Published by

AMERICAN INSTITUTE
for ECONOMIC RESEARCH

Great Barrington, Massachusetts 01230

RESEARCH REPORTS

Vol. LXVI No. 21 November 8, 1999

Gold, Currencies, and the Dollar*

Although often omitted in domestic analysts' assessment of prospects for the dollar, perceptions abroad of U.S. financial and monetary strength must eventually influence its fate—especially as foreign claims against the United States continue to grow.

In 1969, the financial writer for *Le Figaro*, Jean LeCerf, published a definitive study of United States dollar diplomacy of that era from the French perspective, called *Gold and Currencies [L'Or et les monnaies]*, never translated into English. Rereading it for the fifth or sixth time now, one finds that little or nothing has changed for the external position of the dollar.

LeCerf set forth four main themes: Countries like the United States, which issue irredeemable currencies that others hold as reserves, are given a special privilege that usually becomes a curse. The prosperity of other countries and the liquidity supporting global trade depend, in turn, on a constantly growing surplus of dollars held abroad. For the stock of external dollars to grow, the United States must always incur a trade deficit, with reciprocally depressive effects on internationally competitive industries within the United States. But an endlessly rising trade deficit is both economically and politically unsustainable, so that, in the words of President De Gaulle in February 1965, it would be preferable to found the international payments system on "gold, which has a real value, which one only possesses by having earned it, which one cannot transfer to others without risk and without sacrifice."

On the 30th anniversary of the publication of LeCerf's book, it is fitting to review his four main themes and to determine where the United States stands today for each of them. On the whole, the sensation of being on the outside of an expanding balloon that is about to burst is every bit as strong today as it was when LeCerf wrote the essays that became his book. Still, it is important to remember that the risk of the final collapse of the old dollar-exchange standard of the Bretton Woods era had been rising for an entire decade and still did not occur until two years later, in 1971. The time between identification of the problem and its eventual consequences may be quite long.

In the 1960s, the main external problem for the U.S. dollar was the rapid increase of the amounts held by nonresidents, the beginnings of the modern Eurodollar market. Starting at nearly zero when generalized currency convertibility was resumed in Western Europe in January 1959, Eurodollar holdings reached $100 billion by 1970. For comparison, federal debt outstanding was about $400 billion and U.S. GNP was about $1 trillion in 1970. Policy makers of that era defended the rapidly increasing foreign claims on the United States with the rationale that they were necessary for the "healthy expansion of the free world's economy." In those days, it was assumed that global monetary gold reserves would not expand as rapidly as it was desirable for world trade to expand.

Today, in the aftermath of the East Asian debt and payments debacles of 1997-1998, policy makers assume that it is desirable for the U.S. economy to expand rapidly in order to provide a growth stimulus to lagging foreign regions. Still, due to the exigencies of international accounting, their expansion has to be financed reciprocally, at least in part, by our deficit. This aspect of the 1960s, known then as the "Triffin paradox" (after the Belgian-born Yale professor who described it), still bedevils current policy makers who are attempting, now as then, to expand international liquidity (reserves) in U.S. dollars, which remain irredeemable: Great needs for liquidity (reserves) in East Asia, Russia, Brazil, Argentina, and the like, can be satisfied only by an expanding U.S. trade and current account deficit, the net supplier of dollars to the international economy.

Recent U.S. international financial policy has contributed to mushrooming merchandise trade and current account deficits. The merchandise trade deficit for 1998 was $247 billion, a record (below $200 billion in the two preceding years), and reached $31.4 billion for June 1999 alone—a $360 billion annual pace if sustained. The current account deficit, about $100 billion per year in 1996-1997, reached $164 billion in 1998 and was $25 billion for the month of June 1999 alone, another record, with an annualized pace of $300 billion in view.

Standard measures of international financial health treat trade or current account deficits in the range of 4 percent of GDP as unsustainable and potentially disastrous for any country. Any such disasters become the entire world's problem if the issuer of the world's irredeemable central reserve currency incurs them. (The framers of the new European currency, the euro, would have required intervention at the 3 percent threshold if the United States were a member of the European Currency Union.)

Under existing international financial arrangements, it was to be expected that the United States would incur a sizable external deficit to accommodate the recovery of East Asia, Russian reform efforts, and the avoidance of disaster in Brazil and Argentina. The question is the extent to which international perceptions of U.S. "indebtedness" might erode confidence in the dollar. If that were occurring, one might reasonably expect European central banks to stop selling their gold reserves, for example, or impacted groups of domestic producers to intensify their lobbying efforts in Washington, D.C., for protection from what they perceive as a flood tide of imports from the countries accumulating dollar reserves. Both are occurring or have occurred during the second half of 1999.*

Would gold, or silver, or some international monetary standard other than the

---

* This article is by AIER Faculty Associate Walker F. Todd. Dr. Todd is an attorney and economic consultant in Ohio.

* The central bankers might be more favorably inclined toward further gold sales if the gold price rose—ed.

irredeemable dollar be more sustainable and serviceable in the current international economic environment? Was President De Gaulle right in arguing that only gold fits the bill precisely because it is (or was then) difficult to acquire, has real value, and can be transferred only with risk and sacrifice? Are irredeemable reserve currencies better stores of value than gold, silver, or crude oil futures?

Gold prices have been depressed, especially in comparison with various types of financial instruments, in the last few years. Before the September-October 1999 increase in gold prices, preceded by a dramatic increase in crude oil prices during the second half of 1999, the lifetime low for the December 1999 gold futures contract, probably in late summer, was $253.80 per ounce; the contract was worth about $320 one month ago, and last week was about $290. Silver prices, which rose to $7.20 per ounce within the last few years when it was disclosed that the investor Warren Buffett had accumulated an extensive stock of silver, have remained around $5 per ounce during the recent gold price slump and were $5.22 for the December 1999 futures contract earlier this week. Even crude oil, which rose to $24.73 this fall for the December 1999 futures contract from a contract lifetime low of $12.55, has settled back somewhat at $22.51 earlier this week.

In contrast, the dollar, which has been disparaged lately in some circles because of its decline against the Japanese yen (falling from 131 per dollar average value in 1998 to 104 per dollar earlier this week), has remained comparatively strong versus almost all non-East Asian currencies. The currencies of America's other major trading partners, excluding Canada and Mexico, have weakened considerably in 1999, with the euro falling most conspicuously from an initial price of $1.18 to $1.05 earlier this week. The U.S. dollar index (1973=100) was still above 99 earlier this week, versus a summertime peak of about 104. Usually, U.S. exporters find sales difficult when that index is above 95. The obvious corrective device is a weaker dollar to stimulate exports and reduce the trade and current account deficits, but that prescription flies in the face of the financial market stimulus that a strong dollar provides, albeit at the expense of a rising external deficit.

If the dollar is strong, the yen notwithstanding, and if one can earn positive returns holding inflation-protected Treasury bills (4.11 percent early last week) or common stocks (10,649 for the Dow Jones Industrial index earlier this week, 1,354 for the S&P 500 index, versus 1,144 one year ago), then a strong argument can be made for holding the reserve currency (irredeemable dollars) that enables one to purchase those higher-yielding financial instruments. In contrast, gold is down and silver is flat. Even crude oil prices seem to be levitated on the strength of global production cutbacks negotiated by the Mexican petroleum minister, Luis Tellez, who, by the way, negotiated the U.S. Treasury's bailout loan of 1995 while he was chief of staff to Mexican President Ernesto Zedillo.

President De Gaulle's views on gold remain generally sound but probably will prove difficult to vindicate in the near term. Gold still has real value (constant demand in the face of varying supply). Gold still is difficult to acquire, but declining prices and increased potential production at, say, $325 per ounce, tend to make gold much easier to acquire as a monetary reserve than was the case in 1965. Gold still is difficult to transfer physically without risk, but book-entry movements of gold by central banks and other custodians are much more widely available today and have made it possible for almost anyone to own gold without physical delivery. Even new-minted gold coins are much easier to acquire today than before 1974.

The personal or national sacrifice involved in transferring gold today is no less than it was in 1965 at the official price of $35 per ounce. One way of viewing the gold price at $300 per ounce is that it merely offsets the 10-for-1 inflation of the U.S. domestic price level that has occurred since the redemption of the dollar for gold was suspended in 1933. So the sacrifice element of President De Gaulle's formulation still applies.

During October 1999, the Nobel Memorial Prize in Economics was awarded to Columbia University Emeritus Professor Robert Mundell. Like President De Gaulle and the other grand historical characters who appear in LeCerf's book, Mundell over the years has been emphasizing the central monetary reserve role that gold either plays or ought to play in any fixed exchange rate system. He is concerned that the rise of a new reserve currency in the world, the euro, backed by twice the foreign exchange and gold reserves of the dollar, requires that U.S. policy makers rethink the dollar's role as a central reserve currency and, at a minimum, that they coordinate U.S. macroeconomic policy with European policy more closely than in a regime of floating exchange rates with only one reserve currency.

It is appropriate that Mundell's Nobel Prize should coincide with the 30th anniversary of LeCerf's great but still untranslated book. The writings of both men about the same events, the decade leading to the end of the Bretton Woods era, raise all the important, fundamental questions about gold, currencies, and the dollar. All three men mentioned by name here would agree on one central premise: In the late stages of an international expansion unilaterally financed by the United States with irredeemable dollars, it is imprudent to count on continued strengthening of the dollar to sustain the current financial structure, especially so if the trade deficit and current account deficit actually test "unsustainable" levels.

The conclusion just stated suggests that investors holding dollars who believe that international macroeconomic factors are the principal determinant of international capital flows should place at least some reliance on tangible assets, including gold, and exercise some caution with respect to financial assets, including U.S. stocks and bonds, until a new and sustainable equilibrium is reached in the U.S. trade and current account deficits. New conditions requiring this adjustment have arisen or have become manifest only since the spring of 1999. Any new equilibrium could require a significantly lower value for the dollar against currencies other than those of East Asia in the near term and against all currencies outside the North American Free Trade Agreement bloc in the medium term. ❑

OTHER PEOPLES' MONEY

The recent outpouring of self-satisfaction over so-called surpluses and the prospects of paying off the officially recognized national debt of $4 trillion in fifteen years are small potatoes compared with the great and growing obligations—loans, loan guarantees, and insurance—to which we have committed ourselves through the Federal Government.

Gertrude Stein was nearly sixty when she earned her first money from her writings, and was thrilled. She began to take an interest in the subject, and discovered that, unlike the constancy of roses, money is not always money:

> Everybody now just has to make up their mind. Is money money or isn't money money. Everybody who earns it and spends it every day in order to live knows that money is money, anybody who

votes it to be gathered in as taxes knows money is not money.

"The thing that differentiates man from animals," she wrote for the *Saturday Evening Post* in 1936, "is money"—which he counts.[1] "The king is in his counting house counting out his money." But the ability to count money is lost when it is not one's own. Miss Stein's nephew came home and told his father that he had just seen a million horses. "A million?" asked his father. "Well anyway, I saw three," the boy replied. The boy was like Congress. When you earn and spend your own money, you know the difference. "But when you vote money away there really is not any difference between a million and three."

"The natural feeling of a father of a family is that when anybody asks him for money he says no." But once upon a time there was a king who "spent money as they are spending it now. He just spent it and spent it and one day somebody dared say something to the king about it. Oh, he said, after me the deluge, it would last out his time, and so what was the difference." The attitude of Louis XV, who could not be bothered to count his spending or his debts because they were somebody else's problem, has been carried over to modern Governments, compared with whom the *ancien régime* pinched pennies.

Easy Promises: Loan and Other Guarantees

The unreality of the Government's Social Security and Medicare promises is well known. Estimates of the time until these programs go bankrupt vary from 15 to 35 years. The present value of their uncovered obligations exceeds $10 trillion, more than tripling the Federal debt, and the unrelenting rise in this liability as the day of reckoning approaches—if we choose to count it—turns a small pretended surplus into a large actual deficit. But this is not all. Other potential obligations in Federal insurance and loan guarantees are at least as great, though the amounts are difficult to determine because of the open-ended nature of some of the promises. Most of the following data are from *Analytical Perspectives, Budget of the United States Government, Fiscal Year 1999*, which lists and discusses off-budget items that receive little notice in the capital.[2] The quotations, which highlight the differences between the practices of Government lenders and lenders of their own money, are from the same source.

> Q: When is money not money?
>
> A: When it's other peoples' money.

Table 1. **Federal and Federally Assisted Credit Programs** (billions of dollars)

Program	*1996*	*1997*
Direct Loans		
Rural Development and Housing	82	81
Agency for International Development	13	13
Export Food Credits	12	11
Disaster assistance	9	10
Foreign Military Financing	8	8
Export-Import Bank	8	10
Direct Student Loans	12	21
Small business	2	1
Other direct loans	19	26
Total direct loans	165	181
Guaranteed Loans		
FHA and VA Mortgages	610	619
Family Education Loans	102	99
Small Business	31	34
Export-Import Bank	18	22
Farm Service and Rural Housing	11	12
Export Credits	5	5
Other Guaranteed	28	31
Total Guaranteed Loans	805	822
Total Federal Credit	970	1,003
Government Sponsored Enterprises		
Government National Mortgage Assn.	812	862
Federal Home Loan Mortgage Corp.	601	627
Federal Home Loan Banks	153	182
Farm Credit System	57	59
Total Government-Sponsored	1,623	1,730
Total	**2,593**	**2,733**

Source: *Analytical Perspectives, Budget of the United States Government, Fiscal Year 1999,* Table 8-1.

Loans and loan-guarantees of Federal agencies are listed in Table 1. Direct loans are financed by agency borrowing in the capital markets, although their debt is seldom counted in the national debt. This would be acceptable accounting practice if (a) the Federal Government, that is, taxpayers, did not stand behind agency debt, and (b) agencies were prudent in their lending. Neither is the case, with the result that the "Federal Government's inventory of delinquent loans and loan receivables was $37 billion at the end of 1997. Usually, this debt is worked by the agency that made the direct loans or loan guarantees. Little progress has been made in reducing this debt, whereas the private sector has developed sophisticated tools for collecting delinquent debt and quickly disposing of assets acquired through default." The report emphasizes the need "to work delinquent debt more aggressively and take advantage of private sector efficiencies." This includes conformance with the *Debt Collection Improvement Act of 1996*, which requires agencies to "send debt that is over 180 days overdue to the Treasury for offset against Federal payments to the delinquent borrower and to a debt collection center designated by the Secretary of the Treasury." They were also advised to be more strict in selling defaulted loan collateral and debt delinquent for more than a year to more efficient private collectors.

Even more important for delinquency rates than laxity in collection is the loss of the most creditworthy borrowers to private lenders, which accelerates as technology improves private assessments of default risk, "leaving the Federal program facing a smaller pool of riskier clients." Despite efforts to improve collection procedures in the notorious student loan program, "loan levels have risen dramatically over the past ten years as a result of rising educational costs, higher loan limits, and more eligible borrowers. The upward trend is expected to continue for the next five years." Other programs have also grown. The acceleration of loan guarantees in recent years is shown in Chart 1.

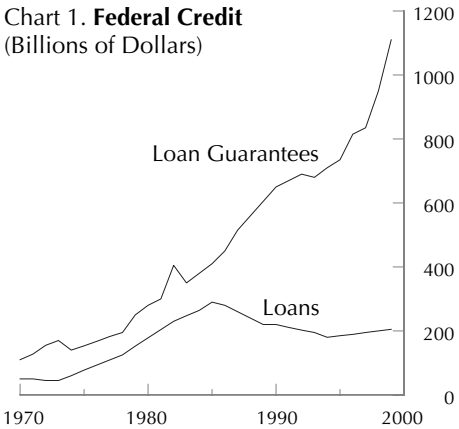
Limited Responsibility, Unlimited Insurance

The bankruptcy and bailout of the Federal Savings and Loan Insurance Corporation in the 1980s is common knowledge. But the program was continued under the Federal Deposit Insurance Corporation, which also insures commercial bank deposits up to $100,000 per account. The FDIC insures $2.7 trillion and the National Credit

[1] The five articles are reprinted in *Look at Me Now and Here I Am: Writings and Lectures, 1909-45*, ed. by Patricia Meyerowitz, Penguin Books, 1971.

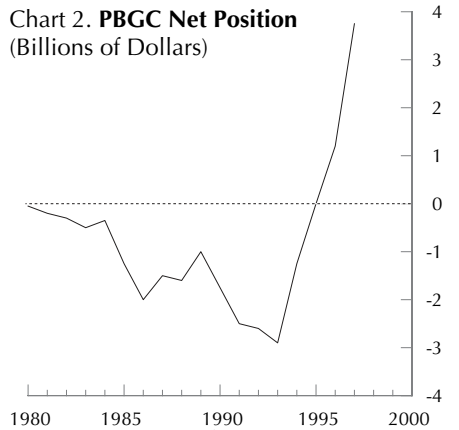
[2] Available from the Superintendent of Documents, Washington, DC, 20402, and through the World Wide Web: http://www.access.gpo.gov/su_docs/budget/index.html.

Chart 1. **Federal Credit**
(Billions of Dollars)



Source: U.S. Government Printing Office, Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 1999.

Chart 2. **PBGC Net Position**
(Billions of Dollars)



Source: Pension Benefit Guarantee Corporation, Pension Insurance Data Book 1997.

Union Administration insures credit union accounts worth $300 billion. The frailty of deposit insurance was demonstrated by the failure of several state programs in the first quarter of the 20th century. An insurance fund devoted entirely to deposits is not a good bet because, unlike life and accident insurance, the risks are not independent. "Deposit insurance" is a misleading term because it does not perform the normal function of insurance—the spreading of risks. The failure of hundreds of Texas depository institutions after the collapse of oil prices and cutbacks in production and exploration was enough to sink the fund. But the Federal Government, unlike states that cannot print money, was able to reimburse the fund and continue its commitment to bailouts.

Deposit insurance generates its own need. It relieves depositors, unlike the buyers of stocks and bonds, of the incentive to examine the conditions of their banks. This relief from market discipline enables banks to take on greater risks—barely noticed by Government regulators because "it's somebody else's money." Most of the losses to the deposit insurance funds in the 1980s came from the deterioration of already insolvent institutions whose closure was politically risky. Ironically, the bailout money is the depositors' own—although taken from them in their capacities as taxpayers, or as consumers when depreciated money is simply printed.

The Federal Government also insures private pension funds of well over a trillion dollars. The Pension Benefit Guaranty Corporation assures the payment of benefits up to specified levels when a company with an underfunded pension plan becomes insolvent. One-third of insured plans are underfunded, mostly in the volatile steel, auto, and transportation equipment industries. These companies have not provided for their own obligations, so the Federal Government does it for them.

The Federal pension guarantee was established by the Employee Retirement Income Security Act of 1974 after heart-wrenching stories of retirees unable to collect pensions because of the cancellation or complicated eligibility requirements of their plans or the bankruptcy of their employers. At the time, most pensions did not require employee contributions, and many firms failed to fund their obligations. A reason that is often given for pensions is that wages deployed in pension funds allow workers to defer taxes—on both income that would otherwise be taxable to them and on the investment earnings of the fund. But this advantage is more than offset, especially for young workers, by the high cost of consumer credit. The more important advantage, however, has been to employees—i.e., the delay of wages by firms in (hopefully) temporary difficulties. In such circumstances, the workers become equivalent to bond- or equity-holders in the firm. They have laid bets on improved earnings. The chances that these bets will be overly optimistic is increased by the willingness of the Government to validate them. Companies can make promises that taxpayers will have to keep.

> A billion here, a billion there, and pretty soon you're talking about real money.
>
> —*Senator Everett McKinley Dirksen* (1896-1969), Bartlett's *Familiar Quotations*.

Attempts by the regulators to limit these promises by requiring up-to-date funding defeats the legitimate purposes of pensions. Small companies have been forced to discontinue their pensions, and workers' stakes in the survival and prosperity of their employers have been undermined. In any case, the enforcement of funding is impossible even in the most favorable circumstances. Companies legally borrow large amounts from their funds, whose values fluctuate with the stock market, and the present values of obligations are sensitive to interest rates. An expanding economy has pulled the PBGC out of the red (its assets from investment of employer premiums less liabilities from bailed-out plans), as we see in Chart 2. But the failure of even one large firm would sink the fund—which is also true of the FDIC.

Space prevents attention to other Government promises that are even more open-ended than those discussed above—such as flood and crop insurance and the Securities Investment Protection Corporation, which protects the customers of failed brokers and dealers up to $500,000 per account. The SIPC is funded by assessments on securities firms. If the fund is depleted, it is authorized to borrow up to $1 billion from the U.S. Treasury on the security of future assessments.

When Thomas Jefferson was too generous in co-signing the notes of friends who later defaulted, only a public subscription saved him from bankruptcy. Governments with the power to print and otherwise command money—three or a million trillion—have no such worries. But taxpayers and consumers do—or should. Gertrude Stein's young acquaintances thought that she, "who had always been so well ahead of every one," had become reactionary in her attitudes toward money. But "[I] am not certain," she responded, "that I am not again well ahead as ahead as I ever have been." ❑

PRICE OF GOLD

	1997	*1998*	*—— 1999 ——*	
	Nov. 6	*Nov. 5*	*Oct. 28*	*Nov. 4*
Final fixing in London	$312.05	$290.60	$296.25	$290.60

Research Reports (ISSN 0034–5407) (USPS 311–190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: $16 per quarter or $59 per year. POSTMASTER: Send address changes to ***Research Reports***, American Institute for Economic Research, Great Barrington, Massachusetts 01230.