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THE PRICE OF GOLD IS NOT THE PROBLEM

Remarks of Wm. McC. Martin, Jr.,

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The international monetary system has been the subject of much uncertainty in recent months. The devaluation of sterling in November provided a shock which, against the background of a persistent deficit in the U.S. balance of payments, precipitated fundamental questioning as to the evolution of the international monetary system, the role of the dollar, and the price of gold. A number of observers in the United States and abroad have come to the conclusion that an increase in the official price of gold would be desirable; others have decided that, even if it is undesirable, a rise in the gold price is inevitable.

I am firmly of the belief that a higher gold price is neither necessary nor desirable. In reviewing with you the problems of the international monetary system, I want to make it unmistakably clear that the future evolution of the system can and should be based on the present price of gold.

There is no doubt that the problems facing the international monetary system are serious. I have no wish to underestimate their gravity. Consideration of the various solutions that have been proposed must be based on a clear understanding of the nature of the problems that we face. This is a time for cool-headed appraisal in the light of history and not for unmindful acceptance of panaceas that risk overturning a system that has provided the monetary framework for an unprecedented expansion of world income and trade in the period since Bretton Woods.

The case I shall put to you in what follows can be summarized in two straightforward propositions.

First, it is imperative to adjust the balance of payments of the United States away from large and persistent deficit and of Continental Europe away from large and persistent surplus. A higher gold price would do nothing to bring about those adjustments.

Second, the nations of the world need a means of increasing their reserves in a way that is not dependent on continuing deficits in the U.S. balance of payments. I am confident that the Rio Agreement on Special Drawing Rights can fulfill this function at the present price of gold.

The Dollar and the U.S. Balance of Payments

The root of the present imbalance in international payments can be traced back to the early years after World War II. At that time, the United States initiated a program of international assistance designed to promote the economic recovery of war-damaged countries. In the process, the United States deliberately created a deficit in its balance of payments, while countries in Europe and elsewhere deliberately sought to achieve surpluses. An important by-product of the recovery program was that it increased the depleted reserves of the war-torn countries--by putting them in a position to accumulate dollar balances and by redistributing U.S. gold reserves--which at the end of 1948 comprised more than 70 per cent of world gold holdings.

Policies designed to encourage a U.S. payments deficit took many forms. We provided funds through the Marshall Plan in amounts larger than was necessary for countries in Europe to purchase badly-needed American goods, thus making it possible for aid recipients to accumulate dollar reserves. We deliberately kept the aid untied by encouraging the spending of U.S. grants and loans in countries other than the United States. Much of the aid was in the form of grants rather than loans, so as to avoid burdening the future payments positions of the recipients. We provided special inducements for direct investment by American corporations abroad. We even encouraged European countries to liberalize their imports from each other while they continued to restrict their imports from the United States, and later we supported the formation of the Common Market.

In these and other ways, the United States adjusted its policies--and its citizens responded in their actions as importers, lenders, investors, and travelers--to the maintenance of a deficit in its balance of payments. In other words, the United States accustomed itself to an outflow of government and private capital in excess of its surplus on goods and services--with the result, as intended, that U.S. dollar liabilities increased and U.S. gold reserves fell. The countries of Continental Europe made a corresponding adjustment to a surplus position--that is to an inflow of capital from abroad combined with a pattern of transactions on current account that resulted in steady and sizable increases in their gold and dollar reserves.

It was during this period that the dollar became the world's major reserve currency.

It is significant that in those early years, we did not describe these payments positions as "deficits" and "surpluses." Many a newspaper article and book were written at that time about the persistent U.S. "surplus" and the intractable dollar shortage. The build-up of U.S. dollar balances abroad, together with the sale of U.S. gold to other countries, was universally regarded as desirable. And so it was.

But, like the man who came to dinner, the U.S. deficit, though invited, stayed too long. And so did the European surpluses. Both became chronic.

A continuing U.S. deficit of substantial size is neither desirable nor tolerable. Such a deficit saps the international liquidity position of the nation, by continually building up liquid liabilities abroad or continually reducing U.S. reserves, or both. A steady worsening of our liquidity position--even while our net worth is improving--cannot be sustained indefinitely. As a reserve currency, the dollar is widely held around the world. It is natural that holders of dollars look to our gold and other reserves, expecting us to maintain a reasonable relationship between our liquid reserves and our short-term liabilities, just as depositors look to the funds held in reserve by their banks.

The United States as a bank to the rest of the world was in the early postwar years a bank with too strong a liquidity position. By means of the Marshall Plan and the other policies I have mentioned, the bank embarked on a deliberate program that transformed its liquid assets into less liquid form, while its liquid liabilities expanded. In the process, the bank basically improved its position, while contributing significantly to world economic growth, for it acquired sound and high-yielding long-term assets around the world as a counterpart to its increasing liabilities. But its liquidity deteriorated, since its most liquid asset--its gold reserves--declined while its liabilities expanded.

This drawing-down in the bank's liquidity position--once welcome--has now gone on for too long. The time has come to arrest it, and to do so decisively. As this happens the bank's depositors--the rest of the world--must adjust to a slowdown in the lending and deposit-creating activities of the bank by providing other sources of capital and by establishing another means of increasing international reserves.

In other words, the world payments pattern is going through a period of transition--away from the pattern I have described--and the transition is understandably a painful one, since it requires a modification of so many policies and habits established earlier. The United States must cut the suit of its payments abroad to fit the cloth of its receipts from abroad. And the countries of Continental Europe must do the reverse--

they must find ways to export capital in an amount equal to the excess of their exports over their imports of goods and services--or else they must reduce their export surpluses. And the adjustment by both sides should be carried out in a way that is compatible with the healthy and inflation-free growth of the world economy.

The U.S. balance of payments program, announced on January 1 by President Johnson, should produce substantial results. That program is more severe than would have been needed had timely action on the domestic stabilization front been taken a year or more ago. Furthermore, the new program necessarily represents a step backward--temporarily--from our aspirations for freer world investment and trade. While the various features of the program are serving a necessary stop-gap purpose, it is essential that the United States strengthen its underlying payments position. This means, at the very least, that it is vital for the United States to pursue effective stabilization policies that promote price stability and a competitive cost structure.

The results of the balance of payments program will be sustainable only if the reduction of the U.S. deficit has as its counterpart a reduction of European surpluses. This is so because there are not many countries outside of Continental Europe that earn large surpluses or that have strong enough reserves to be able to adjust to a substantial improvement of the U.S. payments balance.

I am pleased to say that the reactions of European officials to the announcement of the U.S. program seem by and large to be highly constructive. They have made it clear that they understand the economic necessity I have just mentioned and that they intend to adopt policies designed to facilitate rather than interfere with the adjustment of the payments imbalance.

European officials recognize the need to prevent a reduction in total demand in their economies as U.S. foreign investment and other forms of spending in Europe decrease. They recognize the need to offset through their monetary policies tendencies for the reduction in the flow of dollars to Europe to tighten monetary conditions there and, more broadly, they recognize the need to encourage capital outflows from their markets. And they acknowledge that the pursuit of such policies may result in reductions in their own reserves.

Thus, we have before us the possibility, if stated intentions on both sides of the Atlantic are implemented with proper actions, of a highly successful effort of international cooperation--aimed at rectifying the imbalance in international payments and completing the transition away from the payments pattern that was established, in response to need, in the earlier postwar period.

In the light of this way of looking at the balance of payments adjustment problem, I can now put to you the following question: is there any reason to think that a higher gold price would help to bring about the needed adjustment?

It can be taken for granted that a unilateral devaluation by the United States is impossible; a change in the price of gold in terms of dollars would undoubtedly be accompanied by an equal change in terms of virtually all other currencies.

Would the U.S. balance of payments improve as the result of such an increase in the price of gold? Only to the extent that the enlarged foreign exchange earnings of gold producing countries led them to increase their purchases from the United States. But this would be a very small benefit compared with the magnitude of the U.S. payments deficit, and would be far outweighed by the many disadvantages that would accompany an increase in the gold price. Would American corporations have less incentive to invest abroad? Would Americans travel less? Would developing nations need less aid? Would our imports decrease? Would our military spending in Europe and Asia seem less pressing--if the price of gold were higher? The answer in each case is clearly no.

Would European surpluses decline as the result of a higher gold price? Not at all. In fact, insofar as gold producing nations increased their purchases from Europe, these surpluses would be aggravated.

It seems perfectly clear that a revaluation of gold would make little or no contribution to an adjustment of the imbalance in international payments.

There are those who will accept the point I have just made but will say that an increase in the gold price will buy time for the United States. Buy time for what? They can only mean that it would delay the need for forceful measures to improve the balance of payments--that it would permit the United States to avoid distasteful curbs on capital outflows or other payments abroad and continue to incur deficits, thus putting off the painful adjustment to a healthier balance of payments. It seems clear to me that a measure known to be intended to buy time, if it is not accompanied by action to improve the underlying problem, will in fact buy relatively little time--for markets will anticipate the lapse of the period of bought time and act accordingly. Thus, a rise in the gold price is not an alternative to measures to strengthen the balance of payments. Such measures are required in any event and cannot be avoided by an increase in the price of gold.

The United States can and must pursue domestic fiscal and monetary policies that keep its economy and its price level under control. This is the paramount economic issue of 1968. And it must for the time being persevere with supplementary balance of payments measures to help restore its external payments to equilibrium as quickly as possible. Tinkering with the international price of gold is in no sense a substitute for actions that face up to these hard facts of life.

The Dollar and International Liquidity

I turn now from the balance of payments problem itself to the relation between the U.S. balance of payments and international liquidity and the relevance of this to the price of gold.

It became clear soon after the war that as economic recovery and economic growth proceeded, countries wished to see their gold and foreign exchange reserves increase.

The balance of payments pattern that was established in the postwar period provided a built-in mechanism for expanding not only the reserves of the war-torn countries but also for expanding world reserves. Insofar as other countries added dollars to their reserves instead of using dollar accruals to buy gold from the United States, the U.S. deficit enlarged the reserves of other countries without reducing U.S. reserves. And even when other countries began to use a part of their dollar receipts to purchase gold from the United States, their reserves rose faster than our reserves fell--and world reserves expanded accordingly. But this process had the inevitable effect of reducing the international liquidity position of the United States.

The balance of payments adjustment that must now be accomplished will cut off this major source of reserve growth. Yet the desire of countries around the world to increase their reserves has not diminished and will not diminish. Thus another source of reserve growth will be needed.

It is understandable that nations wish to see their reserves increase over time. Individuals and businesses expect their liquid assets to grow as their incomes grow. Liquid assets are there to be used in times of temporary shortfalls of receipts below payments. But no individual or business and no nation can afford to see its liquid reserves diminish persistently. Taking all nations together we have observed, and will no doubt continue to observe, a tendency to add to reserves over time. What is needed is a steady and dependable supply of new reserves to satisfy this basic desire of nations to increase their reserves--a supply that is neither excessive nor deficient but consistent with the non-inflationary growth of the world economy. A once-for-all or once-in-a-generation increase in the value of gold reserves resulting from an increase in the gold price is no substitute for a gradual and steady accretion of new reserves. It is precisely this need that the Special Drawing Rights are designed to fulfill.

It has been clear for many years that new gold production alone cannot provide the necessary increase in world reserves. It is equally clear that dollars cannot and should not any longer satisfy a major part of the desired growth in the reserves of other countries. This was the basis for the unanimous decision of the members of the International Monetary Fund at Rio last September to proceed with the plan for Special Drawing Rights.

It has been said, and correctly, that the Rio agreement is a landmark in international monetary history. It is a landmark because it introduces a new concept--the deliberate creation of international reserves as a supplement to existing reserves of gold and foreign exchange. The Federal Reserve System is based on the proposition that "money will not manage itself." The SDR Agreement can be said to be based on the view that international money will not manage itself either. The willingness of monetary authorities to cooperate, through the International Monetary Fund, in the creation of Special Drawing Rights has unmistakable implications: it means that the world will be assured of a growing supply of reserves <u>at the present price of gold</u>.

Events of recent months--the shock to the international monetary system following the devaluation of sterling and the strong reinforcement of the U.S. balance of payments program--lend greater timeliness to the implementation of the Rio Agreement. Once the SDR Amendment is completed by the Executive Board of the International Monetary Fund and approved by its Board of Governors, I would hope that governments would proceed promptly to seek ratification from their legislatures.

The Role of Gold

I have said that neither of the two major problems facing the international monetary system calls for an increase in the price of gold. Such a step is neither necessary nor desirable as a solution to the problem of international payments imbalance or to the problem of assuring adequate growth in international reserves. It would be highly disruptive and highly inequitable. A small increase in the gold price would inevitably engender expectations of additional increases in the not-distant future, thus leading both private and official holders of dollars to convert them into gold and negating the increase in international liquidity that the gold price rise was designed to achieve. An increase in the price of gold of sufficient magnitude to avoid arousing expectations of another such move soon would have to be very large. It would undoubtedly be inflationary, for it would expand, by a corresponding amount, both the reserves of gold holding countries and the purchasing power of private gold holders. Neither a large nor a small rise in the price of gold would increase international reserves in an orderly and equitable manner. Countries with small gold reserves would share very little in the increase in reserves. Other means of increasing reserves of countries--particularly those holding little gold--would be required in any event.

The recommendation of a higher gold price based on the fact that the general price level has risen greatly since the early 1930's while the price of gold has been unchanged mistakenly views gold more as a commodity than as a measure of monetary value and a monetary reserve asset. To raise the price of gold because the general price level has risen would be like increasing the length of the yardstick because the average height of human beings has increased.

In addition to these general economic considerations, which argue strongly against raising the gold price, there are considerations of special concern to the United States. A rise in the gold price would break faith with the many nations around the world that have held dollars on the basis of confidence that the United States would stick to its commitment regarding the price of gold.

Those who recommend an increase in the price of gold or are willing to tolerate it seem to me to have decided that monetary management is impossible on an international scale and that we must yield to blind and immutable forces that somehow govern economic destiny. Given the magnificent record of international monetary and economic cooperation we have witnessed in the past twenty years, I refuse to accept the cynical and desperate view that man must turn back to greater dependence on gold.

Let me be unmistakably clear: in my judgment an increase in the gold price would be wholly detrimental to the best interests of both the United States and the international monetary system.

I have been quoted as saying that gold is a barbarous metal. But it is not _gold_ that is barbarous; that wasn't my point. Quite the contrary: gold is a beautiful and noble metal. What _is_ barbarous, when it occurs, is man's enslavement to gold for monetary purposes.

It is important to sort out clearly just what the role of gold is for the United States and for the world economy. The reserves of the United States are mainly in the form of gold, and the international monetary system has as one of its foundations the convertibility of the dollar into gold at $35 per ounce. There are some who believe that the U.S. balance of payments problem could somehow be solved if we cut the link between the dollar and gold. I believe this view is mistaken. In the circumstances ruling in recent years, the United States would have had a balance of payments problem, whatever form our reserves happened to take--for the deficit in our payments inevitably led to a reduction of our reserves. We cannot attribute the payments imbalance to the link between the dollar and gold. We can't solve the payments problem by either cutting the link with gold or by reinforcing dependence on gold by raising its price.

Monetary history, both within and among countries, reveals a steady progression away from exclusive dependence on gold as a monetary instrument. In very few countries now is gold any longer used domestically for monetary purposes--either as a medium of exchange or as a regulator of monetary policy. Supplements to and substitutes for gold have been developed and have taken over gold's role as a monetary asset.

The same development has occurred internationally, and today gold comprises only a little more than half of world monetary reserves, with foreign exchange (mainly dollars and sterling) and reserve positions in the International Monetary Fund making up the other half. The creation and use of SDR's will permit a continuation of this process by which dependence on gold gradually diminishes over time.

Thus gold, which was the major international reserve asset in the past, will continue to be held and used by monetary authorities. But its importance will gradually decline over time as SDR's supply the major part of reserve growth. This evolution, which recognizes the monetary importance of gold but avoids excessive dependence on it, seems to me to be the only rational course for the international monetary system to take.

Concluding Observations

I do not wish to leave you with a false sense of reassurance. The international economy has been passing through critical times and there are serious problems ahead--in the payments relations between the United States and Europe, and in the payments positions of countries in the rest of the world as the U.S. deficit and Continental European surpluses are reduced. Meanwhile, other economic problems need continuing attention, including an adequate flow of capital from the advanced to the developing nations and an effective use of such capital. We must never forget that monetary matters and institutions are not an end in themselves but a means to the end of satisfactory economic growth and stability.

While avoiding false optimism, I do want to leave you with a sense of confidence regarding international monetary problems. A rational and orderly way is discernible through the twin challenges of balance of payments adjustment and adequate growth of international liquidity--a way that takes the Bretton Woods system and the gold exchange standard as a foundation and supplements them as needed with continued international cooperation, on which so much past progress has been based. I have no doubt that our present international monetary system, supplemented and modified gradually over time, can continue to provide a framework for sustained expansion of world trade and payments and, in turn, for uninterrupted advance in living standards throughout the world.

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