THE BALANCE OF PAYMENTS, THE DOLLAR, AND GOLD

Speech by Darryl R. Francis, President
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The United States is currently twice blessed with serious international economic problems. One problem is a weak balance of payments, and the other is a weak international monetary mechanism. The balance of payments problem stems from the domestic inflationary pressures that have developed in the last three years. The United States is not unique with respect to this problem which any country can expect to face if it attempts, through public policy, to force economic growth beyond productive capacity which eventually produces serious inflation. However, the other international economic problem we presently face is, in many ways, unique. It is the growing and obvious weakness in the international monetary mechanism. The United States is the architect of that mechanism, and the dollar is its major bulwark.

Many people tend to confuse these two problems, suggesting solutions to our international economic problem without specifying which problem the solution is designed to correct. Although these two problems are interrelated, they are not the same and cannot be dealt with by the same methods. Once we realize these are two diseases, we can consider appropriate remedies for each. In my opinion, the remedies suggested in the President's January 1st message to correct the balance of payments problem can not be effective. The only successful remedy for that problem is restrictive monetary and fiscal policies at home.

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With respect to the problem of a weak international monetary mechanism, the best solution is for the United States to ultimately eliminate gold from the process. The step taken on March 17 to suspend gold sales to private markets was a step in the right direction, but it may not have been enough. The Special Drawing Rights once again enunciated at the Stockholm meeting last weekend is a further step forward if they can be activated in time and in sufficient volume.

Now that I have given you my recommendations, I will build a factual and analytical structure which I believe justifies these conclusions.

Balance of Payments Problem

There are essentially two ways to correct a balance of payments deficit: through direct controls on international transactions which forces people to reduce their spending, or through monetary and fiscal policy and the price mechanism which induces people to reduce their spending by changes in the environment of the market place. We seem to have chosen the direct control alternative, which I consider unfortunate, unworkable, and, most important, an abridgment of personal choice. When implemented, the President's January 1st call for administrative controls to correct the United States Balance of Payments problem will affect all segments of the American public. Private citizens will no longer be able to travel as freely. Businessmen will no longer be able to invest in foreign countries as freely. Bankers will no longer be able to make foreign loans as freely. Government officials will conduct international affairs more on the criteria of the foreign exchange cost and less on the criteria of general national interest.

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The use of direct administrative controls to correct economic problems has been used widely in other countries, but we have traditionally used economic tools to correct economic problems. The President's January 1st program represents a break with our traditional way of dealing with economic problems.

Reviewing other experiences with such controls may provide insights into its possible success.

On two recent occasions the United States has attempted to use administrative controls to improve the balance of payments. The Interest Equalization Tax of 1963 was designed to discourage investment in foreign stocks and bonds by raising the effective costs of such purchases. The Voluntary Program of 1965 covered a much broader range of capital movements than the Interest Equalization Tax, including corporate direct investments and foreign bank loans. Each of these programs was preceded by a sharp deterioration in the United States balance of payments. Furthermore each was followed by a temporary improvement with a reduction in the capital outflow in the particular segments of the balance of payments at which they were directed. However, other components of the balance of payments sprang additional leaks, and the overall payments position was not permanently improved. Neither of these programs could be considered successful.

The explanation of this lack of success is that administrative actions to solve economic problems run counter to the narrow self-interest of those who are affected. They have substantial incentives

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to devise methods to avoid controls. As pointed out in the Wall Street Journal, they prefer that the problem would be corrected in the marketplace, not at a legislative level. The discipline of the marketplace cannot be evaded or avoided, but legal restriction often can. Evasion of the law is difficult to prevent, especially if the enforcement procedures are weak and the penalties mild. Legal avoidance of the intent of the law by discovering and utilizing "loopholes" in the administrative regulations is even more popular. Inevitably, the authorities in charge of the program implement more restrictive enforcement methods to prevent illegal evasion, and propose more comprehensive controls to prevent legal avoidance. This has been the experience of many foreign countries and seems to be what we are doing.

The logical outcome of such a progressive movement is to plug all conceivable loopholes and introduce the most severe penalties for those who break the rules. The end result is a complete, comprehensive and restrictive set of foreign trade and capital controls which is so complex and unwieldy that it is a serious impediment to domestic growth and an efficient distribution of resources. In addition, as Gabriel Hauge, President of the Manufacturers Hanover Trust and past Chief Economic Adviser to President Eisenhower, observed (at a meeting of the American Chamber of Commerce in London), "The resort to controls of one sort or another to deal with a problem that has its roots deep in the nation's economy is likely to be increasingly ineffective as time goes on . . . "

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Thus, I am rather pessimistic about the success of the January 1st program. Although more comprehensive and more restrictive than our earlier balance of payments programs of 1963 and 1965, it is still far from being a complete set of trade and capital controls.

An administrative program carried to its extreme, might temporarily alleviate the symptoms of our balance of payments problem. The political cost in the form of loss of freedom of choice and the economic cost in the form of misallocation of resources which comes from distorting the price mechanism, would be substantial. I question whether we should or would be willing to pay such a high price for solving a problem in a segment of our economy which represents only five per cent of our national income.

I think it would be wiser if we attacked the prime cause of our present balance of payments problem, the serious domestic inflationary pressures which have developed since 1964, with economic tools. The sharp deterioration of our balance of trade surplus, the strongest segment of our overall balance of payments, is due almost exclusively to domestic inflation. Not only will the resolute use of monetary and fiscal tools to restrain total demand strengthen the balance of payments, but it will also be conducive to stable and non-inflationary growth in the domestic economy.

International Monetary Mechanism Problem

Putting our domestic house in order, however, is only half of the job. The other half is to strengthen the international financial

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mechanism, which has become increasingly and obviously incapable of meeting the long-term needs of world trade and capital movements. The present mechanism as established at Bretton Woods in 1944, largely under the auspices of the United States, is designed to generate a form of international money. This money is needed to meet the needs of world trade and finance, just as domestic money is needed to meet the needs of domestic trade and finance. Unlike domestic money, there is no international central bank to supervise the growth in international money. The mechanism has been allowed to run more or less on its own.

International money is composed of monetary gold stocks, automatic drawing rights on the International Monetary Fund, and non-resident holdings of British pound sterling and United States dollars. These various components of the international money supply must be freely convertible between one another at a fixed price if they are to be considered equally valuable. Holders must be able to shift from dollars to gold to sterling without loss, just as in the domestic economy money holders can shift between currency and demand deposits without loss.

The weakness in the international financial mechanism is the growing fear in some quarters that this free convertibility at fixed prices will not continue in the future. There are numerous cases where such expectations have hurt the domestic economy. Consider the runs on United States banks in the early 1930's. They represented an attempt by people to shift their money holdings out of deposits and into currency,

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because of fear that deposits would lose their convertibility. The short-term solution of the run on the banks in the early 1930's was a one-week holiday, and the long-term solution was the development of deposit insurance which, in effect, guaranteed deposits up to a certain amount. The integrity of our domestic monetary mechanism was restored by these actions and has not been seriously questioned since.

The sterling devaluation in November 1967 was a shock to the international financial mechanism, because one of the component currencies of the international money supply had lost value relative to the other components. Confidence in the mechanism was shaken, precipitating a movement into the component of the international money stock which was expected to be of greater value. This is the underlying reason for the gold rush in the London market. The short-term solution of the run on the London gold market was to give that market a two-week holiday. The long-term solution that has been proposed is to attempt to wall off the private market for gold from the official market for gold.

The two-price, or two-market system for gold will be accomplished by the United States and the other members of the gold pool refusing to buy or sell gold to private persons. In addition, the United States as the only country in the world which has freely bought and sold gold to other governments, will suspend gold sales to any government which buys or sells gold to the private market. This restriction applies to governments buying gold from their own gold producers. It will have a major effect on South Africa which

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has usually added domestically produced gold to its international reserves in periods of balance of payments surplus and drawn down these reserves during periods of balance of payments deficit.

These regulations, if successful, will freeze the stocks of gold held by governments at their present level. New supplies of gold presumably would all go into non-monetary use. The purpose is to separate the demand for gold as a commodity from the demand for gold as a component of the international money supply. The uniqueness of gold is that it has been simultaneously a commodity and also a component of the international money supply. By attempting to separate the commodity demand for gold from the monetary demand for gold, it is hoped that private speculation in gold will have no more effect on the international monetary system than private speculation in any other commodity.

A two-price system for gold will be successful only as long as the commodity market and the monetary market for gold can be kept separate. That in turn depends primarily on two factors. First is that the monetary demand for gold will not grow in the future. Second is that the commodity price of gold will not be significantly higher than the monetary price of gold. If the first condition does not hold, then the monetary demand for gold will pull gold from the commodity market. If the second condition does not hold, the commodity demand for gold will pull gold from the monetary stocks.

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The natural forces of the marketplace would tend to increase the demand for monetary gold stocks. Surplus countries would desire to have some of their increased reserves in the form of gold. On the other hand, deficit countries would most likely prefer to reduce the non-gold portion of their reserves. Such developments would imply that the United States must still continue to act as the residual source of gold supplies to central banks. Unfortunately, after the massive gold losses from December through March of this year, the United States is in a rather weak position to play that role. Our gold stocks stood at $10.4 billion as of the end of March. The United States could probably meet the gold needs of the smaller countries, but not of the larger countries. Thus, if the monetary demand for gold is to be kept from rising, it will be necessary for the major countries of the world to individually and collectively refrain from purchasing gold from the United States. The only conceivable incentive these governments would have to cooperate with us in this way would be their reluctance to see the present international monetary system, based on a fixed official price of gold, disappear. It is ironic that to preserve the gold exchange standard most of the major countries of the world must be prepared not to exchange gold.

A second way in which this system could break down is for the commodity price of gold to rise significantly above the official monetary price of gold. If the commodity price of gold were, for example, $70 an ounce,

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it is quite likely that imaginative profit-minded speculators would manage to find some method of acquiring monetary stocks of gold which are officially priced at $35 an ounce from some central banks.

What could cause the commodity price of gold to rise significantly above $35 an ounce? As with any commodity, that would depend on the supply and demand for gold. The major source of new gold supplies is South Africa, which provided something like 70 per cent of new gold supplies in the last decade. South African gold production increased from 3,700 tons in 1956 to 9,500 tons in 1966 due entirely to the discovery and exploitation of major new gold-mining regions. In 1967 these new mines supplied 83 per cent of South Africa's annual output. It is estimated that at the $35 an ounce price, South Africa's gold production cannot increase above its present level, and will probably decline somewhat in the next few years. Thus, a substantial price increase would be needed to increase new supplies of gold coming onto the market in excess of the present level of $1.5 billion per annum.

With respect to the other side of the market, there are two components to the commodity demand for gold. The first component is the commercial, industrial, and artistic demands. These have grown in the postwar period at a steady rate because of the rise in real incomes and the rise in general price level. They took approximately one-half of the world's gold production in 1967. The second non-monetary demand for gold consists of those gold purchases which cannot be specifically

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identified with the first demand and are assumed to be largely speculative in nature. It is this speculative demand for gold which has shown the sharpest variations from year to year.

As with speculation in any commodity, gold speculation is based on the expectations of buying at a low price and selling at a higher price. Most speculation was based on the expectation that the United States would unilaterally increase the price of gold. Now that the United States, in agreement with the other active gold pool countries, has instead suspended gold sales to the private market, private speculation will be more risky. There are likely to be greater variations in the price of gold and no guarantee that the price cannot go below $35 an ounce. Therefore, some persons who might otherwise have speculated in gold will withdraw from the market.

The sharp decline in the volume of activity in the private gold markets after the March 17th announcement of suspension of sales by the gold pool countries is due to speculators who are obviously waiting to see what further action the central bankers will take. If the central bankers of the major countries refrain from purchasing gold from the United States and agree to activate an alternative form of international reserve asset to supplement the frozen monetary stocks of gold, then the monetary price of gold could remain unchanged at $35 an ounce. Under these circumstances, speculation with respect to a rise in the monetary price of gold would probably decline. Given that the non-speculative demand for gold is only one-half of new production at the

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price of $35 an ounce, it is possible that the commodity price of gold in the future might be below $35 an ounce.

The key to a viable international monetary mechanism is to prevent the commodity demand for gold from affecting our international money supply. The two-price structure for gold is a step in that direction. Whether it is a sufficient step will depend upon the degree of cooperation among the major governments of the world. Generally, such cooperation is hard to achieve because governments, like persons, so often see the narrow, short-term disadvantages of cooperation in a stronger light than the wider, long-term advantages. People tend to highly discount both the risks and the benefits associated with actions to affect the future. It generally takes a period of crisis to force people and countries to subordinate their short-term interests to achieve some long-term goal.

An analogy may be drawn from the Cuban missile crisis of 1962. Prior to that event no effective policy efforts had been made towards nuclear disarmament or arms control although a considerable amount of intellectual effort had gone into analyzing the substantive issues. That crisis led the United States and the Soviet Union to the brink of a nuclear war. The horrors of such a possibility became very real in the minds of policy makers on both sides. After that event a substantial amount of progress was made.

With respect to the international monetary problem, the substantive issues have been carefully and exhaustively analyzed over the past four

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years and realistic economic solutions are available. What are required are policy level decisions to go ahead. If the panic which surrounded the gold speculation during the Ides of March created the crisis atmosphere in the minds of the world's central bankers to go ahead with a change in policy, then this will have been the most beneficial monetary development in the past twenty years.

Perhaps these expectations of cooperation by the world's major central banks are too optimistic. They may still insist on making purchases from our gold stock and refuse to activate a paper gold in sufficient quantity. That lack of cooperation is not apparent now and hopefully will not develop, but it is worthwhile to investigate alternatives in the event of a breakdown of the present high level of international cooperation. If such a breakdown were to become apparent, private speculation of an increase in the monetary price of gold would probably force up the commodity price of gold, and the United States would be forced to take unilateral action to correct the problem. There are only two solutions which the United States can unilaterally choose. One is to raise the price of gold, and the other is to withdraw completely from the gold market by suspending sales to foreign central banks as well as to foreign private persons. I do not under any circumstance favor raising the price of gold. It would perpetuate that "barbarous metal" in international monetary use. We have quite rightly broken the link between gold and our domestic money. We should also break the link between gold and international money. The supply of money, neither international nor domestic, should be dependent over the longer run upon the accidents of supply and demand in the marketplace for just one commodity.

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In the event the paper gold proposal should break down, I favor the United States unilaterally abandoning its promise to buy and sell gold at the fixed price of $35 an ounce. Unpegging from gold does not mean that the United States dollar would automatically be devalued. Devaluation is a change in the price of the dollar relative to other currencies, not relative to gold. To see whether the dollar would, in fact, be devalued, one must consider the possible reactions of foreign countries to the unpegging of gold. There are two: first, they could continue pegging the value of their currencies to the dollar. If their currencies were pegged to the dollar at the present exchange rate, the dollar would not be devalued in any meaningful sense. Second, they could peg their currencies to gold, in which case the international value of the dollar with respect to other currencies which are tied to gold would fluctuate. This action is unlikely because no other country would likely be willing to assume the heavy responsibilities of maintaining the gold standard. They would eventually face the same dilemma presently faced by the United States. In addition, they would be reluctant to see their currencies fluctuate with respect to the dollar. This would upset the trading practices of their exporters and importers with that country with which about 20 per cent of the world's trade is conducted. On balance, therefore, it is most likely that foreign countries would continue to peg their currencies to the dollar, even without the present gold backing.

If the dollar is likely to continue to be held by foreigners, even in the absence of gold backing, why the reluctance of United States

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officials to unpeg gold? Because of the repeated commitment of the United States to maintain a fixed price of gold at $35 per ounce. The United States could handle this issue by agreeing to compensate those foreign governments which have held dollars rather than purchasing gold because we asked them to do so. Such compensation would consist of allowing certain friendly central banks to turn in their green chips for gold chips if they desire at the rate of $35 per ounce of gold.

Some observers are fearful that if we unilaterally suspend gold sales to foreign central banks, the rest of the world, especially European countries, would not accept new dollar holdings. They feel that the option to purchase gold is necessary to induce foreigners to accept dollars. To prevent dollars from flooding into their country when they had balance of payments surpluses, these countries would impose various types of exchange controls. Let's assume for a moment that is the case. We would still be better off than we are now. At present, the United States is imposing exchange controls on its citizens in order to reduce our balance of payments deficit in the expectation that this will increase confidence in the dollar and reduce purchases from our gold stock. If we suspend gold sales, the pressures on the United States to maintain or expand these exchange controls would be reduced. I believe it is better to face the possibility of the Europeans imposing controls on United States citizens than the certainty of the United States imposing controls on United States citizens.

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In any event, the possibility of the Europeans imposing exchange controls is small. First, this would be the only time in history that a country has imposed exchange controls to reduce a surplus in its balance of payments rather than to reduce a deficit. Second, and more important, if the only issue is providing the Europeans with another alternative to holding dollars, there are techniques now available through Special Drawing Rights of the International Monetary Fund which could be activated to syphon off undesired dollar balances held by European central banks.

I mentioned before that actions to solve important problems usually must take place in an atmosphere of crisis so that the narrow parochial interests of the participants is subordinated to their collective long-term interests. If the gold crisis of early March did not create a sufficiently strong crisis atmosphere in the minds of the world's central bankers, an action by the United States to suspend gold sales to central bankers probably would.

An international financial mechanism based on dollars and Special Drawing Rights would be superior to one based on dollars and gold. Unlike gold, Special Drawing Rights can be expanded or contracted with the needs of trade and are not dependent upon the accidents of new gold discoveries for their supply. We need an international money based on paper and confidence just as we have domestic money based on paper and confidence. Basically, the value of our currency is supported by

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our production of goods and services and its purchasing power is dependent on our willingness to inject rational and responsible judgment into our budgetary and monetary management.

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