

GOLD, THE DOLLAR AND OUR BALANCE OF PAYMENTS

Remarks by

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Tonight, at Mr. Swanson's suggestion, I am to talk about international monetary developments. This is almost impossible to square with our first conversation, when he warned me to stay away from serious subjects. Not even Mark Twain could extract much humor from the current situation, even though his reference to a gold mine as a hole in the ground owned by a liar might have some relevance to certain of the proposals advanced by proponents of an increase in the price of gold. But perhaps it is too harsh to characterize these proponents as "liars" -- it may be simply an excess of "deGaulle" that causes them to be so strident in their advocacy. And they are correct, at least in concentrating their attention on the barbarous metal, for it is the loss of gold from our monetary stocks that has enlarged the area of our anxiety over monetary policy and the U. S. dollar. Why this loss has occurred and what alternatives are being considered to alter the role of gold I will attempt to sketch for you this evening.

To give the appearance of logic to this talk, I should, I suppose, start with a rational explanation of why gold is so highly prized in monetary systems. I'm not sure I can. Attitudes toward gold are not susceptible of rational analysis. Sufficient perhaps to acknowledge its entrenchment in all our instinctive yearnings for a well-ordered and disciplined world -- coupled with a not unreasonable distrust of government motives. G. B. Shaw summed it up succinctly when he said:

"You have to choose (as a voter) between trusting to the natural stability of gold and the natural stability of the honesty and intelligence of the members of the government. And

with respect for these gentlemen, I advise you, as long as the capitalist system lasts, to vote for gold."

I suspect, though, we no longer have the choice.

For example, consider our domestic situation. We are projecting a GNP of substantially more than \$800 billion this year, none of which will be paid for in the accursed metal. We are on the verge of a checkless society, when even paper symbols of the transfer of wealth will diminish in importance. To cap it all, the citizens of this country, who are the wealthiest in the world and logically would be the best customers for gold, are forbidden by law to own gold bullion. Finally, with the removal of the gold cover on Federal Reserve notes, there will be no domestic link left in our monetary system. Under these circumstances, it seems unimportant whether the holes in the ground are full or empty.

It is in the world monetary systems that gold still holds its ancient tyranny; but even for nationals of the developed countries of the West, the logic of private purchase of gold as an investment is hardly a clear case. Its value is pegged at a fixed price. Gold not only earns no income, but it costs somewhat more than 6 per cent per year to hold. True, there will be a speculative gain if the price is raised, but the speculative values are hardly as measurable as those inherent in the stock of a major U.S. corporation. And the odds against an increase in the price of gold are not diminished by the firmly reiterated declaration of most of the major industrial nations of the free world that there will be no change in the price of gold. How credible are these declarations? That cannot be answered without a close look at our monetary uses of gold; our present monetary stocks of gold, the rate of consumption, and the alternatives being discussed in different countries.

What monetary uses has our gold? It has provided an inaccessible cover for Federal Reserve notes; through the limited convertibility of foreign dollar claims it has furnished what some argue is the major reason the U. S. dollar has maintained its status as a reserve currency; and it has been the means of settling part of our continued deficits in the balance of payments. Because it is so much in our minds, let's start this analysis with a look at our balance of payments position.

Table 1

The Balance of Payments of the U.S., 1958-67
(Billions of U.S. Dollars)

	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967**</u>
Exports of goods and services	23.0	23.5	27.0	28.6	30.3	32.3	36.9	39.0	43.0	45.6
Imports of goods and services	-20.8	-23.3	-23.2	-22.9	-25.1	-26.4	-28.5	-32.0	-37.9	-40.2
Balance on goods and services	2.2	.2	3.8	5.7	5.2	5.9	8.5	7.0	5.1	5.4
Remittances and pensions abroad	-.7	-.8	-.7	-.7	-.7	-.9	-.9	-1.0	-1.0	-1.4
Balance on goods & services, remittances & pensions	1.5	-.6	3.1	5.0	4.5	5.0	7.6	6.0	4.1	4.0
U.S. Govt. grants & capital flows, net	-2.6	-2.4	-2.8	-2.7	-3.0	-3.6	-3.6	-3.4	-3.4	-4.2
U.S. private net investment abroad	-2.9	-2.3	-3.9	-4.4	-3.5	-4.5	-6.5	-3.7	-4.2	-5.1
Foreign net investment in the U.S.		.9	.3	.7	1.0	.7	.7	.2	2.5	3.9
Errors & omissions*	.5	.4	-.8	-1.0	-1.2	-.4	-1.0	-.4	-.3	-.9
Balance on international accounts	-3.5	-4.2	-3.9	-2.4	-2.2	-2.7	-2.8	-1.3	-1.3	-2.3

* Reflects mainly "hot flows" of funds.

** Annual rate based on first nine months.

Source: U.S. Department of Commerce, Survey of Current Business.

The fourth quarter of 1967 saw a catastrophic turn in our balance of trade. It now looks as though the liquidity deficit for 1967 will exceed \$3.5 billion.

So much for our position: what are we doing about it? Because of the continued drains caused by Vietnam, direct investment, and the limited prospects of quick improvement in our current account, the President on the first of January announced a program which is supposed to improve the balance by about \$3 billion in these ways: by curbing direct investment, \$1 billion; by tightening the restrictions on lending by financial institutions, \$.5 billion; by curtailing travel, \$.5 billion; by cutting back government expenditures overseas, \$.5 billion; by stepping up the encouragement of U.S. exports, \$.5 billion. And the surtax, of course, is thrown in to curb final demand.

While I do not intend to enter into a discussion of the merits of the program, its chances of total success are certainly questionable. Not only are parts of it dependent upon legislation, but it also assumes that there will be no retaliatory measures by other countries, malicious or forced by circumstances.

As to legislation, your appraisal of the news is as good as mine. It is hardly encouraging. What about retaliation? One of the few bright spots of the last two years has been the extraordinary cooperation that has developed among central bankers. At least for them, the ancient wisdom of hang together or hang separately has been heeded. There is reason to believe they are sympathetic to our attempts to remedy our deficit position, and are not contemplating immediate retaliatory efforts, even though the areas of their anxiety will be considerably enlarged. Less certain is any assurance that central governments will be all that cooperative to accept a trade-off of short-term losses for long-term gains. Cries for protection of "our" industry from "theirs" have

always been a part of every country's political heritage -- although muted for a few years, these ancient tunes are coming back in style, and it's an unusual politician who fails to respond when they are played loud enough. Protectionism is mutually reinforcing -- once the commitment to retaliate has been made, there is no problem in finding countries or industries to retaliate against. The effect on world trade can only be disastrous.

A requirement that the U.S. eliminate its balance of payments deficit as a condition precedent to a serious inquiry into international liquidity and the roles of gold has the same immediate appeal to a belief in a world of rational discipline as an argument for a return to the gold standard. It assumes that governments will confine themselves to an area of response determined by traditional monetary goals. If you are in deficit, you contract your economy, increase interest rates, and accept a higher level of unemployment; in response, capital flows in, imports fall as the domestic market shrinks, and exports increase as price adjustments make your products more competitive. It seems to me there are two very large reasons why this orthodoxy will no longer work if applied by this country. First, we have officially and emotionally embraced another orthodoxy. Expressed in the statement of national economic policy of the Full Employment Act of 1946, we have pledged ourselves to a full employment economy. Secondly, there is a response of scale among nations. Because of our enormous position in the economy of the world, changes in our domestic policies are quickly reflected officially and privately in the economies of other countries. It was one thing to urge upon France, in the early 1950's, or upon England in the 60's, that they should deflate their economies by whatever means to expiate their financial sins, for the effect on other major industrial countries could be compensated through conventional mechanisms without reproducing the same conditions in their countries. But it is quite something else for the U. S. The economies of the rest of the free world are immediately responsive to changes in

ours. As has been pointed out a number of times by our foreign critics, we do export inflation -- but it must also be remembered we export recessions as well. And recessions have more political impact than inflation. Our trading partners, forced by their national interest to protect their balance of payments, respond with changes in their monetary and economic policies that usually reinforce the deflationary pressures set in motion in the U.S. And some of these changes, like devaluation, may be more or less involuntary reactions without alternatives.

It is at least arguable that our balance of payments deficit has been less an international problem than a solution to easing the liquidity pressures of our trading partners and the beneficiaries of our aid and military assistance programs. Of the increase in free world reserves (\$20 billion), about 65% was in foreign exchange. Of this, 90% was composed of U.S. dollars, which reflected that part of our deficit our creditors were willing to hold in dollars, which has been no small contribution to world liquidity. For the world as a whole, there is always a "balance" of payments. It is simply a matter of double entry bookkeeping. For every deficit there must be a surplus. If the President's aggressive attack on our balance of payments deficit is successful, then obviously some of those nations in strong surplus positions will have to adjust their sights downward, and some others will have deficits of their own to settle. There is no way of predicting how the adjustment will be distributed with any degree of precision, but if it corresponds roughly to our trading partners, the burden will fall on Canada, Japan, the United Kingdom and West Germany, in that order. Nations that have benefited from capital flows from this country will also bear their share. The principal ones have been Canada, West Germany, the United Kingdom and Australia. It might be speculated that like so many broad programs, the impact will be most severe on countries least able to sustain it.

Nothing I have said should be taken as approval of continued and deepening deficits in our balance of payments. I have a fundamental distaste for financial

irresponsibility, and the word "deficit" has unpleasant connotations for me in any context. What I am saying is that because of our role in the world, correcting our balance of payments is not going to do much to solve the broader problems of world liquidity. A program to eliminate our deficit will force a readjustment of reserves in the world, but it won't add any except as it may make dollars a little more acceptable. To start with, I am not all that sure the dollar is in all that danger professed by some of the gnomes, who are not all in Zurich. Until some other alternative emerges for reserve expansion, it is still as good as gold in most countries, for want of any other options. Further, the number of dollars a country will hold is regulated in substantial measure by that country's national interest in financing world trade of its people. An all-out effort by the U.S. to alter its economic policies to redress the U.S. deficit may, in fact, alter foreign attitudes about the dollar, and may indeed have a moderating effect on world liquidity pressures; but fundamentally, I suspect, by reducing the level of world trade and the need for expanding reserves however constituted. In support of this conclusion, which I must admit is contrary to an article of faith of many of my betters, let me explain.

As was pointed out by Messrs. Butler and Deaver of the Chase Bank in an article on "Gold and the Dollar", which appeared in "Foreign Affairs" a few months ago, "nearly one-quarter of world trade crosses our frontiers; we provide nearly half the world's private foreign investments; probably more than half of all international money transactions are denominated in U.S. dollars."

Given this position, it is less noblesse oblige than self preservation to be concerned about the impact of our short-range economic objectives on the rest of the world and the possible responses of other countries. The possibility of a return to a world of controls is not a pleasant one to contemplate.

Next let's take a look at gold stocks. Much has been made of the imperishability of gold. And it is. A substantial part of the gold mined in the history of the world is still in existence; one authority has estimated that all the gold ever mined could be put into a cube 90 feet square, or about 100,000 tons. Although the mining of gold has expanded enormously since 1900, it has not kept pace with the liquidity needs and industrial

needs of the world. Nor has the speculative desire to hold gold shown any sign of abatement. The two principal sources of gold for the free world have been mines and Communist sales--both of these sources showed a decline last year. Even more significantly, monetary stocks in the non-communist world showed a net loss in both 1966 and 1967. In short, all the gold produced from traditional sources in the last two years has either gone into industrial uses or has been reburied by hoarders.

Table 2

Supply and Use of Gold, 1953-67
(Millions of U.S. Dollars)

<u>Year</u>	<u>New Production</u>	<u>Russian Sales to West</u>	<u>Net Official Purchases*</u>	<u>Private Demand**</u>
1953	845	75	455	465
1954	895	75	670	300
1955	940	75	665	350
1956	975	150	490	635
1957	1015	260	690	585
1958	1050	220	680	590
1959	1125	300	750	675
1960	1175	200	345	1030
1961	1215	300	600	915
1962	1290	200	330	1160
1963	1350	550	840	1060
1964	1395	450	725	1120
1965	1435	550	400	1585
1966	1440	--	-95	1535
1967***	1069	--	-225	--

* Addition to monetary reserves of the non-Communist countries.

** For industrial use and speculation purposes in non-Communitis countries.

*** First nine months.

Our gold supply has been the principal sufferer. From a high point of \$24.6 billion in 1949, our supply has dropped to \$11.8 billion as of a few weeks ago. There are two channels of escape -- through central bank demands from other countries, or through the London gold pool.

Let us start with the first of these. Generally, the number of dollars a foreign central bank is willing to hold depends partly upon the quantity needed to finance the trade of its economy in dollar areas, partly upon its assessment of the continuing value of dollars, and partly upon its political interests as they relate to the U.S. Because the U.S. dollar is regarded as a reserve currency -- i.e., to be counted as a gold equivalent in official reserves -- central banks have been willing to hold substantial numbers.

For example, out of the approximately \$64 billion of official reserves in the free world at the end of 1966, \$23 billion was in reserve currencies -- either dollars or pounds. And if from the \$64 billion you exclude the United Kingdom and the U.S., because their reserves have been largely in gold, 45% of the remainder has been in dollars and pounds, but mostly dollars. These dollars got into reserves, as I said earlier, because of our continued U.S. deficits -- deficits paid for only partially in gold, the balance in dollars. The reason most frequently ascribed to the willingness of foreign central banks to hold dollars has been their convertibility into gold at a fixed exchange rate; but certainly as important a reason is the industrial productivity of the United States. The capacity to pay debts is at least as important as collateral, as every banker knows.

But it is not only the dollars lodged in the reserve accounts of foreign central banks that represent a threat to our gold supply, but the dollars that are in economic pipelines, such as in foreign bank accounts

denominated in dollars. These totaled 17.6 billion at December 31, 1967 . These dollars are held because they are truly the world currency, and are essential to the process of trade. Short of a total world-wide economic disaster, there is no more reason to expect these dollars to be presented as claims against our gold stock than for all of a bank's depositors to demand specie at the same time. But their presence does pose a continued threat simply because of their sheer size.

It might be useful to give you an idea of how these dollar claims are converted into gold. As you know, our Treasury will pay out gold only to the Bank of England to restore the gold pool, or to a foreign central bank. A Frenchman who no longer wishes to hold dollars can do two things with them: he can exchange these dollars for francs or other currencies through the French banking system, with the dollars eventually finding their way to the French central bank. The Bank of France periodically appraises its stock of dollars against the demands of the French banking system for dollars, and their own national interest. If their stock of dollars is too high--and unfortunately, they nearly always think so--they present these dollars to the U.S. for gold.

For the non-official holder of dollars who wants gold, there is the gold pool. Here he can join the oil sheiks and others who prefer gold to a currency--provided their own country permits them to own gold, which may or may not be a deterrent. The London gold pool is a consortium of the larger industrial nations, now excluding France, who have agreed to use the Bank of England as their agent to buy or sell gold in any quantity at roughly \$35 an ounce. Periodically the Bank of England requests the countries making up the pool to reimburse its gold stocks. Our share now is 59 per cent. Our gold loss last year through the pool and through claims presented by

foreign central banks amounted to \$1.175 billion.

The pool is extraordinarily responsive to world conditions. The British devaluation and the war in the Middle East have produced the most severe buying sprees; but in addition to these, like any other volatile commodity market, the gold market quickly reflects the hopes and fears inherent in any infinite range of rumors. Unfortunately, this commodity also happens to have a monetary role. For better or for worse (and occasionally there is a better; although the pool has been a net seller, there are days when gold can be bought by the pool), the monetary stocks of the major industrial, non-Communist countries, except France, are linked to the pool.

As I said earlier, central banks have developed remarkable patterns of mutual assistance. Official gold transfers from this country generally have been less of a danger than the unpredictable surges in the gold pool. Still, though, the twin questions of price and access to our gold stocks remain.

How do we free ourselves from the inflexibility of the present arrangements? Of all the many proposals ranging from a return to the gold standard to flexible exchange rates, one of the most intriguing is the one advanced by Butler and Deaver, those two economists at the Chase I quoted earlier. I am not endorsing it, but let me describe it to you for its merits as one of the more imaginative proposals. Briefly stated, their proposal is to "clearly indicate that we will never support a price higher than \$35.00 an ounce even if other central banks should use their dollars to buy all the gold in the U.S. Treasury." To buttress this statement, the U.S. Treasury would make sales and purchases only at that price, and at its discretion. What would be the consequences?

It would be the end of the gold pool. It would also mean loss of control over the foreign exchange value of the dollar. Instead of linking

these two commodities via the pool and the unlimited convertibility privilege, they would be separated. And separate they certainly would, especially at first, for they would now be priced on their individual merits. The contemplation of the confusion and dismay among gold hoarders is almost enough in itself to recommend the proposal.

Dollar markets would be the immediate concern of central bankers. If they were unwilling to accept the dollar standard, the rate might well sag for a time. But a sure limit would be the trade advantage given the U.S. To offset this, there might be retaliatory measures of trade and exchange restrictions, but as the authors pointed out, the resulting chaos would be to no one's advantage, and would be contrary to the responsible behavior the European central bankers have consistently demonstrated in the post-war period--behavior not always consistent with published statements.

The criticism that acceptance would be endorsement of permanent U.S. balance of payments deficits does not follow either. Instead of requiring the U.S. to take unilateral steps to redress its position--steps which are certain to cause them to wince--there can be a bilateral effort to assist us by assuming a larger share of aid to under-developed countries, encouraging expansion of their own capital markets, and by reducing some of their tariff barriers.

I am sure there are holes in this argument--if they don't exist, the argument will be changed by the critics to produce them. As Paul Samuelson once said, "Gold is to economists what sex is to biologists--except sex has far more real importance."

The fact is, I suspect, the U.S. has to take the initiative in freeing a complex and expanding industrial world society from the preoccupations with the price of gold, if we are to get on with the real problem of

making the present system of international finance capable of supporting world economic growth.

So we come to the world monetary dilemma--the growth of monetary reserves in the free world must keep pace with the expansion of world trade; but with no substantial increase in traditional gold sources in sight, an understandable reluctance to hold sterling, and a general unhappiness with U.S. economic policy, which has made foreign central bankers uneasy about dollars, the principal post-war sources are no longer adequate.

The fear that preoccupation with the balance of payments may distract us from the larger considerations of world liquidity and gold is a real one, I think. In the crisis climate that now seems a permanent part of our world, the relief that follows discovery of an expedient seldom has much relevancy either to the enormity of the problem involved or to its long-range solution. The price for time gets progressively higher.

Any analysis of long-range solutions has to start with some history. The Bretton Woods Agreement was the "great step forward" for the free world in its attempts to move away from the rigidities of the pre-World War II international monetary systems. Out of it came the International Monetary Fund, which was designed to accomplish these things: 1) to provide a source of emergency credit for participating nations, and 2) to provide a mechanism for the stabilization of exchange rates. In its first objective it has succeeded rather well, but the second objective succeeded too well. Although it is explicit in the framework of the Agreement that nations can make periodic small adjustments in their exchange rates to meet shifts in their currency relationships to other currencies, the prejudices of several thousand years against changes in currency values were impossible to overcome.

A number of expedients were added during the next 20-odd years to

cushion surges in exchange markets. Credit facilities were added through the B.I.S.; swaps or guaranteed currency loans were contributed by Bob Roosa along with special bonds for foreign central banks denominated Roosa bonds in his honor; significantly, central banks of the major industrial nations of the non-Communist world moved closer together for their mutual protection--but until last summer nothing was done to enlarge the owned reserves of the free world. Then came S.D.R.'s--special drawing rights. Although the label carries a connotation of a credit instrument, this was only to placate certain intransigent members of the I.M.F. who wanted to preserve the appearances. They are much closer in a philosophic sense to an original proposal advanced by Keynes during the Bretton Woods discussion for a new monetary unit than they are to the credit portion. Subject to a number of restrictions to protect the I.M.F. community from abuse of the new units, the proposal contemplates the addition in an orderly way of a new monetary unit to the members' reserves--a unit to circulate on a parity with gold and dollars among signatory nations for severely limited purposes. The present timetable requires ratification by the legislative bodies of the governments involved, which may take another year. Before any are issued, a vote of 85 per cent of the membership is required. This was one of the compromises to please the French, and will assure a veto right to the Common Market countries. How quickly they will come into existence, how receptive central banks will be to them, are questions yet to be answered.

There are those who still feel the central uncertainty in international exchange markets will continue to be the role of gold--and generally this means its price. Again, doubling its price has the virtue of simplicity. As the owner of the largest single gold stock, the U.S. would be the principal beneficiary. We could pay off our principal debtors and still have as much

as we have now. Adjustments could be made to salvage our reputation for financial probity on an ad hoc basis by supplemental payments to our special friends. World gold production would be stimulated. So goes the argument.

In rebuttal, there are these points to be made: 1) Having maintained repeatedly there would be no change in the price, the U.S. would have at least as difficult a time reestablishing its credibility as the British Government following devaluation. 2) While it would benefit us in the short run, the benefit to France, the speculators, South Africa, and Russia would be disproportionate. 3) It would certainly bring about a reallocation of resources directed to the mining of gold, which in the present state of things in the world should be of low priority. 4) It would be a one-shot expedient when what the world really needs is a mechanism which will permit the continuing adjustments of reserve needs. We have the framework of this mechanism in the I.M.F. and the ancillary institutions. We encourage manufacturers of things to continuously refine and adapt them to our changing uses; we should be equally willing to accept the necessity of adaption of political and economic institutions, instead of seeking always for the dramatically new once-and-for-all solution.