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The London Gold Market and the Devaluation of Sterling, 1965. This is a revised draft of a "top secret" paper, written by or under the direction of J. S. Fforde, that covers the position of the British Government regarding the operation of the London Gold Market in the event of a devaluation of sterling. Sterling's devaluation in November 1967 eventually quickly led to the disbanding of the official Gold Pool in 1968, although the London Gold Market continued to function.

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LONDON GOLD MARKET (REVISE)

The instantaneous effect of a devaluation of sterling would be to raise the sterling price of gold on the London market in line with the devaluation itself. This would be followed by a massive increase in the market demand for gold. The change in the sterling parity would not only create expectations of changes in other parities: it would cast great doubt on the ability of the U.S.Treasury to maintain its selling price of $35 per ounce. Gold would therefore be preferred to currencies unless and until these doubts were either:-

(i) removed by wholly convincing national and international actions,

or (ii) confirmed by the adoption of a new structure of gold parities that was expected to endure.

Those in a position to exercise their preference for gold would do so. Increased demand would not necessarily be confined to private account. The monetary authorities in many of the smaller countries, who are not members of the Ten and for whom considerations of international monetary co-operation are bound to be less strong, might well seek further to increase the proportion of gold in their reserves; and would place their orders on the London market if they preferred to avoid the risk of incurring the displeasure of the U.S.A. by earmarking in New York. This attempt to diversify reserves, in favour of gold, could occur within the Sterling Area as well as outside it. Countries with low gold reserves but with gold-guaranteed debts to the I.M.F. would be particularly anxious to get into gold.

Apart from operations on behalf of the selling consortium, the supply of gold to the London market comes mainly from South Africa. This is occasionally supplemented by Russian selling. The supply from South Africa has recently exceeded new output there owing to a deterioration in that country's balance of payments. The Russians have sold no gold since April 1964. In the situation following a devaluation of sterling, the supply would become erratic, because a steady flow of sales could not be expected to continue during a period of extreme uncertainty.

In these circumstances, therefore, the burden of maintaining orderly conditions in the free gold markets would at times fall entirely upon the sales consortium operating through London. Until recently, only $270 million of gold was available for this purpose (of which, at the end of June $150 million has been sold). But at the Basle meeting early in March this year it was agreed that sales should go on even if the $270 million were reached, pending a further review of the situation by the members. It is clear that the market demand for gold that would follow a sterling devaluation would require consortium operations much larger than have yet been contemplated.

Maintenance of the international monetary price of gold at $35 per ounce, following a devaluation of sterling, would almost certainly depend upon the effectiveness of international co-operation. If the Americans could rely on sufficient short-term assistance to protect their gold stock against a crisis of confidence, the corner could be turned - on the assumption that the basic deficit in the American balance of payments was beyond doubt being eliminated. If international support for the dollar were forthcoming, the question of how best to handle the market demand for gold would have to be answered in that context.

It cannot, however, be assumed that the main countries of Continental Europe would be prepared to support the present price of gold, or even that they would be prepared to refrain from action that would positively provoke a change. Much would depend upon what had happened to sterling. Provided the manner and extent of the sterling devaluation were not such as to provoke immediate retaliatory moves by any of the leading countries, co-operation in support of the present price of gold could probably be maintained for a time. But some European members of the consortium might prove unwilling to continue their support for very long, or indefinitely. In the event of international co-operation, in defence of the dollar, breaking down the gold sales consortium would break up. The most likely defectors would be France, Belgium and Holland. Italy would stay with the Americans for as long as she could. The Germans would be undecided. But confident prediction, at the time of writing, is impossible. Suffice to say that a break-up of the consortium, and the associated wider breakdown of co-operation, would create a quite different set of circumstances to the one outlined in the preceding paragraph; and that the question of how best to handle the market demand for gold would have to be answered in a different context. The remainder of this note therefore discusses the gold market problem in terms of these two alternative sets of circumstances.

First, let it be assumed that measures for the co-operative defence of the dollar were taken by the Ten. Even so, no member would enjoy losing gold in any quantity, least of all the Americans who have a 50% share in the gold sales consortium. Someone in the U.S. Administration might therefore again suggest that the London market should be closed, stabilisation operations brought to a halt, and U.S. sales confined to monetary authorities for "legitimate monetary purposes". This proposition might well find support in some quarters on the Continent, both because it might appear as an attractive means of relieving the burden on the consortium and, in certain cases, because of an ingrained jealousy of London's predominance.

In practice, however, closing the London market would make matters worse, as the Federal Reserve fully realise. Demand would merely be transferred to other less efficient markets among which no single one would be likely to dominate - though the Swiss market would probably be the largest. On these markets gold would go to a heavy premium over $35 per ounce; and this premium would attract a substantial proportion of new supplies. The existence of these disorderly conditions would cause a further lack of confidence in currencies and particularly in the U.S. dollar. One way or another, the Americans would find themselves subject to a drain of gold "for legitimate monetary purposes", some of which would inevitably trickle through to supply the premium markets. We would therefore advise very strongly against closing the London market, and suspending stabilisation operations, in the circumstances envisaged. Conditions in exchange markets would be bad enough. It would make no sense to aggravate them by deliberately engineering disorderly gold markets. By the same token, there would be no sense in suspending stabilisation operations while keeping the London market open and allowing the price to go where it would.

It should not be thought that stabilisation operations could easily and effectively be resumed, if these were subsequently considered necessary, once the London market were cloned. The London market is a dominant market, and the world market price can be effectively controlled by official intervention there, with a minimum of technical difficulty. Effective intervention through the various other markets, London being closed, would be technically much more difficult and complicated.

The alternative assumption, a breakdown of co-operation, must now be considered. In these circumstances the burden off holding down the London market price would fall entirely upon the Americans. We ourselves would have no appreciable resources to deploy. So long as the Americans considered that the battle was worth fighting, they would be very well advised to go on providing us with resources to conduct stabilisation operations. For it would be more than ever vital to demonstrate to world opinion that the Americans had the strength and determination to carry through their declared policy. It would, in addition, be highly impolitic to close the London market and allow demand to be transferred to free markets in countries unfriendly to the policy of maintaining monetary gold at $35 per ounce.

If the Americans rejected our advice, and refused to continue supplying us with the gold needed, we would have to choose between closing the market or allowing the London price to move freely. In our view it would be better to keep the market open rather than transfer business to other markets. <u>Some</u> official intervention, then or subsequently, would be desirable; and there would accordingly be both an immediate and longer-run advantage in maintaining London as the dominant market where the bulk of new supplies were sold. If, nevertheless, the Americans requested us to close the market we might have little option but to comply. This would, however, depend upon Anglo-American financial relationships at the time - which cannot be confidently predicted.

The Americans might, alternatively, decide the battle was not worth fighting and might then act to protect their gold stock by temporarily suspending all sales of gold for legitimate monetary purposes. The presumption would then be that sales would only be resumed at a very much higher price. In that event, there would be no point in continuing to hold down the London price. Stabilisation operations would be suspended and a period of disorder would ensue pending a realignment of the gold parities of all the main currencies. During such a period of disorder, it might well be necessary to close the London gold market for a short period until dealings could be resumed on a rational basis.

Conclusions

(i) We would advise very strongly against closing the London market and suspending stabilisation operations, following a devaluation of sterling, unless it became clear that a move in the sterling parity had pulled the foundations out of the entire structure and that everything was immediately in a state of flux.

(ii) If our advice were rejected by the Americans, it would still be better to keep the market open, allowing the price to move freely (subject to some modest intervention on our own account), rather than transfer the business to other markets. But we recognise that we might in some circumstances be unable to resist an American request that the market be closed.

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***Source*:** *Bank of England Archives*, OV44/133, 2278/1.