# GOLD, SDRs AND OTHER MATTERS

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This is a short account of what I think we achieved at Washington DC consultation (April 2011) as well where I think we should be going. Our deliberations have been given greater urgency by what the Standard & Poor's said about the US debt and what has happened to the price of gold even in the short span of one week.

On gold we went over some familiar ground but also could see that it excites strong loyalties. There are several ideas about gold – as a monetary base on its own, as an addition to the SDRs to 'harden them, as a 'circuit breaker' which gives an early warning as to the impending dangers.

## Gold as a monetary base

This is the option for those who want price stability. The appeal of gold is that it is 'no one's liability'. The tables presented at the consultation in Washington DC (April 2011) were designed to show the property of gold standard as the guarantee of price stability. Indeed, between the time Isaac Newton standardized the gold content of sterling at £3.19s.9d in 1660 (if I recall correctly) there was zero trend in the British price level till 1939. There were cycles of inflation – 1797–1815 (when the Bank of England went off gold and adopted paper currency during the French Wars), 1919–1921 (when Bank of England had again gone off the Gold Standard during the war; it did not return until 1924), with each episode followed by a sharp deflationary movement. There was also a long downward trend in prices in the second half of the 19th century, matched by an upsurge in the twenty years 1895-1914. But while the Gold Standard gives price stability, it sacrifices economic – income and employment – stability. The trade-off between price stability and income or employment stability is the Phillips Curve trade-off. Thus during the period 1861–1913, which was the original period for which A. W. Phillips fitted his famous Phillips Curve, there were six-and-a-half regular eight-year cycles of unemployment. Indeed the research in trade cycles began in the second half of the 19th century because crises and fluctuations in income/employment became quite regular. It was the Great Depression that was excessively deflationary and led to high and persistent unemployment for ten years and longer. It was then thought, by Keynes principally but by others as well, that gold as a monetary base had a deflationary bias. This idea has not gone away.

The Gold Exchange Standard was mooted by David Ricardo when the Bank of England went back on gold after 1815, but the Bank chose a full Gold Standard. Ricardo felt that the Bank could economize on gold stocks if it adopted the Gold Exchange Standard. It would make the money supply more flexible as long as some prudence was exercised when it came to assuring the convertibility of the currency. In the late 19th century Indian currency was based on this idea, which Keynes surveyed in his *Indian Currency and Finance*.[1] This was the standard adopted at Bretton Woods which then broke down in August 1971. The Gold-Dollar Exchange Standard is associated with a twenty-five year period of full employment and steady economic growth but it came to an end owing to inflationary pressures and a lack of fiscal discipline in the United States. The convertibility of the dollar could not be guaranteed by the US. Since 1971 we have been on the dollar, a fiat currency serving *faute de mieux* as an international reserve currency .

It will be impossible to revive the Gold Standard or even the Gold Exchange Standard.

## Gold as SDR supplement

From what we were told about the SDRs, the idea that gold could be added to the four currencies currently comprising the SDR is legally a non-starter. Since SDRs are everyone's liability, and gold is not part of any currency's base, gold cannot be made part of SDRs as it cannot be collected when some country presents SDRs to a Central Bank.

Despite this legal barrier we must not give up exploring the case for gold at the global level. If the case makes economic sense then a legal basis can be explored. We should explore what changes would be necessary to the IMF articles if we are to 'lace' SDRs with a 'gold lining'. The purpose will be to make the SDRs a putative international currency which can be used as a means of payment and a store of value. Will this require allowing private holding of SDRs? Should we let SDRs be traded like any other currency on forex markets as they may be more stable than the component currencies? If, as per the Articles of the IMF, no country is allowed to base its currency on gold, can the IMF make SDRs its own liability and stand ready to exchange the SDRs for a combination of currencies and gold or all currencies converting gold at the prevailing market price? If so, will adding gold not help make SDRs worth holding as stores of value?

[1] Keynes, John Maynard (1913), Indian currency and finance, Macmillan, London

Parenthetically in the light of the Hainan Summit, should the BRICS currencies be seen as potential candidates for inclusion in the SDR in future? The 5 Rs – RMB, Rupee, Rouble, Real and Rand – are not yet ready but surely they are candidates knocking at the door. How would the SDR look if it had the five plus the old four? How do the 5 R's correlate in their movements with each other and with the SDR?

One argument about the IMF playing a bigger role in solving the problem of global imbalances is that if there were alternative sources to the dollar as places to park the surpluses in the privilege of the dollar as well as the pressure on the US to deliver stability would be that much less. One could even argue that it has been the flooding of surpluses into the T Bills which caused the conditions – cheap credit, malinvestments etc. – that led to the crisis of 2007–09.

How can this be done? Can the IMF become like a bank (not a Central Bank) and take deposits and lend them out to countries that may need them for investment? What changes would be necessary to the Articles of the IMF for this to happen?

Not all this may be legally feasible but if it makes economic sense then one can explore what needs to change to make it legally possible.

## Gold as a circuit breaker

This does not require any legal move at all and is happening right now. The price of gold is a sort of bellwether as it reflects the uneasiness in the market about the fragility of currencies. The question is, can this role be given any official sanction?

I am sure there are many more ideas others have. I look forward to further exchanges.

## ABOUT THE AUTHOR

Lord Desai is Emeritus Professor at London School of Economics