

The world gold-exchange standard reduced opportunities to conduct flexible monetary policy because of limited gold stores and a volume of gold in a monetary unit. Therefore, there will be verified a hypothesis that there is impossible to conduct the protectionist economic politics during the recessions within the framework of the gold exchange standard.

2. Historical Background

Notes (banknotes) let to increase fiat money despite their early convertibility in gold coins according to the fixed parity. A relatively high global demand for the gold until the First World War related to needs of mints producing golden coins, i.e., coins of the real value. Problems with too little gold and silver to mint an enough volume of circulate coins caused a production of more banknotes which only theoretically should be convertible into the gold or silver coins. A surplus of notes production versus merchandise production caused inflation and promoted limits of banknotes convertibility into the gold. The attempts to limit the gold in the external reserves of many countries were made before the First World War. Before 1913, there was a practice in many countries to hold their external reserves in convertible foreign assets. Especially, relatively poor countries preferred to hold their reserves in interest-bearing form in reserve-centers countries because of cheaper costs than accumulating the gold bullion. According to Lindert's estimations the foreign exchange reserves rose from less than 10% to approximately 20% of total gold and foreign reserves of central banks and governments from 1899 to 1913 (Bloomfield 1963; Lindert 1969; Eichengreen and Flandreau 2008).

However, during a relatively stable time periods, e.g., after the First World War, inflation rates were higher than a growth of gold prices (Hergt, 2013). During the First World War, the gold prices were much higher and gold exports were embargoed. Gold production dropped since 1915 and gold stocks were insufficient according to the needs. It was a reason to withdraw gold coins from the circulation in many countries and to concentrate the gold at central banks. It was a change from the gold coin standard to a gold-exchange standard. In result, the global gold reserves were almost 70% higher in 1925 than in 1913-1914 whereas the global production of goods and services was approximately 20% higher. Therefore, there was no problem of too little gold reserves for a gold coin standard but a problem of gold distribution, named gold "maldistribution". The U.S. Bank of Federal Reserve and the Bank of France held

more than 50% of the global monetary gold, i.e., more than needed to cover their monetary circulation. A shortage of gold was characteristic for other countries. In this way, there was an impossible task to restore a prewar parity of gold, i.e., prewar prices of gold in particular currencies. Such a situation could cause deflation and economic recession. The solution of this problem was found at Genoa Conference in 1922 that institutionalized a prewar practice to supplement gold with other assets. In this way many countries hold their external reserves in the form of foreign bills.

Thus, foreign exchange reached 28% in 1925, 31% in 1926 and 36% in 1929-1930 of total reserves of central banks and governments. However, the devaluation of British pound sterling and a suspension of its convertibility into the gold in 1931 caused losses for countries and people having reserves in this currency. Governments and people lost their faith in foreign exchanges. Therefore, the share of foreign exchange in total external reserves dropped to 19% in 1931 and to 8% in 1932 (Eichengreen and Flandreau, 2008).

3. Recession in 1929-1933 and the Cancellation of the U.S. Dollar Gold Convertibility

The great economic crisis and recession (also named the great depression) in 1929-1933 also promoted a depreciation of the U.S. dollar. The U.S. authorities cancelled the dollar convertibility into the gold in 1933 despite information about the certificates (notes) convertibility into the gold, which was placed in many banknotes, e.g., an inscription on the U.S. 20-dollar certificate (note) dated 1928 as follows: "Gold certificate" and "In gold coin payable to the bearer on demand" (see Picture 1).

U.S. dollar depreciation was necessary because of a big growth of banknotes in circulation in the aim to stimulate demand and a growth of the economy according to the John Maynard Keynes's theory (Keynes 2007; 1936). It was the end of the gold-exchange standard and the gold price amounting 20.67 U.S. dollars per troy ounce (oz.). Such a situation confirms the hypothesis about the impossibility to conduct the protectionist (especially Keynesian) politics in the market economy within the frameworks of the gold exchange standard.

There was also established a new official price of gold amounting 35 dollars per ounce but most private possession of the gold (i.e., coins, bullion, and certificates) was forbidden. However, it was only a formal price because investors and ordinary people were not able to buy the gold in the legal way according to the United States Gold Reserve Act of 1934 (Public Law 73-87, 48 Stat. 337). A real price on so called gray market was higher. However, there are no official statistical data concerning the unofficial and illegal gold market.

4. Bretton Woods System and the Limited Gold Exchange Standard

There were successful attempts to establish a convertibility of dollars into gold according to fixed parity but only for states at the Bretton Woods Conference in 1944.

Dollar was not convertible into the gold for individuals. Moreover the U.S. authorities hoped for only formal and not real dollars convertibility into the gold because of a weakness of European and Asian economies after the second world war. Such a situation was changed in 1960s and France and other countries required to change their dollars reserves into the gold according to the low parity of 1944. Therefore, this system was formally suspended and really cancelled by so called Nixon shock in August 1971. The Smithsonian Agreement in December 1971 was an attempt to maintain the Bretton Woods fixed exchange rate system that included an official growth of the gold price from 35 to 38 dollars per ounce but without any long-term results. Nixon shock caused a transfer from the fixed (rigid) exchange rate system to the floating exchange rate system in March 1973 (Coffey 1974, Dey 2016, Staszczak 2015). Nowadays, there are no fixed gold exchange standard and convertibility of any currency over the world.

5. Attempts to Establish the Market of Gold Certificates in 1968-1973

The establishment of the U.S. gold market in 1968 (gold certificates) and in 1974 (the real gold) without the gold exchange parity created the legal and official gold market prices that were independent from the government prices. This event caused a growth of gold prices in a long period. However, this growth was not stable and monotonous process. There were increases and drops dependent on the global political-economic situation (Historical, 2014; Statista, 2018; Public Law, 93-373, August 14, 1974, Stat. 26650.

Changing market prices of all commodities depend on changes of their supply and demand. The same principal concerns prices of the gold. A lack of the fixed gold money standard (a political reason) promoted an increase of fiat money in circulation without enough cover in goods and services. It caused a growth of inflation that promoted a slow growth of gold prices in longer time on the one hand (an economic reason). However, on the other, a lack of gold coins in circulation and of the fixed gold exchange standard caused a reduced demand for the gold from the state mints and it limited a growth of prices. Market prices of gold and other commodities can be higher or lower than production costs. Many gold mines obtained profits, so prices of the gold were usually enough for an important part of a gold mining business.

A legal trade in gold certificates since 1968 against a real metal promoted lower market prices of the gold because of a creation of an additional commodity basing on the faith. During the economic growth in 1968-1969 the average gold price rose from 39.31 \$ per oz to 41.28 \$ per oz and changes in the U.S. real gross domestic product (GDP) achieved 4.9% and in 1968 and 3.1% in 1969. During the economic stagnancy in 1970, when change in the U.S. real GDP achieved 0.2%, the average gold price fell to 36.02 \$ per oz. Nixon shock and the high U.S. annual inflation rates achieving 4.30-6.16% promoted the economic growth in 1971-1973 and changes in the U.S. real GDP rose from 3.3% to 5.6%. These events influenced on the fast growth of the average gold prices from 40.62 \$ per oz to 97.39 \$ per oz (Economic, 2014; Historical, 2014;

Inflation, 2014). The first détente period and a lack of tension between the ideological West and the Soviet bloc in 1969-1979 (Gaddis 1983) did not cause any important drop of the gold price. The free gold market and speculation played more important role.

6. Beginning of the Contemporary Real Gold Market

The U.S. legal trade in real gold since 1974 was related to the difficult global economic situation. The first oil shock (i.e., a big growth of oil prices created by OPEC) in 1973-1974 created the economic recession in 1974-1975 of the ideological West, (changes in the U.S. real GDP achieved -0.5% in 1974 and -0.2% in 1975) and the average gold prices rose to 154.00 \$ per oz. in 1974 and to 160.86 \$ per oz. in 1975 (Economic, 2014; Historical, 2014; Staszczak, 2015). The biggest growths of the gold prices were in 1973 and 1974, i.e., during the global political crisis connected with the first oil shock and the first part of the economic recession. It could be related to the big inflation rates amounting to 6.16% and 11.03%, oil panic and speculations promoted by the possibility to legal invest in the real gold by the U.S. citizens. A growing demand for the gold price on the beginning of the recession was connected with human faith in the real value of the gold and other merchandise and with an escape from only symbolic values of domestic and foreign notes. Former Federal Reserve Chairman Ben Bernanke said in 2011: *"... I pay attention to the price of gold, but I think it reflects a lot of things. It reflects global uncertainties. The reason people hold gold is as a protection against what we can't really, really, really bad outcomes. And to the extent that the last few years have made people more worried about the potential of a major crisis, then they have gold as a protection"*, (Hergt, 2013).

In the second part of the economic recession in 1975 the average gold price was only little higher than in 1974, in spite of the big U.S. annual inflation rate amounting 9.20%, (Economic, 2014; Historical, 2014; Inflation 2014). It means that the panic on the gold market finished in 1975 and that human money reserves decreased because of recession and inflation.

7. Conclusions

The first world war in 1914-1918, the global economic recession in 1929-1933 and requirements to change dollars for the gold by France and other countries before the Nixon shock in 1971 disturbed the global system and were most important reasons of the final fall of the gold exchange standard. All the above-mentioned events disturbed the gold exchange standard. Moreover, government's intervention in the market economy needed a flexible monetary policy without limits of gold resources and this fact confirmed the hypothesis. Such a situation promoted contemporary fiat money system without the gold fixed parity for any currencies over the world. The establishment of the legal free market of gold certificates in 1968 and of the real gold in 1974 in connection with the first oil shock in 1973-1974 promoted a big growth of gold prices.

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APPENDIX:

Picture 1. Twenty U.S dollars' gold certificate of 1928 used as a circulation note convertible into the gold



Source: Scanned original certificate.