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The Substitution Account: Another Scheme

The 34th Annual Meeting of the International Monetary Fund was held in Belgrade, Yugoslavia, October 2 through 5. Establishment of a "substitution account" received much attention, although final agreement on the details of such a measure was not reached. Thus the plan will not be enacted until next year's meeting at the earliest. The substitution account would enable foreign nations with surplus dollars of dwindling purchasing power to exchange them for the Fund's SDRs, and this would reduce international pressure on the United States to restrain inflating. With the surplus dollars received by member countries, the IMF would purchase U.S. Treasury securities and thereby help finance Federal deficits. We agree with The Wall Street Journal editorial that calls the measure a "substitution scam." The scheme, if put into effect, would be still another "band-aid" attempt to shore up the present ill-conceived international paper money system.

Monetary officials from 138 countries discussed a number of issues at the 34th Annual Meeting of the International Monetary Fund (IMF). These issues included: assistance to developing countries nearing the end of their financial resources who must nevertheless find ways to pay for imported oil; increases in members' quotas to the Fund in order further to assist member nations with balance-of-payments deficits; and the establishment of a "substitution account" that would "accept deposits of U.S. dollars from members of the Fund and certain other official holders in exchange for an equivalent amount of SDR-denominated claims."^{*}

The origin of the substitution account scheme can be traced to John Maynard Keynes' proposal in 1943 that the world's monetary reserves be centralized in an International Clearing Union. Keynes suggested that countries' reserves should consist of gold plus a new international currency unit, "bancor." Bancor was intended for the use of central bankers, not private citizens or entities. Keynes' vision of a new postwar international monetary arrangement was that bancor be convertible into gold at a fixed rate, which presumably could change if inflating depreciated paper money claims to the gold monetary unit. Bancor would be created by members of the International Clearing Union against their deposits of gold or by utilizing so-called overdraft facilities.

At the Bretton Woods Conference in 1944, the United States and other nations rejected Keynes' proposal and instead proposed a plan that became the basis of the IMF. The major feature of the IMF was that the U.S. dollar (then redeemable in gold at \$35 per ounce) was made the key currency of the international monetary system. The dollar thus became the world's "reserve currency," and it

was to be used by other nations to "back" their own currencies and to settle international obligations. U.S. monetary officials reasoned that, with the United States holding about 700 million ounces of gold, other member nations would gladly accept dollar obligations because dollar claims were in fact claims on the huge U.S. gold reserves.

The Post World War II International Scene

Upon this presumed base of gold, the United States pursued inflationary policies throughout the 1950's and 1960's. Not surprisingly, U.S. balance-of-payments deficits became chronic, increasing substantially during this period. As these events unfolded, nations that had accumulated U.S. dollars in their reserves and had the option of redeeming them for gold, increasingly exercised this option. Obviously, they had more confidence in gold than in U.S. claims to gold.

The IMF's Special Drawing Right (SDR), or "paper gold," was devised in 1968, and the first SDRs were issued on January 1, 1970. This new form of international liquidity would, its supporters claimed, "supplement the use of dollars and gold as official reserves and . . . reduce the dependence of the world community on continued United States deficits to meet future liquidity needs."[†] Although SDRs initially were defined as one thirty-fifth of an ounce of gold, or the equivalent of one dollar, the "definition" was meaningless because neither the IMF nor any other institution has ever been willing to redeem SDRs with gold. (Dollar claims then were still redeemable by law, but not in actual practice.) Even the pretense that SDRs were tied to gold was soon dropped. In July 1974 the SDR became a unit of account equal in value to a weighted average of 16 fiat currencies. As the exchange value of the dollar has depreciated in terms of most major foreign currencies during the past decade, an SDR is now valued at approximately \$1.34, rather than the \$1.00 of 1970. The Bretton Woods system continued on "borrowed time" until August 15, 1971. On that date President Nixon officially made the U.S. dollar a fiat currency by ending the last remnant of dollar-claims-to-gold convertibility, which the dollar claims held by official foreign institutions constituted.

The supremacy of the U.S. dollar on the world market subsequently was increasingly challenged by bankers and politicians of other nations. Regardless of the desire shared by the United States and other nations to maintain a viable international monetary system, foreign nations were no longer content with their rapidly increasing stores of depreciated dollars. What has ensued has been a series of efforts by world monetary leaders to

* IMF Survey, October 15, 1979, p. 303.

† "A Substitution Account: Procedures and Issues," *Quarterly Review*, Federal Reserve Bank of New York, Summer 1979, p. 42.

"keep the show on the road," based on the initial premises of Bretton Woods. These efforts, described in detail in the July 30, 1979 *Research Reports*, have failed. The substitution account, in our view, is neither more nor less than another such effort. Like its predecessors, it may succeed for a time.

No More U.S. Opposition

At their meeting in the fall of 1971, members of the Fund gave serious consideration to the substitution account, because the postwar international monetary arrangements were in complete disarray. At that time, U.S. financial leaders found the substitution account proposal largely unacceptable, but in more recent discussions the Fund's Interim Committee was asked to formulate a proposal that will be the basis for further discussion and probable approval by the whole Fund at next year's meeting. The U.S. position apparently has undergone a change, but the seeds of that change were sown years ago.

The financial press has reported that the substitution account has been forced upon a reluctant United States by foreign governments that are the major holders of dollars. However, the substitution account was proposed in 1973 by the Trilateral Commission's Monetary Task Force, which presented the details in a report entitled, "Towards a Renovated International Monetary System." One of the authors of that report was Richard N. Cooper, who is presently Under Secretary of State for Economic Affairs. The outline of the substitution account in the Trilateral Report is virtually identical to the proposal presented at this year's IMF meeting. We doubt that the similarity is merely coincidental.

Major issues awaiting settlement by the IMF's Interim Committee include: (1) the status of SDRs to be issued by the Fund to member nations depositing excess dollars in the substitution account (i.e., will the new SDRs be able to be traded among nations, and will they be exchangeable with outstanding SDRs?); (2) the exact procedure by which member countries could use the substitution account; and (3) the sharing, if any, of the liabilities for exchange rate losses incurred by the IMF from its creating SDR liabilities backed by dollar assets. These matters appear to be the most significant obstacles that prevented an agreement on the substitution account at the IMF's Annual Meeting this past October. Reported comments made by finance ministers, central bankers and the world financial press suggest that these obstacles may be insurmountable.

The substitution account probably appeals to U.S. monetary authorities because it will enable other nations to "dump" their excess dollar holdings without causing chaos on foreign-exchange markets. In the recent past, when the dollar ruled the international roost, the United States did not need to take the exchange risk posed by substitution accounts. Now, with major dollar-holders emphatically demonstrating their lack of confidence in the dollar, the United States is willing to undertake half of this risk if the IMF will assume the other half.

A Way Out?

As depreciation of the dollar vis-a-vis the "hard" currencies accelerates, the substitution scheme would buttress the value of the dollar. It would do this because excess dollars held by foreign central banks could be transferred to the IMF's substitution account in exchange for SDRs, which would get those banks out of dollars without their having to sell the dollars in the foreign-exchange markets. U.S. officials might believe that imported oil thus could

be paid for by the simple expedient of printing more dollars, inasmuch as OPEC nations receiving depreciating dollars for their oil would have the option of exchanging dollars for interest-earning SDRs. (The interest rate is an average of the major trading nations' treasury note rates.)

Pressure for the substitution account comes from another direction. In the event that the substitution account is not activated and OPEC continues to be paid only in U.S. dollars, the major oil exporters to the United States will face a major dilemma. The Saudis and other OPEC people realize that they are trading their oil for paper money that has lost half of its purchasing power since 1970. The oil exporters reportedly might demand payment in a unit comprising a "basket of currencies" and possibly gold in order to protect the purchasing power of the payments they receive. If this change occurred, further erosion of the value of the dollar, and possibly of other currencies, probably would follow, inasmuch as the OPEC nations hold more than \$100 billion. But the substitution account will protect the purchasing power of OPEC surpluses only if some other nation(s) cover the IMF losses on its dollar holdings. This also applies to other surplus-dollar countries.

The United States has made clear that it seeks to devise a plan providing an "equitable division of any costs" arising from decreases in the value of the dollar. The United States is seeking the best possible terms for itself in order to minimize future larger liability. Hence, the "fifty-fifty" arrangement.

Another feature of the substitution account that holds appeal for U.S. officials is that the dollars deposited in the account would be used to purchase U.S. Treasury securities. Thus the U.S. budget could remain in chronic deficit and the shortfall would be financed at least in part in a domestically noninflationary manner by the IMF's purchases of Treasury debt. This would relieve pressure on the Federal Reserve to monetize the Federal debt, and it would reduce upward pressure on interest rates in the United States. Congress therefore could increase Federal spending and budget deficits with less worry about the inflationary impact of its actions.

The Past Is the Future

This latest attempt to prolong the international paper money nonsystem was appropriately called "The Substitution Scam," by *The Wall Street Journal*. Inflating-embezzling will continue as long as politicians successfully devise schemes periodically to bolster the public's confidence in paper money. As we suggested in "Lengthening the International Credit Rope Cannot Prevent the Hanging" (*Research Reports*, July 30, 1979), "... 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, after having tried many substitute schemes, monetary officials still have only one effective long-term solution to international payments imbalance: the abandonment of unsound domestic policies and the adoption of sound policies."

Inflating ultimately results in a recession, a lesson that monetary officials are unwilling to acknowledge. The United States may be nearing the end of the road of the "great inflation" that began with the Keynesian-inspired attempts to inflate the economy out of the Great Depression and continued with a new international monetary system. The end of the world-wide experiment in monetary inflating cannot be determined with precision, but

the key "variable" in this equation is the willingness of the public to accept depreciating paper as a medium of exchange, a unit of account, and a store of value. When Americans, Europeans, Japanese and the major oil exporters decide en masse to refuse U.S. paper money, the inflating scam will be over and a new monetary system doubtless will emerge to replace the outmoded arrangement. The substitution account scheme simply postpones that inevitable day, and it reveals that monetary officials have not changed their "spots."

STEPS IN THE RISE OF INTEREST RATES

Interest rates on all U.S. Treasury securities have risen dramatically since late 1977 and are well above the levels of any prior cycle. On October 22, 1979 yields on new issues of 3-month Treasury bills soared to a record 12.93 percent, up from the previous high of 11.84 percent a week earlier. These rates were well above the peak 9.91 percent of the 1973-74 cycle and 8.10 percent of the 1969-70 cycle. Since the Federal Reserve announced its change in policy on October 6, the rate on these short-term Treasury securities has increased more than 280 basis points (1 percentage point equals 100 basis points).

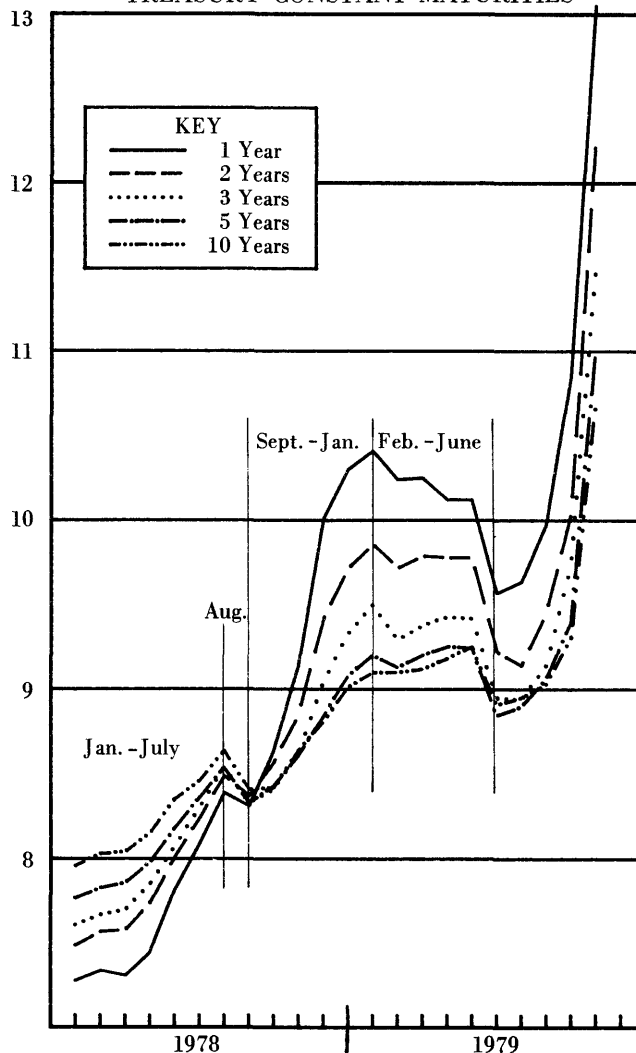
Sharp increases in interest rates also have occurred in the longer-term Treasury securities. Monthly rates from January 1978 through October 1979 are shown in the accompanying chart. The chart reveals that there have been five distinct sub-trends during this 2-year generally upward trend of interest rates. During the first, from January through July 1978, shorter-term rates increased much more than did longer-term rates. Nonetheless, shorter-term rates remained less than longer-term rates, and the yield curve (implied in the chart) remained upward sloping, reflecting the higher yields necessary to compensate investors for the greater risk of committing funds for longer periods.

The second sub-trend was a brief period of decreasing rates, during which the longer-term rates fell more than the shorter-term rates. At the end of August 1978, the yield curve was nearly flat. Rates again turned upward in September 1978, the beginning month of the third sub-trend. Shorter-term rates continued to increase more rapidly than long term. The curve became downward sloping in October, and the slope became steeper throughout this third period, which ended in January 1979. During this period, investors apparently came to believe that yields eventually would decrease; therefore, they were willing to accept lower returns for longer-term securities than for shorter-term issues.

The upward trend in rates peaked in January for the 1, 2, and 3 year constant maturities, but the 5-year yield during April was 5 basis points above that for January, and the 10-year yield was 10 basis points higher in May than in January. The downward trend in most Treasury yields for February through June was the fourth sub-trend. As the duration of this trend lengthened, many analysts asserted that interest rates had peaked for this business-cycle expansion. Rates continued downward through June and into July, but we concluded at the time (*Research Reports*, July 23, 1979):

"Business conditions historically associated with the beginning of a cyclical downward trend in interest rates now are more evident than at any other time during this business cycle and most interest rates recently have trended downward. On balance, however, the evidence suggests that interest rates will increase further during this cycle and that their eventual peaks may well set

MARKET YIELDS, TREASURY CONSTANT MATURITIES



Note: Yields on actively traded issues adjusted to constant maturities. Monthly data are averages of daily rates through August 1979. September 1979 data are for the end of the month, and October 1979 are for the 19th. Source: *Federal Reserve Bulletin*.

record highs." The current upward trend was just beginning, although we did not know it then.

The present upward trend in interest rates has included unprecedentedly large increases in rates. The discount rate has risen from 9.5 percent in July to 12 percent in October, and the Federal Funds rate has increased from an average 10.5 percent in July to about 13 percent in October. The extraordinary increases in yields may or may not continue in the short term. Much depends on what the Federal Reserve's actual practice will be as differentiated from what it said it would do. Until that becomes clear, interest rates may be highly volatile.

ANOTHER CHANGE IN TREASURY GOLD SALES PLANS

On October 16 the U.S. Treasury discontinued its scheduled auctions of gold and announced that future sales would be of varied amounts and at varied frequencies, with the details revealed only days before the sale. On October 25 the Treasury reported it would sell up to

1.25 million ounces on November 1, only 2 weeks after its preceding sale. The price of gold decreased little after these announcements, suggesting that gold is in "strong hands." Nevertheless, a substantial decrease in the price of gold during coming months is a possibility, but we do not know of a reliable basis for predicting if such a decrease indeed will occur or, if it does, its probable duration or magnitude.

On October 16, the Treasury stated that it was discontinuing its regularly scheduled gold auctions but was planning to make future sales of gold in varied amounts at varied frequencies, with only "several days" advance notice of the sale. According to newspaper accounts, the Treasury official said that the "...speculative run-up [was] having an effect on confidence in the future, confidence in currencies in general and confidence in the control of inflation." By creating the prospect of large gold sales driving down the gold price from time to time, the Treasury obviously intended thereby to discourage gold purchases and thus to force down its price. The Treasury announcement was a virtual admission of the monetary significance of gold. Although the price of silver and of platinum, to name just two "other commodities," had increased proportionately more than the price of gold this year, and although speculation obviously played a part in those price rises, the United States took no special steps to influence the prices of those commodities.

Some analysts interpreted the change in the Treasury's gold sales plans as a "face-saving" method of completely terminating its gold sales. In their view, the Treasury might want to end gold sales because those sales failed to keep down the price of gold and may have had the perverse effect of promoting higher prices by directing increased attention to the role of gold. If Treasury officials reached this conclusion, they could not publicly admit it because such an admission would further boost the price of gold. The plan announced would enable them to discontinue gold sales without aiding the fortunes of gold holders and possibly even with some success in pushing down the price because of greater uncertainty.

Only key Treasury personnel know what was planned when the announcement was made. If they had hoped the announcement alone would substantially depress the price of gold, they must have been disappointed. On October 16, the day of the announced change in sales plans, the London p.m. gold fixing was \$394.25. The next day the price dropped to \$386.00, and the next to \$380.50. But the following day it jumped to \$393.00, near which it remained through October 25. On that date, the Treasury revealed that, indeed, its gold sales had not been terminated. It announced it would sell up to 1.25 million ounces on November 1.

The First of Many?

The amount of the November 1 sale was substantially more than the monthly 750,000 ounces the Treasury had sold from May through October. Moreover, the November 1 sale was to be held only about 2 weeks after the final regularly scheduled sale on October 16. If gold were in "weak hands" (that is, held in significant part by investors hoping to reap short-term profits), the prospect of such large and frequent sales surely would have sharply depressed the gold price. On October 26, the London p.m. fix did decrease by \$16.80, to \$375.00. But it held near that price before rising to \$382.00 on October 31, when this was being written. Such price resistance to potentially highly adverse events suggests that the demand

that earlier this year pulled up the price of gold has a firm foundation. As we pointed out in the preceding issue of these reports in the article, "Greed and Tulips vs. Fear and Gold," that foundation is an increasingly widespread warranted fear of holding wealth in the form of rapidly depreciating paper currencies.

Of course, we do not know the Treasury's plans for gold beyond the November 1 sale. Conceivably, the November 1 sale could be the last for an extended period, inasmuch as the price of gold has remained in the high \$300 range and the foreign-exchange value of the dollar has trended upward since the Fed's announced change in monetary emphasis on October 6. Thus, there is not an urgent need for further gold sales to prop the dollar. Furthermore, Treasury officials might want to see what the Federal Reserve's policy is in practice and how it affects confidence in the dollar. If monetary policy clearly becomes less expansionary, inflationary fears might subside and the price of gold might drift downward for a time. In that event, the Treasury might suspend gold sales.

Alternatively, in their zeal to punish gold buyers, Treasury officials might conduct frequent and large gold sales during the coming months, even if inflationary expectations decrease. Such gold sales, while the economy was in a recession, were conducted at the beginning of the January 1975 through August 1976 downward trend in the price of gold (from nearly \$200 to about \$100). If a similar situation arises again, we believe that the price of gold again would trend downward for a time. However, because gold seems to be in "stronger hands" now than in 1974, we doubt that any such price decrease would approach the 50 percent drop of 1975-76. Nevertheless, the decrease could be substantial, and those with a direct or indirect interest in gold should recognize this possibility.

Another possibility is that if, indeed, Fed policy is less expansionary for a time, it will be reversed upon early evidence of a severe recession. Fed officials deny this, but monetary officials made such denials in the past as well. Yet, in the end, inflating accelerated, paper dollars depreciated at higher rates, and the price of gold rose.

In our discussion of the October 6 Fed policy change (*Research Reports*, October 15, 1979), we wrote, "... we do not believe that U.S. officials suddenly have become 'born again' sound money men. In our opinion, events forced U.S. officials finally to renounce, at least for the time being, more inflating." When the conditions that forced the policy change ease, we expect that the inflating-embezzling scheme will be reinstituted and that the price of gold eventually will exceed the recent high.

When that will be, we do not know. Nor do we know whether or not a substantial gold price decrease will occur before then. Furthermore, we doubt that anyone has a reliable basis for predicting those changes (Who knows what the Treasury will do?), which is the reason why anyone trading gold on the basis of short-term price forecasts probably will be unsuccessful.

PRICE OF GOLD

	1978	1979	
	Nov. 2	Oct. 25	Nov. 1
Final fixing in London	\$221.50	\$391.80	\$378.50

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