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Dollars, Gold, and International Payments

Remarks of Wm. McC. Martin, Jr.,
Chairman, Board of Governors of the Federal Reserve System,

before the
Annual Dinner Meeting of

The Bond Club of New York

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Two weeks ago, a proposal to modify our laws regarding the holding of gold as monetary reserves was put before the Congress by the President of the United States.

In the interval since, we have had considerable discussion not only of that proposal but also of the entire subject of dollars, gold, and international payments.

To me, that is as it should be, for these are matters that deserve the interest and understanding of us all. Accordingly, I should like to add some comments on them tonight, though I realize that little that I might say could seem new to a group as well versed in finance as this.

I'd like to begin with general observations on a couple of points that I hope every American will keep in mind.

First, what is involved here is not merely a matter of finance. That is attested by the recent entry into this discussion of one of the world's foremost political leaders, the President of France, with some suggestions that would downgrade the role of the dollar in international operations. The fact is that if the financial standing of the United States declines, the power and influence this country wields in the world's affairs--and seeks to direct toward the preservation of world peace--inevitably will decline as well.

Second, what we must constantly strive for in the conduct of our monetary and fiscal affairs is to provide assurance to every holder of the U. S. dollar--at home or abroad--of a full measure of value for his money. That requires that we make it a prime objective of national policy to preserve the integrity of the dollar, both in respect to its domestic purchasing power and to its international convertibility into gold, at $35 an ounce. If we do not preserve that integrity, we are not going to maintain confidence in the dollar--and without that confidence, we cannot possibly sustain the prosperous economies here and abroad that depend on the dollar and the trade it finances.

Fortunately, the strength and stability of our domestic economy, which go hand in hand with the strength and stability of the dollar, continue impressive. Our course forward on the path of relatively steady growth has been maintained unbroken now for 48 months, a record almost unrivaled in peacetime history. That is a performance in which we can all take pride. To prolong it, as I'm sure all of us would like to do, we must of course be on the alert to safeguard ourselves against the development of imbalances, in the credit field or elsewhere, that could bring a bitter end to the long sweet spell of prosperity. But for the moment, most if not all goes well here at home.

On the international front, we have been doing decidedly less well. The center of trouble is, of course, the continuing, chronic imbalance in our international payments accounts, where--instead of realizing hopes for a significant improvement--we added a further $3 billion deficit in 1964 to the more than $20 billion pile of deficits accumulated in the preceding six years.

As all of you know, a broad program aimed at ending our balance of payments deficit was launched yesterday by President Johnson in a special message to Congress in which the President declared emphatically that "the dollar is, and will remain, as good as gold, freely convertible at $35 an ounce."

The Federal Reserve System shares the President's concern about the deterioration in our balance of payments and his determination to improve our payments position and to strengthen confidence in the dollar. The System and the banking and financial community have been assigned major roles in the President's program.

The central focus of the program is on measures to reduce financial outflows, which have been heavy in recent years and in recent months have contributed to a worsening of our international payments position. In the fourth quarter of 1964, for example, bank credit to foreigners expanded by $1 billion.

To help assure the success of the program, the System is requesting all banks to limit credits to foreigners that are not clearly and directly for the purpose of financing exports of U. S. goods and services. Over all, the objective is to hold outstanding credits (including export credits) to foreigners during 1965 to a level not over five per cent above the December 31, 1964, outstandings. In most instances, this should be the minimum goal for individual banks.

I am confident that the financial community, of which you here are an important part, will join with the Federal Reserve System in this urgent national effort to restore balance of payments equilibrium and to maintain the dollar "as good as gold." To a considerable extent, the success of the President's program will depend upon our efforts.

Now I'd like to take up the earlier Presidential proposal, to amend the gold reserve requirements, which now has been approved by the House of Representatives by a vote of 300 to 82 and is to come up for consideration in the Senate in the near future.

The Federal Reserve Act, as it stands, requires each Federal Reserve Bank to maintain a gold certificate reserve of at least 25 per cent against its Federal Reserve notes in actual circulation, plus a further gold certificate reserve of at least 25 per cent against the deposits it holds.

The amendment the President has proposed would retain the requirement of a gold certificate reserve of 25 per cent or more against Federal Reserve notes, which constitute the principal part of our currency today. But it would eliminate the requirement of a like reserve against the deposits, which consist mainly of member banks' funds.

That conditions now call for some change in the legal requirements seems clear. By the end of 1964, the ratio of the Federal Reserve Banks' gold certificate holdings to their deposits and notes combined was 27.5 per cent, down 2 points from a year earlier and only 2-1/2 points above the legal minimum now prescribed in Section 16. If developments well within the range of possibilities should occur, the legal minimum could be breached soon, possibly within a year.

In the half century since the enactment of the Federal Reserve Act, the function of gold in our monetary system has undergone fundamental change. More than three decades ago, coinage of gold, redemption of bank notes and deposits in gold, and private acquisition and holding of monetary gold were discontinued in this country. Domestically, these actions in effect ended the private use of gold as a store of value. Internationally, they enlarged the availability of U. S. gold for official settlements with other governments in response to the needs of our foreign commerce and investment.

The readiness of the U. S. Treasury to buy and sell gold at the fixed price of $35 an ounce in transactions with foreign monetary authorities has greatly contributed to the willingness of foreign monetary authorities and private foreign residents to hold a growing total of dollar reserves and working balances. Consequently, the U. S. gold stock has come to play the dual role of supporting the international convertibility of the dollar and of facilitating the interconvertibility of other currencies among themselves and into the dollar.

This dual role of our monetary gold has in turn helped the dollar to attain a unique position in international commerce and finance. And the universal acceptability of dollars has greatly facilitated the record expansion of international trade over the past 15 years, with world trade rising from less than $60 billion to nearly $160 billion. For this reason, the availability of U. S. monetary gold holdings to meet international convertibility needs is a matter of vital importance not only to the United States but the entire present system of international payments on which the free world relies.

In consequence of the large and persistent deficit in the U. S. balance of payments after 1957, many foreign countries accumulated dollar balances in excess of their needs for working balances, reserves, and investments. Their monetary authorities used such excess dollar balances to purchase gold from the U. S. Treasury and the resulting decline in the U. S. gold stock has contributed to the sharp reduction in the System's reserve ratio.

Gold certificate reserves of the Federal Reserve Banks today are considerably below the peak of $23.4 billion they reached in September 1949, when U. S. held about 70 per cent of the free world's monetary gold. Over the period from 1949 through 1964, net sales of U. S. gold to foreign monetary authorities reduced our gold certificate reserve by $8.4 billion. In the same period, growth in Federal Reserve deposit liabilities and notes in circulation absorbed in required reserves $3.5 billion. Over these 15 years, therefore, Federal Reserve Bank holdings of gold certificates in excess of the minimum required by statute have on balance declined by $11.9 billion.

In substantial part United States' sales of gold to foreign monetary authorities since 1949 have reflected post-war recovery of the free world from the monetary chaos created by the Second World War, and the desire of the major foreign industrial countries to reestablish convertibility of their currencies. These countries sought to accomplish this by accumulating monetary reserves partly in the form of gold and partly in the form of dollar balances. Between the end of 1949 and the end of 1964, the dollar component of monetary reserves of foreign countries rose by $10 billion (from $3 billion to $13 billion) while their monetary gold stocks rose by $16 billion (from $9 billion to $25 billion). Foreign private holdings of dollars also increased by $8 billion, from about $3 billion to nearly $11 billion.

As you know, the Federal Reserve has acted to prevent the outflow of gold from exerting a deflationary impact upon our economy. To this end, the Federal Reserve offset the effects of the decline in its gold certificate holdings by expanding its holdings of U. S. Government securities. In addition, the System further increased its Government security holdings in order to sustain an expansion of bank credit consistent with a growing economy and a relatively stable average of prices.

Over the years ahead, the continued growth of U. S. economic activity will require continuing monetary expansion consistent with a stable dollar. Under prospective conditions, it appears all but certain that the gold certificate reserve ratio of Federal Reserve Banks, for domestic monetary reasons alone, will steadily decline, even if gold sales to foreign monetary authorities are small. Of course, any substantial further outflow of gold would accentuate such a decline.

I might note here that, to take care of the possibility of emergencies, the Federal Reserve Act has long contained provisions empowering the Board of Governors to suspend the gold reserve requirements, initially for a period of 30 days, and thereafter for periods of 15 days each. It seems clear, however, that the authority to suspend was intended to facilitate adjustments by those Reserve Banks whose reserves fall temporarily below required levels, and not to provide a solution to a national problem of more than temporary import.

Accordingly, the time seems ripe for legislative changes in the reserve requirements that will, as President Johnson said in his Economic Report,

> ". . . place beyond any doubt the ability of the Federal Reserve to meet its responsibility for providing an adequate but not excessive volume of bank reserves,"

and

> ". . . place beyond any doubt our ability to use our gold to make good our pledge to maintain the gold value of the dollar at $35 an ounce with every resource at our command."

Opinions may differ on what changes in the gold reserve requirements might best fit the country's needs. It seems to me that the method proposed by the President, which would eliminate the gold cover against the deposits and stop with that, provides a practical response to a practical question, and a response properly proportioned to the present circumstances. By removing the reserve requirement against deposits, it would free approximately $4.8 billion in gold now earmarked for cover purposes and raise the total free gold certificate holdings to about $6.2 billion.

Moreover, by retaining the traditional gold "backing" for Federal Reserve notes, the proposal would be reassuring to those who, in their continuing concern for the stability of the dollar, see in a gold cover requirement an important element of strength. The value of any currency is so much a product of confidence that one should not disregard this positive advantage of limited repeal.

The removal of the reserve requirement against deposits would seem to me fully adequate to meet our present and foreseeable needs and sufficiently ample to remove any doubt anywhere about our ability to defend the dollar abroad, and to further advance the progress of our domestic economy.

Regardless of what is done about legal requirements, there is an inescapable practical requirement that we maintain an adequate gold stock to back up the role of the dollar as a key currency in world trade. Hence the need to conserve our gold stock will in itself continue to exert a helpful disciplinary influence on monetary and other policies.

Let me say in closing that all of us need to be mindful that sound money is not established by statute alone.

In the end, our nation cannot have sound money unless its monetary and fiscal affairs are soundly managed. And sound management of our country's financial business depends upon the judgment, integrity, and courage of those charged with responsibility for these matters, not only in the Federal Reserve System, but also in the Congress and in the Administration as well.

The paramount necessity, in any event, is that we have the will and determination to preserve the value of our money, and that we demonstrate it unceasingly in our fiscal, monetary and debt management policies. If we do so, no change that we make in the gold reserve requirements will, in my judgment, impair the soundness and stability of our currency system; if we should fail to do so or, worse still, if our country should ever positively embrace inflation as an acceptable course, it would be unrealistic to suppose that any reserve requirement or other like statute, would suffice to save the dollar.

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