Published Weekly by
AMERICAN INSTITUTE
for ECONOMIC RESEARCH
Great Barrington, Massachusetts 01230

RESEARCH REPORTS

Vol. XLVI No. 31 July 30, 1979

Lengthening the International Credit Rope Cannot Prevent the Eventual Hanging

The gold standard functioned automatically to force the abandonment of unsound credit practices and to correct early the distortions fostered by those practices. But the corrections involved recessions and their related hardships. To eliminate or minimize such hardship, officials repudiated the gold standard and adopted successively, the gold-exchange standard, the Bretton Woods System, and the current nonsystem of floating rates among paper currencies. Far from easing economic hardship and distortions, these alternative schemes simply have postponed and heightened them. Even now, U.S. officials must "bite the bullet" with a policy of restraint or see a worsening of economic conditions and a further loss of confidence in the dollar. The Nation would have fared better under the gold standard, and it would fare better under that standard in the future.

During much of the 19th century, the leading countries of the world were on the gold standard. Three key features of a monetary system on the full gold standard are: (1) the monetary unit is a fixed quantity of gold of set purity; (2) all domestic currency and coin are freely exchangeable for gold, and vice versa, at the monetary unit's value at the government mint; and (3) there is no restriction on the importation or exportation of gold. Fixing the monetary unit as a weight of gold established fixed exchange rates among the currencies of all countries on the gold standard. The rates reflected the ratios of the weights of gold.

The unrestricted interchangeability of gold and currency by citizens and foreigners tended to restrain unsound domestic monetary and fiscal policies and, in so doing, to move temporary international payments imbalances toward equilibrium. If inflating occurred in one country, domestic prices would rise, exports would decrease, imports would increase, and the nation would have a balance of payments deficit. Foreigners then would obtain more of the nation's currency with which to claim its gold. The loss of gold would restrain credit extensions and force deflating, thereby remedying the prior economic distortions (including the higher general price level) facilitating a resumption of sound economic growth. Lower prices eventually would bring about an increase in exports, a decrease in imports, and the elimination of the balance of payments deficit.

Under the classical gold standard the adjustments at times seemed harsh. Inflating fostered unsustainably rapid economic expansions ("booms"), and the consequent loss of gold, credit restraint, and deflating were accompanied by economic contractions ("busts"). The reduced output, employment, income, and consumption that were aspects of the contractions brought hardship to the people. Deflating forced by the loss of gold was blamed for the suffering, not the prior inflating.

Gold-Exchange Standard

Adherence to the gold standard by the leading countries was abandoned when World War I began in Europe. To help finance the war effort, governments promoted inflating (the creating of excess purchasing media). One of the inevitable consequences was a rise in the general level of prices, or a decrease in the purchasing power of currency. Indeed, units of most inflated currencies after the war exchanged for less than half the amount of gold that they were specified as before the war.

Participants in a monetary conference held in Genoa in 1922 attempted to find a way to avoid the painful deflating that was necessary for removing the distortions that remained in the monetary systems of many countries. This conference recommended an international arrangement for "economizing the use of gold by maintaining reserves in the form of foreign balances." As a result of this recommendation, the "gold-exchange standard" was adopted by France, Germany, and many other European countries. The international gold standard, which had served the world well for more than a century, was not restored.

Under the gold-exchange standard, central banks were authorized to count, as part of their monetary reserves, currencies that could be converted into gold, namely, the U.S. dollar and the British pound at the time. This arrangement made possible the settling of international payments imbalances by transfers of such a currency (or claims payable in it) instead of by shipments of gold. Inclusion of this foreign currency as part of the monetary reserves of a country increased its reserves and enabled its banking system to create additional purchasing media.

Thus, when the central bank of a country participating in the gold-exchange standard obtained possession of some convertible foreign currency paid to it in settlement of another country's payments deficit, the bank usually did not demand gold in exchange for the currency. Instead, the bank regarded the currency as an addition to its monetary reserves, and the banking system of that country originated additional purchasing media just as if the reserves had been augmented by the receipt of gold.

Inasmuch as the country that had "settled" its payments deficit by paying currency had shipped no gold, the total of purchasing media in use in that country was not reduced, as it would have been under the international gold standard. Deflating and the resulting decrease in general prices that formerly had forced correction of a payments deficit did not operate under the gold-exchange standard as long as the surplus nations

held the deficit nation's currency rather than present it for redemption in gold. Moreover, worldwide international reserves were thus augmented and any nation therefore had more opportunity to postpone the correction of domestic policies causing payments deficits.

Bretton Woods System

Before World War II ended, the United States was intent on the development of a new international monetary system. During July 1944, representatives of 44 nations convened at Bretton Woods, New Hampshire, to discuss the postwar international monetary system. A major objective of the participants was to design an arrangement that would ease pressure on countries with payments deficits immediately to deflate domestically. Sharp in the memory of everyone was the high unemployment of the 1930's and the aggravation of that problem resulting from the erection of barriers to international trade and capital flows as nations sought to support domestic output and retain international reserves. A repetition of that experience was to be avoided at all costs, and so, thought leading conferees, deficit countries had to be spared the need to adopt policies of sharp restraint, which they alternatively might try to avoid by isolationist policies or by competitively devaluing their currencies, that is reducing the amount of gold of their monetary unit.

Out of Bretton Woods came the International Monetary Fund (IMF), from which deficit countries other than reserve-currency countries could borrow funds for the financing of temporary balance of payments deficits. A key aspect of the IMF system was the role of the dollar as the primary "reserve currency." Because the dollar was one thirty-fifth of an ounce of gold and because dollar claims held by official monetary institutions could be exchanged for gold with the U.S. Treasury, the dollar could be used by other nations to fix the value of their monetary units and to settle their international obligations. Gold, itself, also could be so used. Exchange rates thus were fixed among currencies, inasmuch as currency units were fixed weights of gold directly or indirectly through the gold dollar. The new system was a variation of the gold-exchange standard, the IMF being the new aspect.

In addition to extending the period deficit countries would have to adopt domestic policies for curing the deficit, the IMF system seemed to exempt the United States from making any domestic policy adjustments to eliminate its international payments deficits. Inasmuch as the dollar was the international asset, the U.S. simply could create as many dollar claims as "needed" to finance its deficits *as long as surplus countries were willing to hold dollar claims as their monetary reserves.* The system seemed secure. At the end of 1949 the U.S. had $24.6 billion in gold valued at $35 an ounce. This was nearly 70 percent of the total gold holdings of all free-world governments and central banks. Surely, surplus countries would willingly hold dollar claims, but even if some presented the claims for gold, there was plenty of gold with which to redeem the claims, concluded many supporters of the new system.

During the late 1940's and early 1950's, inflating occurred in the U.S. as purchasing media hoarded during the war was put back to use in the economy. Although prices did not rise at alarming rates, another manifestation of inflating – persistent balance of payments deficits – was apparent. From 1950 through 1957, the United States incurred a cumulative balance of payments deficit of $10.3 billion, which was a large sum at the time. By 1958 and 1959, the deficit reached $7.2 billion during just those 2 years. Until 1958, the U.S. international payments imbalances were not worrisome to many government officials because they were small in relation to U.S. international transactions. But during this 10 year period surplus nations increased their presentation of dollar claims to the U.S. Treasury for gold, as they had a right to. By the end of 1959, the U.S. gold stock was $17.8 billion, 28 percent less than that at the beginning of the decade.

After a substantial portion of the U.S. gold stock was claimed, U.S. officials began urging the leaders of the other major surplus countries not to present dollar claims for gold and promising that the United States would adopt domestic policies of restraint to end the payments deficits and the accumulations of dollar claims. Leaders of those countries faced a dilemma. On one hand, they did not want to continue accumulating dollars, which in the process promoted inflating in their countries, but on the other hand they realized that they could precipitate international monetary chaos and a possible worldwide depression if they pressed their claims for gold and confidence in the dollar was destroyed. Generally the surplus countries acquiesced to U.S. urgings that they hold the dollar claims and not jeopardize worldwide economic growth.

However, U.S. monetary authorities did not adopt domestic policies of restraint as they had promised. Instead, U.S. officials developed a number of schemes to help finance the U.S. payments deficits without much loss of gold. Among these were the General Agreement to Borrow, swaps, Roosa bonds, increased IMF quotas, Special Drawing Rights (SDRs), and the "two-tier" gold market. Each after a period proved ineffective as a cure for the payments deficits, but together they postponed the loss of confidence in the dollar and enabled U.S. politicians and bankers to continue their inflationary practices for a while longer.

In spite of repeated lengthenings of the international credit "rope," the United States eventually abrogated its promise to pay gold for dollar claims presented for such redemption. On August 15, 1971 President Nixon ordered the "gold window" closed, and thereby the Bretton Woods System came to an end. At that time the value of U.S. gold holdings at $35 an ounce was $9.7 billion and short-term dollar claims held by foreigners were an estimated $60 billion, two-thirds of which were owned by foreign official institutions.

The Bretton Woods System generally attained the goal of promoting international transactions. But the cost was high – too high. That system enabled massive inflating to occur on a worldwide scale, fostering enormous economic distortions and dangerously weakening the social fabric essential to the preservation of economic and other freedoms. In spite of that experience, those in control remained untiringly committed to avoiding the one solution to the international payments and monetary problems: the adoption of sound, noninflationary domestic policies.

The Floating Exchange Rate, Paper Nonsystem

In the Smithsonian Agreement, finance ministers of the major industrialized countries agreed on a new schedule of fixed exchange rates among their currencies which included a *de jure* devaluation of the dollar to one thirty-eighth of an ounce of gold. However, the specification of the dollar as that weight of gold was functionally meaningless because the U.S. Treasury would not exchange gold for dollar

claims at that ratio. The Smithsonian schedule of exchange rates lasted a little more than a year. In February 1973 another *de jure* devaluation of the dollar was made (to one forty-second of an ounce of gold) in an attempt to keep the fixed rate system operable. It failed within months. By the spring of that year, general floating of exchange rates had begun among the paper currencies of the leading countries.

Proponents of floating (flexible) exchange rates asserted that market determination of foreign-exchange rates would be a cure-all in that they would eliminate international payments imbalances *and* the need for adjustments of domestic policies: changes in prices of currencies (exchange rates) automatically would bring about needed changes in import and export prices of goods and real rates of return on capital and thereby would reduce international payments imbalances. Each nation thus could follow whatever domestic policies it chose. Deficit countries would not have to practice restraint when international reserves and borrowing capacity approached exhaustion, nor would they have to erect barriers to international transactions. Chronically surplus nations would not have to accumulate more international reserves and create additional domestic purchasing media in the process, nor would they have to establish legal barriers to keep out foreign capital seeking a haven in their currencies. International monetary utopia at last, so the advocates of floating expected.

However, floating rates have not worked as their proponents asserted they would. The floats have not been "clean"; they have been "dirty." That is, foreign and U.S. officials have not refrained from influencing their exchange rates by buying or selling currencies from time to time. To accomplish this, swap agreements were increased a number of times, IMF quotas were increased a number of times, the IMF established special borrowing facilities, SDR allocations were increased, and the U.S. issued foreign currency securities to private foreigners for the first time in history. Still currency exchange rates fluctuated wildly. Major European nations with close financial ties attempted to ameliorate the adverse effects of these wild gyrations on their economies by forming the "snake" arrangement in 1973 and the European Monetary System early this year. Since floating became widespread, barriers to free international merchandise and financial flows have become more numerous. Floating hardly has been the solution its proponents promised.

"Strong" currency nations, or those practicing sound policies and experiencing balance of payments surpluses initially bear the onus of adjustment under a clean floating rate system. As their currencies appreciate vis-a-vis deficit country currencies, their domestic productive sector suffers, as exports decrease and imports increase. Those nations can prevent that effect by promoting inflating in their countries at a rate approximating that of the deficit countries and/or by imposing barriers to international flows, both of which impede sound economic expansion. While surplus nations thus have no good options, leaders of profligate deficit countries gain the reward of temporarily higher output and consumption, which acts as an incentive to expand their profligate policies.

In time, however, "boom" distortions, rapidly rising prices, and decreasing confidence in their currencies overcome the earlier blissful conditions in deficit countries. This is the current situation in the United States. Now U.S. authorities are again confronted with a dilemma. If they adopt a domestic policy of restraint, it might foster deflating and the correction of distortions attributable to prior inflating, but the correction might also involve a temporary business contraction and its attendant suffering. If they continue to inflate, the distortions will worsen (including an accelerating rate of price increases) and convincing the public to have confidence in the dollar will become more difficult, perhaps impossible. Moreover, the greater distortions eventually would have to be corrected, but for a politician, a problem postponed is a problem solved.

Thus, after having abandoned a monetary system (the gold standard) that was proven effective in forcing early correction of unsound domestic economic practices in order to avoid the temporary suffering associated with that correction, and after having tried many substitute schemes, monetary officials still have only one effective long-term solution to international payments imbalances: the abandonment of unsound domestic policies and the adoption of sound policies. The monetary schemes that have been tried simply have delayed and worsened the distortions that eventually must be corrected. When they are, the associated suffering, some of which is now just becoming apparent, will be great.

Adherence to the gold standard could have prevented the enormous economic distortions now apparent, and re-adoption of that standard (at an appropriate "price" for gold) most assuredly would aid in the restoration and future preservation of long-term economic improvement. Better late than never!

STRENGTH FOR THE DOLLAR?

Measures announced last November to defend the foreign-exchange value of the dollar were successful – at least through May – and large amounts of foreign currencies borrowed early this year for use in dollar-support operations were largely repaid by the end of April. Official intervention can stem the slide of a currency for a time, but the comparative soundness of monetary policy will determine the long-term trend of its foreign-exchange value. With signs of a recession becoming dominant in this country, U.S. officials probably will have a good opportunity soon to demonstrate that fighting inflation and protecting the dollar is their top priority. We highly doubt that is is; therefore, we expect the long-term trend of the exchange value of the dollar will continue to be downward in terms of the traditionally strong currencies.

On November 1, 1978 a program was announced by officials of the U.S. Treasury and Federal Reserve Board "to strengthen the dollar and thereby counter domestic inflationary pressures." The plan included: a declaration that U.S. monetary policy would be tightened; an increase in Treasury gold sales; an increase in "swap" lines of credit; sales of U.S.-held IMF Special Drawing Rights for foreign currencies; and the issuance of up to $10 billion in foreign-currency-denominated U.S. Treasury securities. Coordinated intervention in the foreign-exchange markets by German, Swiss, and Japanese monetary authorities also was planned.

The deterioration of the dollar in the foreign-exchange markets accelerated from early August through October 1978 (see the accompanying chart). During the month of October alone, the value of the dollar fell 10.4 percent against the mark, 9.6 percent against the Swiss franc, and 7 percent against the yen.

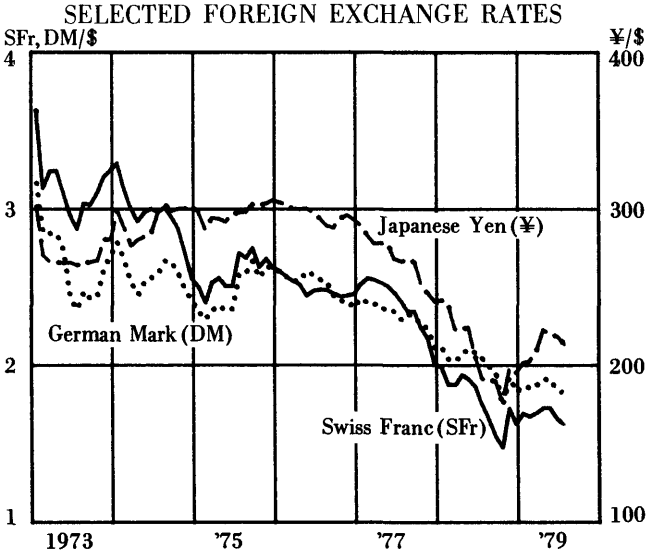
After the November 1 announcement, U.S. monetary authorities began massive intervention in foreign-exchange

markets. By the end of November the dollar had advanced 16.7 percent against the Swiss franc, 12.2 percent against the Japanese yen, and 10.8 percent against the German mark. Some reversal of this strengthening in the dollar occurred in mid-December, after the Iranian political turmoil became heated and OPEC announced an unexpectedly large 14.5 percent increase in oil prices for 1979. Substantial official intervention supported the exchange value of the U.S. dollar. By the end of December, U.S. monetary authorities had sold a total of $6 billion in foreign currencies in its dollar-support operations since the November 1 announcement.

Extensive use of swap agreements was made throughout the period. These agreements provide for the Federal Reserve to credit the account of a foreign central bank with dollars and in return that bank credits the Fed with an equivalent amount of its currency at the then-current exchange rate. The Fed uses this currency to purchase dollars on foreign-exchange markets. Swap credits are repaid by the borrowing central bank as quickly as market conditions permit in conformance with the short-term nature of the swap facilities. On October 31, 1978 Federal Reserve swap credits outstanding with central banks totaled $1.6 billion. By the end of January, U.S. use of swap commitments totaled $4.6 billion, which was substantially less than the $5.5 billion owed earlier in the month.

In January the demand for U.S. dollars increased. Foreign-exchange analysts asserted that the increased demand was attributable in large part to the rising price of oil, inasmuch as more dollars would be needed worldwide to pay the increased oil bill. This strength of the dollar in the foreign-exchange markets continued for some time, and the Federal Reserve and the Treasury were able to acquire by the end of April an equivalent of foreign currencies to repay all outstanding swap debt to foreign central banks. Even with official sales of U.S. dollars to obtain these foreign currencies, the foreign-exchange value of the dollar trended upward during the first 4 months of 1979. Of all the funds used by U.S. authorities in defense of the dollar from November 1, 1978 through April 30, 1979, only $4.1 billion in medium-term, foreign-currency-denominated U.S. Treasury securities placed in German and Swiss domestic markets remained outstanding at the end of April. Moreover, from the end of January to the end of April, liabilities to foreign official institutions (principally holdings of dollar-denominated U.S. Government securities) decreased nearly $16 billion (from approximately $163 billion to about $147 billion), which suggests that foreign official institutions also sold a substantial amount of dollars in the foreign-exchange markets during the period when the value of the dollar was relatively "strong."

SELECTED FOREIGN EXCHANGE RATES



Note: End of month data; latest data July 24, 1979.

During more recent weeks the foreign-exchange value of the dollar again has fallen against the usually strong currencies, and the Federal Reserve reportedly has again intervened to support its value. Reasons suggested by analysts for the renewed weakness of the dollar include: the realization that the higher oil prices provide only a temporary net increase in the foreign demand for dollars; the belief that officials of strong-currency countries prefer now to have their currencies appreciate in dollar value in order that those countries might pay lower domestic-currency prices for imported oil; and a cyclical trend toward more restrictive monetary policies in the strong-currency countries than in the United States. We have no idea of the accuracy of these suggested reasons. In view of the many participants in the foreign-exchange markets, we doubt that anyone knows the primary motives for marginal changes in buying or selling pressure at any given time.

In the short run of even a number of months, the trend in the foreign-exchange values of currencies can change abruptly, as the recent period of strength of the dollar and another similar period during 1975 demonstrate. But in both of these instances, the upward trends in the dollar's value followed periods of sharp downward trends and were accompanied by massive official intervention in the foreign-exchange markets in support of the dollar. In 1975, the amount of Federal Reserve intervention from February through July was a little more than $1 billion. Compared with the amount of intervention during the recent period, that amount seems small, but at the time it was considered very large. Those facts suggest another noteworthy aspect of foreign-exchange trends: over time larger amounts of intervention are needed to quell succeeding currency "crises."

In the long run, the foreign-exchange value of the dollar will reflect the soundness of U.S. monetary policy in relation to that of other countries. Although U.S. officials repeatedly have pledged to practice monetary restraint, they have yet to do so to a significant degree. Even late into the current business expansion, inflationary policies still were in effect. Now that signs of an impending recession are predominant in key economic statistics, U.S. officials almost surely will be pressured to adopt even more inflationary policies ostensibly to stimulate the lagging economy. This will be another clear test of their "resolve" to protect the value of the dollar. For the good of the Nation, we hope they will practice the monetary restraint they preach, but we are nearly certain that they will not. Therefore, in the long run the value of the dollar in terms of the strong currencies probably will continue to trend downward.

PRICE OF GOLD

	1978	*1979*	
	Jul. 27	*Jul. 19*	*Jul. 26*
Final fixing in London	$194.05	$299.15	$305.20

Research Reports **(ISSN 0034-5407) (USPS 311-190) is published weekly at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Second class postage paid at Great Barrington, Massachusetts 01230. Sustaining membership: $9 per quarter or $35 per year.**