SNAPSHOT

Golden Rule

Why Beijing Is Buying

Alan Greenspan


If China were to convert a relatively modest part of its $4 trillion foreign exchange reserves into gold, the country’s currency could take on unexpected strength in today’s international financial system. It would be a gamble, of course, for China to use part of its reserves to buy enough gold bullion to displace the United States from its position as the world’s largest holder of monetary gold. (As of spring 2014, U.S. holdings amounted to $328 billion.) But the penalty for being wrong, in terms of lost interest and the cost of storage, would be modest. For the rest of the world, gold prices would certainly rise, but only during the period of accumulation. They would likely fall back once China reached its goal.

The broader issue -- a return to the gold standard in any form -- is nowhere on anybody’s horizon. It has few supporters in today’s virtually universal embrace of fiat currencies and floating exchange rates. Yet gold has special properties that no other currency, with the possible exception of silver, can claim. For more than two millennia, gold has had virtually unquestioned acceptance as payment. It has never required the credit guarantee of a third party. No questions are raised when gold or direct claims to gold are offered in payment of an obligation; it was the only form of payment, for example, that exporters to Germany would accept as World War II was drawing to a close. Today, the acceptance of fiat money -- currency not backed by an asset of intrinsic value -- rests on the credit guarantee of sovereign nations endowed with effective taxing power, a guarantee that in crisis conditions has not always matched the universal acceptability of gold.

If the dollar or any other fiat currency were universally acceptable at all times, central banks would see no need to hold any gold. The fact that they do indicates that such currencies are not a universal substitute. Of the 30 advanced countries that report to the International Monetary Fund, only four hold no gold as part of their reserve balances. Indeed, at market prices, the gold held by the central banks of developed economies was worth $762 billion as of December 31, 2013, comprising 10.3 percent of their overall reserve balances. (The IMF held an additional $117 billion.) If, in the words of the British economist John Maynard Keynes, gold were a “barbarous relic,” central banks around the world would not have so much of an asset whose rate of return, including storage costs, is negative.
There have been several cases where policymakers have contemplated selling off gold bullion. In 1976, for example, I participated, as chair of the Council of Economic Advisers, in a conversation in which then U.S. Treasury Secretary William Simon and then Federal Reserve Board Chair Arthur Burns met with President Gerald Ford to discuss Simon’s recommendation that the United States sell its 275 million ounces of gold and invest the proceeds in interest-earning assets. Whereas Simon, following the economist Milton Friedman’s view at that time, argued that gold no longer served any useful monetary purpose, Burns argued that gold was the ultimate crisis backstop to the dollar. The two advocates were unable to find common ground. In the end, Ford chose to do nothing. And to this day, the U.S. gold hoard has changed little, amounting to 261 million ounces.

I confronted the issue again as Fed chair in the 1990s, following a decline in the price of gold to under $300 an ounce. One of the periodic meetings of the G-10 governors was dedicated to the issue of the European members’ desire to pare their gold holdings. But they were aware that in competing with each other to sell, they could drive the price of gold down still further. They all agreed to an allocation arrangement of who would sell how much and when. Washington abstained. The arrangement was renewed in 2014. In a statement accompanying the announcement, the European Central Bank simply stated, “Gold remains an important element of global monetary reserves.”

Beijing, meanwhile, clearly has no ideological aversion to keeping gold. From 1980 to the end of 2002, Chinese authorities held on to nearly 13 million ounces. They boosted their holdings to 19 million ounces in December 2002, and to 34 million ounces in April 2009. At the end of 2013, China was the world’s fifth-largest sovereign holder of gold, behind only the United States (261 million ounces), Germany (109 million ounces), Italy (79 million ounces), and France (78 million ounces). The IMF had 90 million ounces.

However much gold China accumulates, though, a larger issue remains unresolved: whether free, unregulated capital markets can coexist with an authoritarian state. China has progressed a long way from the early initiatives of Chinese leader Deng Xiaoping. It is approaching the unthinkable goal of matching the United States in total GDP, even if only in terms of purchasing-power parity. But going forward, the large gains of recent years are going to become ever more difficult to sustain.

It thus seems unlikely that, in the years immediately ahead, China is going to be successful in vaulting over the United States technologically, more for political than economic reasons. A culture that is politically highly conformist leaves little room for unorthodox thinking. By definition, innovation requires stepping outside the bounds of conventional wisdom, which is always difficult in a society that inhibits freedom of speech and action.

To date, Beijing has been able to maintain a viable and largely politically stable society mainly because the political restraints of a one-party state have been offset by the degree to which the state is seen to provide economic growth and material wellbeing. But in the years ahead, that is less likely to be the case, as China’s growth rates slow and its competitive advantage narrows.

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