The International Monetary System & the Role of Gold

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"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

—**Eugene Black**

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Robert S. Brown*

Most people become disturbed the minute the discussion turns to international capital markets, international banking, the International Monetary Fund, international payments problems, or the role or non-role of gold in the settlement of international accounts. We all tend to think of these issues as extremely complex; but like most complex things, they work on a set of principles, and if we can understand these principles, we can understand the problem and the answer.

There is much talk these days about world-wide inflation, and domestic inflation, and what governments could do to stop inflation. Economists talk as though our rising prices at home were one problem, our balance of payments difficulties another, and the high interest rates, our abandoning gold, and the rise in the price of gold yet other independent problems. Actually, these are not isolated problems. They all tie together into one common problem that can and must be solved.

In this paper I hope to define that problem and the principles involved.

Let me discuss separately (1) domestic inflation, (2) international inflation, and (3) international monetary problems.

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MONEY — ITS HISTORY AND FUNCTIONS

History has much to show us regarding money and international trade, and human experience, through recorded history, can teach us more about economic and financial affairs than some economists with mathematical formulas and elaborate theories. Economics is not an exact science even though some economists claim that they can "finetune" the economy like a space ship. Economics is a social science and very "inexact". Pour acid over baking soda and you get the same results every time. But pour an increased money supply into an economy and the immediate results will differ greatly, although high prices will almost certainly be the eventual consequence.

What does the record of human experience reveal about monetary standards and money?

Humans have used just about everything one can imagine as money ever since they needed a medium of exchange to make their trading easier. The list is long and includes beads, sea shells, feathers, stones, wheat, cattle, iron and copper coins and precious metals. Over the centuries, however, two metals emerged as man's favourites, gold and silver. The use of gold coins may be traced back to the time of Darius the Great of Persia who ruled from 521 to 485 B.C. But it was not until the last century, after more than 2000 years, that gold finally won out over silver. The Chinese were the first to use paper money — at about the time when Marco Polo visited China in the 13th century — and with disastrous results. The first European paper money dates from the 17th century, and produced as similarly sad results as the Chinese experiment. Yet despite its chronic failures, the popularity of paper money has increased steadily — at least with governments. Politicians and dictators, kings and bureaucrats have never stopped trying to use paper instead of gold.

There are many definitions of what constitutes the money supply. It is usually considered to be currency in circulation plus demand deposits in commercial banks (M^1). Some

economists add time deposits in commercial banks (M^2), and still others the time deposits in Mutual Savings Banks and Savings and Loan Associations (M^3). Finally, (M^4) and (M^5), respectively, include large negotiable certificates of deposit of commercial banks and of all banking institutions, respectively. But whether we refer to money as currency in circulation, or employ the broader term of purchasing media, whether we include just demand deposits or also time deposits, money must possess three attributes:

(1) It has to serve as a medium of exchange. It must be acceptable to the sellers of goods and services, for they expect to use it in exchange for other goods or services which they want to buy.

(2) It must serve as a measure of value. It must be a reliable measure of the value of goods and services.

(3) It must be a trustworthy store of value.

Most economists would agree that money ceases to be "money" if the public refuses to accept it in exchange for goods and services, or if more and more people begin to measure the value of goods not in terms of money, but, let us say, in terms of cigarettes, as they did in post-war Germany when the money ceased to be dependable. A progressively depreciating currency will continue to be accepted for some time as money as far as its functions as a medium of exchange and a measure of value are concerned. In the long run, however, the break-down of a currency's store-of-value function is likely to prove the death of it. People expect their currency, their demand deposits, their time deposits, and the money they have loaned out, to keep its purchasing power. If they conclude that this expectation is wrong, that they cannot predict what their money will be worth a year, or two years, or five years hence, their disillusionment leads to a breakdown in the operations of their money and credit based economy.

THE CAUSES OF INFLATION

What do we really mean when we use the word "inflation"? Webster's dictionary defines inflation as "an

increase in the volume of money and credit relative to available goods, resulting in a substantial, continuing rise in the general price level".

In the United States the federal government controls the supply of money and credit. It does so through the Treasury and through its taxing and spending activities, i.e. its fiscal and monetary policies.

Why is inflation taking place in our country? Indeed why is there inflation all over the world today? Some people blame it on big government, others on big business and labor; still others blame the Arabs, or even Mother Nature. But most of these observers are dealing mainly with inflation's symptoms. Not many have attempted to identify the root cause of this world wide phenomenon, even though some economists have recently moved in the right direction by attributing inflation to the federal government's ever-increasing spending. Few Congressmen however accept this argument, and only too many economists still fail to emphasize why fiscal deficits are inflationary.

Actually, the root causes of inflation are not as hard to discover as many economists make them out to be. All we need to do is substitute common sense for some elaborate theories. Most people will agree that when the demand for an item exceeds the supply, the price goes up. And since prices of almost all goods and services have gone up in recent years, logic suggests that the excess of "total demand" over "total supply" must have been great during this period.

But what constitutes "total demand" and "total supply"? "Total demand" is the amount of dollars which individuals, corporations and government entities are willing and able to spend on the purchase of goods and services. During the Great Depression, many individuals and corporations were reluctant to spend as much as they could have spent; "idle savings" piled up, total demand declined, and unemployment rose. But that was during the 1930s! Since then, "total

demand" has risen much faster than "total supply", in the United States and throughout the world; and prices have risen correspondingly. Between 1967 and mid-1975, for example, the American Gross National Product (GNP), which indicates how much the people were willing and able to pay for goods and services, increased by 45 per cent, whereas the GNP in real terms, (the actual goods and services provided) increased by only nine per cent.

It is obviously easier to create money and credit, more or less out of thin air, than to build factories and produce goods, and there is always the danger that governments, trying to appeal to the voters, will increase "total demand" more rapidly than the economy can produce goods and services. Between 1967 and mid-1975 the money supply (M^2) rose by 75 per cent in the U.S., whereas the output of goods and services (GNP in real terms), as we pointed out, grew by only nine per cent. It is thus not surprising that the consumer price index rose by about 63 per cent.

The size of the work force, its efficiency and the output capability of machines and equipment, do not change abruptly from one year to the next. Factory and service output can be projected with considerable accuracy. Thus, if "total supply" falls short of "total demand", the reason for the disequilibrium is as a rule that "total demand" has risen disproportionately and did so because the government created an excess of purchasing power.

Increased income does not have to create imbalances. In a free market economy, rising earnings are normally compensated by a corresponding gain in the output of goods and services. This happens because no one can demand and obtain, for any length of time, wages or prices that are more than the value of the services or goods he produces. Sooner or later he will be forced out of the competitive market because his customers will have found a more economical alternative.

There are occasional exceptions to this rule, such as a rise in the earnings of labor union members which are not

matched by a corresponding growth in the output of goods and services. But even an excessive rise in wage — excessive in relation to increased productivity — is only temporary, because it leads either to higher prices and hence declining demand, or to declining profits and thus to reduced production. In either case excessive wage increases produce unemployment — unless the government increases the "total demand" to support the inflated wage level.

It thus stands to reason, that sudden distortions in the supply and demand relationship almost invariably result from a sharp increase in total demand — demand, that is, in excess of the increase in total production. This occurs when: a) the government creates an excessive amount of "total demand"; or, b) an unusually large amount of purchases are financed through an expansion of credit. Buying with borrowed money will increase overall demand without any compensatory gain in immediate output; unless the debt comes about through a decrease in someone else's consumption — meaning that someone else first had to save the money, which others borrow.

"Borrowed money" is created through deficit spending by the government or through the extension of new bank credit. In either case such debt creation is inflationary. Both direct purchases of goods and services by the federal government and purchases by the recipients of social spending add to total demand. If the government fully finances its outlays by taxes, then the taxpayers must reduce their purchases by an equal amount and there is no increase in total demand and no inflation, but when the Treasury "sells" securities to the Federal Reserve System or to commercial banks to finance government deficits, these banks create deposit money which adds to the "total demand" and thereby pushes prices upward.

Similarly, when private individuals and corporations purchase goods and services with borrowed money that has been created through the commercial banking system, they too increase total spending and thus contribute to inflation. Inflation is avoided only if the borrowings are someone's

savings or if somehow overall production is promptly and proportionately stimulated, which is quite unlikely.

Between 1967 and 1975 the amount of credit extended, directly or indirectly, by the Federal Reserve Banks to the Federal government increased by more than 85 per cent and that by commercial bank loans by almost 90 per cent.

There is no secret about the causes of inflation. If banks extend credit for non-productive purposes, and the government finances its deficits not through taxation or by borrowing the savings of the people, but through an increase in the money supply, "total demand" will increase faster than "total supply", and prices will rise. The spiralling inflation of the past few years was thus perfectly predictable.

So much for domestic inflation! Now let's look at the international situation.

THE INTERNATIONAL PICTURE

The world monetary system has gone through four phases. The first phase lasted from prehistoric times down to about the year 1800. It was not really a system at all, but was a spontaneous answer to existing needs. There were thousands of different kinds of money in circulation, most of them in the form of coin. Almost all coin contained some portion of rare metal, gold or silver. A merchant desiring to do business in a foreign market had to acquire coinage that circulated in that market. He took his own coin to a money changer — a trader who dealt in foreign coins — and exchanged it, on the basis of its metallic content, into the desired foreign coin.

Towards the end of the 18th century Great Britain emerged as the world centre of trade, of commerce, of commodity markets and of banking. London, as the hub of an extensive colonial empire, found that her banking system was called upon to act as an international institution.

The buyers of goods, throughout the world, or their bankers, simply instructed their London bank to debit their

account, and to credit the account of the seller. Commodities were quoted in terms of pounds sterling and paid for in pounds sterling through bank transfers in London. To operate smoothly and without major losses to the buyer or seller, this system presupposed, of course, that the value of pounds sterling remained more or less constant in terms of the currencies of the buyer and the seller. Thus, with her central banking itself hardly a century old at that point, England moved the world into a second phase of international monetary arrangements. This was the "Gold Standard phase".

The currencies of all nations on the gold standard, a fast growing number after 1873, were convertible into gold at a fixed rate, both for foreign and domestic holders. The central bank of each gold standard country stood ready to buy or sell gold at a fixed price. Deposits in London banks, linked to gold, financed trade throughout the world and by the end of the 19th century, almost the whole civilized world was operating on the gold standard. Metallic gold and the British pound sterling were the universal terms of monetary measurement. Even though Britain fought wars in the Crimea, China, India and South Africa, the value of her pound remained stable and was accepted freely throughout the world.

But the whole structure suddenly fell apart in the summer of 1914 when World War I burst upon the world and destroyed these financial arrangements. Self-preservation brought about a change in national attitudes. National defence came before cooperation; currencies were blocked; inflation was used to help pay the cost of the war. World War I thus put an end to the easy and automatic international convertibility of currencies under the gold standard.

Phase three commenced, characterized by much government intervention, loss of flexibility, loss of freedom, loss of trade, and a retreat to forms of mercantilism and isolationism that had been dying out in the 19th century. War imports had top priority and governments controlled exports lest they benefit the enemy. Governments managed

the mechanism by which one currency was exchanged for another, and thus controlled almost the whole of the balance of payments. This third phase gradually terminated after the end of the war.

In the 1920's the so-called "Gold Exchange Standard" appeared. Under it not only gold but certain currencies which were convertible into gold served as national monetary reserves.

Under a strict gold standard, any noticeable net surplus or deficit in the balance of payments was promptly settled by gold shipments, and the country exporting gold thus felt a mild deflationary effect. The country importing gold felt a mild inflationary effect. As long as these monetary forces were allowed to work, and to work promptly, the price levels in the various countries tended to hover around the point where trade was in balance.

The first major nation to return to a gold standard after World War I was the United States of America. Several other small American countries joined soon after. Germany, following her tremendous post-war inflation, returned to gold in 1924, Great Britain in 1925, and by 1931 fifty nations were again on the gold standard.

But something had happened. Of the fifty countries, twelve returned to the traditional gold coin standard; six adopted a gold bullion standard (under which the central banks bought and sold gold only in the form of gold bars weighing 400 oz. (worth $ 8,269 each) thus effectively barring the average citizen from buying and holding gold); while the remaining thirty-two nations settled for a gold exchange standard. The popularity of the gold exchange standard rested in part on the argument put forth by some economists and other experts that not enough gold was being mined to meet the needs of the expanding trade and of the monetary requirements of the gold standard nations. To off-set this seeming scarcity of gold, the gold exchange standard provided a way to "economize" in the use of gold by using a substitute, namely foreign exchange. And since then, for

the past fifty years, the world has been looking for ever new substitutes.

One reason for the seeming scarcity of gold was, of course, the fact that while the money supply and prices in general had doubled as a result of the World War I inflation, the price of gold had remained unchanged. The gold reserves in relation to the money supply were thus smaller than they had been before the war, and the low price of gold (as compared with the general price level) while discouraging gold mining, encouraged the use of gold for ornamentation.

Moreover, after the sharp depression of 1920-22, the feeling grew that it was more important to avoid deflation than to stabilize the monetary system. Thus many weapons in the arsenal of wartime monetary powers continued to operate under peacetime conditions. Exchange controls, quotas, tariff barriers, import licences became the order of the day; and international trade dwindled. In the meantime, central bank after central bank acquired foreign exchange as assets, only to discover (in due course) that they were holding as reserves certain currencies that, because of devaluations of other reserve currencies, were themselves subject to unpredictable devaluations.

Then it happened! In the spring of 1931, little Austria's over-extended Kredit-Anstalt collapsed, taking that nation off the gold exchange standard. Panic spread to nearby Germany, whose banks too had borrowed short and loaned long. In July of 1931, Germany left the gold standard. Next was England, which ended her ties with gold on September 19, 1931; and finally, on April 20, 1933, the United States put a permanent exchange rate. The United States, too, had left the gold standard. In January 1934, the United States devalued the dollar by 41 per cent, fixing the new mint price of pure gold at $ 35.00 on ounce, and thus, the gold content of the new dollar at 13.71 grains compared with a previous gold content of 23.22 grains and a previous mint price of $ 20.67.

The dollar devaluation of 1934 raised the price of gold by 69 per cent and thereby raised the dollar value of

American reserves from $4 billion to $6.8 billion. The higher gold price stimulated gold mining, and induced foreigners to exchange some of their gold for "undervalued" dollars, especially since the growing political tensions in Europe made a transfer of savings from Europe to American advisable. The Treasury's gold holdings grew from $6.9 billion in February of 1934 to $22.7 billion by December of 1941.

The devaluation of a reserve currency means, of course, the destruction of a portion of the assets of the central bank of any country that had used that reserve currency as a banking reserve. The great internal and international credit expansion of the 1920's was made possible through the gold exchange standard. As the gold exchange standard collapsed during the 1930's, the international monetary scene became chaotic. Exchange rates fluctuated — sometimes freely, sometimes under the influence of political management. Nationalism was a prevailing passion. Competitive devaluations destroyed confidence and trade simultaneously. The economies of the world were in deep depression, and recovery did not come until after the outbreak of World War II.

As World War II began, governments again instituted all the old wartime controls. More and more gold was transferred to the United States and converted into dollars, and in September 1949 American holdings of gold reached an all-time peak of $24.8 billion.

THE BRETTON WOODS SYSTEM

As World War II drew to an end, the nations of the world determined to set up a new world monetary system to assure economic stability and growth. In July 1944, delegates from 44 nations met at Bretton Woods, New Hampshire. These money managers were determined to design a system that would serve the free world better than the discredited gold exchange standard. What they came up with was the International Monetary Fund system and its associated institutions. The International Monetary Fund is a reserve bank for the central banks of all its member countries.

Member countries were required to pay 25 per cent of their membership quota in gold and the remaining 75 per cent in their own currency. In return, they were entitled to borrow freely from the Fund foreign exchange equal to the amount which they had paid in the form of gold, and, with certain restrictions, an additional amount equal to the portion of their quota which they had paid in their local currency. The relationship of one currency to another currency, according to the agreement, was to remain fixed within narrow limits. Exchange rates were to be altered only with approval of the Fund.

At the time of Bretton Woods, the United States was the only country redeeming its currency in gold. Accordingly, the Bretton Woods Articles of Agreement provided that every currency was to convertible into dollars with the dollar in turn convertible into gold at a fixed rate. This proviso, perhaps unwittingly, produced a new gold exchange standard system, this time based on the dollar which was assumed to be "as good as gold".

With the member nations of the IMF electing to treat the dollar as equal to gold, since dollars were thought to be redeemable in gold on demand, the dollar became the reserve currency of the world, which put the United States of America and the Treasury and Federal Reserve into much the same role of being the world's reserve banker as the Bank of England had held prior to World War I.

CURRENCY STABILITY VERSUS FULL EMPLOYMENT

Meanwhile, a new idea had gained priority in the minds of the managers of our economy. The goal of stable prices had become passé. By the terms of the Employment Act of 1946, the President of the United States was instructed to maintain maximum employment, and, following the teachings of John Maynard Keynes, many economists felt that "a little inflation" stimulated business activity and therefore employment and hence was good! Contrariwise, deflation caused unemployment and thus was bad! Also, according to Keynes,

a little inflation in times when the economy was stagnant was especially desirable. Professor Paul Samuelson, whose Keynesian oriented college economics textbook was the most widely used in America, proclaimed that a 5 per cent a year inflation was acceptable and probably beneficial.

In 1960 another economic goal came into vogue under President John F. Kennedy — economic growth. A little inflation was said to stimulate that too. Inflation also made growth seem greater than it actually was. As a result, there was not much concern about the chronic deficits and the creeping inflation of the 1960s. Since the 1950s, the Treasury has been operating at a deficit year after year, with rare exceptions, augmenting the nation's money supply at an ever growing rate.

Some of the surplus dollars created by the Treasury and Federal Reserve in turn found their way into European banks. Since, under the Bretton Woods Agreement, these American dollars, presumably redeemable in gold, were "as good as gold", only a few foreign central bankers chose to convert their dollar holdings into gold. The majority kept most of their dollars in United States bonds or in other dollar denominated instruments which paid them interest, on the assumption, of course, that their dollar assets could be converted into gold at any time.

The foreign central banks and treasuries in turn issued their own currencies based on these growing dollar holdings, and thus "imported" the United States inflation. Between December 1957 and July 1971, American gold holdings dropped from $ 22.9 billion to $ 10.5 billion, and during the same period short term liabilities to foreigners rose from $ 15 billion to $ 60 billion.

THE DEBATE OF THE GOLD SUPPORT SCHEME

Quite naturally, the creditors became increasingly concerned as they watched the United States continue to live beyond her means, issue more and more I.O.U.'s and pay out much of her most liquid asset — gold. To reassure

foreign creditors and to make the American citizens aware of the worsening situation, Washington applied a series of "band-aid" remedies, such as recalling the dependents of American military stationed abroad, prohibiting Americans to own gold abroad, taxing investments made overseas, and lowering the tourists "customs free" allowance. And when in 1960, the price of gold briefly rose to over $ 40.00 on the free gold market in London, Washington, together with other central banks, began to sell enough gold in the London market to keep the price below $ 35.

That worked for a while. Eight years later, however, in March of 1968, the hunger of gold buyers had become so insatiable that central bankers no longer wanted to dip into their reserves to hold down the price of gold. Despite the fact that total gold production in the free world amounted to about $ 11 billion between 1960 and 1968, central bank holdings increased by less than half a billion dollars.

In March 1968, therefore, the central banks of the major countries under the leadership of the United States decided on a so-called new "solution" to the gold problem, a "two tier" system of pricing gold, which in reality was only a return to the free market system for pricing non-government gold that had prevailed before 1960.

During the eight years of the London "gold pool", U.S. Treasury officials and others had come forth with all kinds of promises and resolves, but they never got around to the fundamental problem of balancing the Federal budget, and thus, staunching the constant outflow of dollars and the build-up of short term indebtedness. On top of this, America attempted to have guns and butter at the same time. While the nation waged a costly war in Asia, Washington continued foreign aid, farm price support programs and welfare payments at a steadily increasing rate. All this created more and more dollar expenditures which meant more and more dollars went abroad further increasing the nation's short-term liabilities.

We all know the rest of the story.

With the trade situation worsening, and short-term liabilities to foreigners mounting at an alarming rate in the spring and summer of 1971, President Richard Nixon finally, on August 15, announced that the U.S. would no longer redeem the U.S. dollar in gold! The dollar, once the most prestigious currency in the world, became completely inconvertible! On December 18, 1971, at the Smithsonian Institute, the dollar was devalued by 7.9 per cent, followed by another devaluation of 10 per cent of February 12, 1973. The collapse of the International Monetary Fund system was now in progress, and all of this was due to just one basic cause, the chronic American balance of payments deficit.

It did not come as a surprise! It had been predicted for more than 12 years. All during the late 1950's, people had been disturbed by the revival of a monetary system that without any doubt had been a major cause of the Great Depression of the 1930's: the gold exchange standard. The only difference was that during the 1920's, the British pound formed the basis of the gold exchange — and after World War II the dollar!

THE FOURTH PHASE

The world has entered the fourth phase of the world monetary history! There is a rather good chance that it, too, is approaching terminal paralysis. The repeated currency crises since the late 1960's represent serious warnings.

Some still claim that there is not enough gold to return to a gold standard. But this was never true. If gold were re-valued to say $ 175.00 an ounce this would increase the world monetary gold reserves more than four times to $ 200 billion.

In addition, such a sharp increase in the price of gold would greatly stimulate gold mining as it did in the 1930's, and it would reduce the demand for industrial and jewelry purchases. More important, a restoration of the gold standard would restore confidence and provide more price stability. Hoarding gold would become much less attractive, for gold pays no interest and is really only a defensive position against

inflation. Much of the gold now hoarded would come out of hiding and be converted into dollars or other stable currencies.

PROSPECTS

But this apparently is exactly what the governments of the world, under the leadership of the United States, try to prevent. At the Interim Committee meeting of the Group of Twenty in August 1975 an agreement was reached which effectively closed the door on the French-led attempt to re-establish gold in the international monetary system. In November 1975 the heads of state of the United States, France, West Germany, Britain, Italy and Japan met at the Chateau Rambouillet in France, and in effect accepted the decision of the August meeting of the Group of Twenty, thus paving the way for the Jamaica meeting in January 1976, which provided for the substitution of SDRs for gold as the basis of the international monetary system.

Since the supply of gold is limited, a system tied to gold, as was the Bretton Woods system, automatically sets limits to the amount of credit which can be created world-wide.

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"Free Enterprise was born with man and shall survive as long as man survives."

—**A. D. Shroff**

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