ARTICLES

International Monetary System

Money and Gold in a World of Turmoil

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As events of the recent past have demonstrated, money and gold have lost none of their power to generate controversy and crisis. The gold-exchange system, which provides the basis for settlements among nations, has come under increasing pressure since the devaluation of sterling in November 1967. In the ensuing two years there have been no fewer than four major currency crises that have seen huge amounts of money flow between countries.

However, the roots of present difficulties lie far deeper than any question of parities between two nations. Both long-term deficit countries—the U.S. and Great Britain—have failed to solve their persistent problems, while surplus nations such as Italy, Japan and Germany have continued to accumulate reserves.

Rules of the Game

Under the "rules of the game" in international monetary affairs, substantial payments imbalances are supposed to be cured by systematically altering the rate of exchange among currencies without stigmatising the government taking the action. In the real world, though, devaluation is a bitter prescription for governments to administer. It is commonly understood to represent failure to remain competitive in world markets. It may indicate the vulnerability of a currency to further deterioration, and it often rewards the very ones who have helped to bring it about—speculators and others who have abandoned the national money. Upward revaluation is also generally resisted, as it penalises exporters by raising the prices of their goods in other nations. In addition, current attitudes toward payments settlements place the blame for imbalance and the full burden of adjustment squarely upon the deficit countries.

Until recently, gold played a major role in leaving the international monetary system open to destabilising speculation. The 1967 gold rush removed twice as much gold from international reserves as the sourdoughs got out of Alaska in the Klondike strike. Consequently, a two-tier arrangement was developed for the gold market, insulating official stocks from speculative demands. Although this marked a major change in the role of gold, continued activity in the private gold market has combined with the convertibility privilege in some countries to reduce still further the gold reserves available for international settlement.

Viability of Monetary Arrangements

The recent periods of stress, complicated by reluctance to adjust currency values when necessary and the continuing debate on the proper role of gold, have caused great concern about the viability of our existing monetary arrangements. Such anxiety is quite understandable. As the late British economist D. H. Robertson once said, "A monetary system is like a liver. It does not take up much of our thoughts when it goes right, but it attracts a great deal of attention when it goes wrong."

The key question today seems to be whether the monetary system has irrevocably "gone wrong." Before we opt for radical change, though, we should evaluate the overall record since 1944, when our monetary structure was last overhauled.

As World War II neared its end, some men of vision saw the need for new institutions. Their efforts led to the conference at Bretton Woods and laid the foundations for a whole catalog of modern institutions: the World Bank, the International Monetary Fund, the General Agreement on Tariffs and Trade, and other organisations that have become vital to the world economy. The results of this movement toward economic unity speak for themselves. We have had almost 25 years of unprecedented economic growth and prosperity. Since 1950, Free World exports have risen by almost 250 p.c. Discounting inflation, growth in the industrialised nations has averaged 4.4 p.c. a year over the same span. And while inflation itself has become a source of concern, it has been kept reasonably well in check over the past decade.

In short, the Free World has made great and steady economic progress. As Pierre-Paul Schweitzer, managing director of the International Monetary Funds, has said: "The achievements of the system and the related revolution in national policies have changed our whole way of describing the economic climate. We no longer describe cyclical phenomena in the terms used 30 years ago—prosperity and depression. The problems have been transposed to a different key and we speak now of overheating and recession."

Appeal for Radical Changes

Unfortunately, the rising sense of frustration over financial problems is reflected in the growing appeal of a radical change in the monetary system, especially in the USA. If we are in a bind from a loss of gold, goes one refrain, why not increase its price and at least buy a little more time? Or why not cease paying out gold and let the dollar depreciate in the exchange markets of the world?

Upon analysis, these proposals turn out to be less of a solution than an abdication of responsibility. To permit the exchange value of the dollar to fluctuate freely, for instance, would be to pull the props out from under all existing international trading and financial arrangements and put nothing in their place. Uncertainty about future currency values would likely prove a major inhibition to international trade. In addition, it would be no easier to carry the burdens of our troops abroad or the aid program with a depreciating currency.

The proposal to increase the price of gold, on the other hand, reminds one of the last desperate attempts of the losing poker player to stay in the game by revaluing the chips.

How can we justify refusing to correct the basic causes of our deficits and trying to buy time by breaking faith with all the holders of dollars who have accepted our repeated pledge to maintain the $ 35 price? Other countries would be forced to follow and devalue their own currencies, so a higher gold price would achieve nothing in terms of restoring equilibrium in our external payments. Instead, it would certainly be taken as a symbol of our unwillingness to deal with these problems. By revaluing gold, we would not only break faith with our international trading partners, but we would also be destroying a fixed relationship that constitutes the cornerstone of world monetary arrangements. Such a willful act would likely upset the entire structure of world trade.

International Discussions Possible

By rejecting the temptation to use the enormous power of the U.S. as a lever for unilateral action, we leave the way open for international discussions that can result in positive accomplishment. Such efforts are especially relevant to an area where accord is vital—the provision of an orderly growth in the supply of reserves to set up a margin of liquid resources for financing imbalances in world trade.

While there is no fixed relationship between monetary reserves and trade, trends have clearly raised questions as to the adequacy of present international monetary arrangements. World monetary reserves as a fraction of annual world imports have dropped from 55 p.c. a decade ago to about 35 p.c. now. Unfortunately, gold reserves are not increasing, so no surplus nation can add to its gold reserves without drawing down those of one of its trading partners.

Recent accumulation of world reserves has been the result of an outflow of dollars generated by the U.S. payments deficit. Clearly, alternative methods are needed, both for the sake of orderliness in reserve growth and for protection of the dollar as the free world's key currency.

There are those who feel that orderly growth of world reserves can be guaranteed only through a major reshaping of the monetary system. For this purpose, they advocate that "another Bretton Woods" be convened. At this time, however, such a conference would likely be interpreted as an act of desperation, aggravating existing tensions and stirring up uncertainty without producing mutually acceptable reforms.

Patient Negotiations Necessary

The proper path, it seems to me, is to continue adapting the system through patient negotiation within existing organisations. The value of this approach has been more recently demonstrated in the discussions within the IMF that have led to the agreements on Special Drawing Rights—the so-called SDR's.

This new form of reserves, often called "paper gold", will be issued by the IMF to member coun-

tries in proportion to their subscriptions in the fund, and will increase the ability of nations to obtain needed currencies for balance-of-payments settlements. Special Drawing Rights have the potential of alleviating problems caused by erratic shifts in reserve quantity. They will also provide the system with strengthened defenses against currency speculation.

These SDR's will be international legal tender, since IMF members have agreed to accept them from each other as a form of international payment. SDR's will be an attractive form in which to hold international reserves. Unlike gold they will earn interest. Unlike dollars and other national currencies they will carry a gold guarantee.

From 1950 to 1968, the rest of the world gained reserves at a rate of about 5.5 p.c. a year, or roughly as fast as the growth in world trade. This gain in reserves, though, was made possible only because the U.S. continually supplied them, through the dollars drained by years of balance-of-payments deficits and the gold paid out to those nations unwilling to hold dollars.

Proper Economic Policies Needed

While increases in reserves are vital, adequate funds for the settlement of imbalances are no guarantee of an orderly monetary system. Proper economic policies on the part of both deficit and surplus countries to facilitate adjustments of their payments imbalances are clearly the only foundation on which international trade relations may attain stability.

As Otmar Emminger of the German Central Bank points out: "In cases where a serious attempt was made to eliminate a big external deficit by restraining domestic demand, the adjustment mechanism nearly always worked with astonishing speed and vigor. Where adjustment has failed up to now, either no attempt at all or only a half-hearted and belated attempt has been made at responsible management policies." For the U.S. this means acting with restraint in both the fiscal and the monetary areas.

But given the unique position of the U.S. in the world, we can hardly expect that fiscal and monetary restraint will lead us to a position of permanent payments surpluses. We are the richest nation in the world, so it is appropriate that we should maintain leadership in assisting the less-developed nations. We are the most powerful, so the burden of defense in the Free World falls squarely on our shoulders.

Long-Term Investment Outflow in the USA

Consequently, we must condition ourselves to accept a long-term investment outflow on the capital account. It is illusory to imagine that we can realistically attempt to eliminate the capital outflow through direct controls. Ideally, we can, however, offset it through a trade surplus and through the yield on our overseas investments.

At present, our income from past investment far exceeds new outflows of direct investments. But if the restrictions on capital outflows, imposed a few years ago to reduce our payments deficit, are maintained for an extended period, such controls can be most harmful. Reduced flows of foreign investment today will certainly reduce profits tomorrow, and thus depress future return flows of income.

Nor do I believe we can expect any better results from controls of imports by means of quotas or a special surcharge. This is a game others can play—perhaps even more successfully than we can—and the whole of economic history points up the dangers of retaliation.

We do not seek a strong balance of payments as an end in itself, but rather as a prerequisite to shouldering the burdens and responsibilities of world leadership, economic and political alike. This fact of life, though, should impel us to redouble our efforts to restore the trade account surplus that until 1968 served to offset our overseas capital spending.

Problems of Inflation

One important step in rebuilding our trade account surplus is coming to grips with the inflation that has bedeviled us for the past three years. In this period, growth in demand for imports and rising prices for U.S. exports have made America less competitive in world trade. The trade surpluses that averaged over $ 4 billion a year between 1957 and 1967 have vanished.

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Since the last quarter of 1968, this vital sector has actually been in deficit.

This deterioration has been seriously aggravated by the inability to maintain stable prices in the United States. Firm action against the inflationary pressures, which became serious in 1965, was not taken for more than three years. So an upward momentum of prices continued to build and an inflationary psychology became more firmly established.

In my own field of banking, we have seen inflation boost the prime lending rate to a record 8.5 p.c. This development was the product of inflation, and not a cause as some have erroneously stated. It is also the product in part at this particular time of the tight money policies that are being pursued by the Federal Reserve and the Government to cure inflation.

These policies are not only unavoidable, but proper in my judgment. The only acceptable way we can control inflation is by restricting credit, cutting down on Government expenditures and raising taxes. The Government has done all of these things. Unfortunately, there is a time lag between the imposition of these controls and their effectiveness, and I'm afraid that there is no way of correcting our past mistakes without a painful period of adjustment.

Fiscal and Monetary Discipline

Stabilising prices through fiscal and monetary discipline is essential to the welfare of everyone in the country. Persistent inflation would undermine our society and make us incapable of dealing with either our domestic or our foreign problems. A period of continued high taxes and high interest rates will be painful temporarily, but it is far less painful and less enduring than the alternatives.

The financial community recognises the urgency of bringing inflation under control and is seeking to put brakes on credit demand through measures designed to channel available funds only into those uses that have a directly stimulating effect on production. Business, too, must recognise its responsibility by restraining its demand for investment funds. By the same token, labor must exercise restraint in its wage demands, and the consumer must cooperate by not buying goods to hoard. An alternative to responsible action by the private sector in slowing the pace of demand could be the imposition of wage and price controls.

Surprisingly and disturbingly, the public opinion polls show growing sentiment in favor of such controls, but I am delighted that the Nixon Administration has rejected this course. Our experience in World War II has demonstrated that controls just don't work effectively and are hard to get rid of once adopted. They lead inevitably to changes in the whole fabric of our society through which both American business and labor have less freedom to conduct their own affairs.

Although a return to price stability is of paramount importance in restoring our trade balance to a reasonable level, projected increases in imports together with more competitive export markets pose a further problem. If we are to pursue the highly desirable goal of liberalising world trade, we can only confront an import-export squeeze through creative approaches designed to increase the attractiveness of our exports.

One such initiative that comes to mind is the limited export paper discount program undertaken by the Export-Import Bank, in cooperation with U.S. commercial banks. Under this plan, the Eximbank encourages export financing by making loans against a bank's holdings of eligible export debt obligations. By making medium and longer term debts more liquid in this fashion, banks are given greater flexibility in financing international transactions that have a directly favorable effect on our balance of payments. Such initiatives are most worthy especially in the near future, a period in which encouragement of exports is vital.

Path of Cooperation

If the United States and other leading nations can conduct international business in a stable framework—keeping inflation under control, restoring balance to the monetary system and liberalising world trade—further modifications affecting settlements among nations could be studied in a more reasonable atmosphere, without the pressure of necessity. For example, there might be merit in considering the adoption of somewhat greater flexibility in exchange rates—perhaps a slightly wider band or a so-called "crawling peg".

Clearly, there is only one path that offers real promise of leading us to our long-term goals in trade, monetary affairs and world development—that of cooperation grounded in fiscal and monetary discipline. We must begin by acknowledging the growing interdependence of our national economies. Then we must expand and strengthen our international institutions in a common approach to world problems that goes far beyond anything that has evolved so far.

None of this will be easy. But only by establishing a truly integrated world economic order can we begin to fulfill the ancient dream of prosperity for all. If we learn to manage our common economic problems it might be possible to bring about a reduction of the political frictions that divide nations today. At this point, the ultimate prize may be only a glimmer of hope. But one day it might come: The road of cooperation could lead to a peaceful world.