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CHANGING THE UNITED STATES COMMITMENT TO GOLD

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INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
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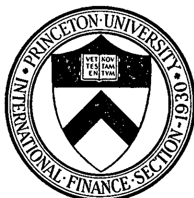

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CHANGING THE UNITED STATES COMMITMENT TO GOLD

On March 17, 1967, the Secretary of the U.S. Treasury made a speech before the Annual Monetary Conference of the American Bankers Association at Pebble Beach, California, that greatly stimulated public discussion of the possibility of unilateral action by the United States in case other countries did not cooperate in "enabling the United States to deal with its [balance-of-payments] problem," thereby undermining the international monetary system by subjecting it to "radical and undesirable change."

Before Secretary Fowler's remarks at Pebble Beach, most public discussion concerning the role of gold and the dollar in the international monetary system was confined to academic circles. Shortly after Mr. Fowler's speech, however, two major banks, Chase Manhattan and the Bank of America, challenged the desirability of the Treasury's inflexible gold buying and selling policy, thereby adding a new dimension to the controversy. They made the suggestion that the United States should, in future, deal in gold with foreign central banks only at its own option. Former Under Secretary of the Treasury Robert V. Roosa, Executive Vice President of the American Bankers Association, Charls E. Walker, and officials of the First National City Bank of New York rushed to defend the *status quo* on gold and the dollar. Chase Manhattan subsequently "clarified" its initial remarks by issuing a statement generally interpreted as a retraction. Later, the American Bankers Association too released a comprehensive policy statement strongly in support of maintaining the close link between gold and the dollar.

The line of argument for breaking the close link between the dollar and gold is generally based on the observation that the existing supply of monetary gold is limited; that private world demand for gold is increasing and now exceeds the current supply of newly-mined gold (at the fixed price of $35.00 plus a small service charge); and that, to ensure continued stability of the present international monetary system, countries would have to demonstrate far more willingness to assume responsibility for the system's viability than they have in the past. This would involve such steps as pooling existing monetary gold stocks to ensure confidence in continued dollar-gold convertibility, adopting more appropriate fiscal and monetary policies, and liberalizing restrictions on capital exports by surplus countries. Continuation of the present trend can only result in further drains on the limited stock of U.S. Treasury gold,

reductions in overall international liquidity, inefficient and increasingly restrictive balance-of-payments controls—reduced levels of international trade, investment, and foreign aid—and higher levels of interest rates, all of which tend to retard rates of world economic growth.

On the other hand, those opposed to breaking the close tie of the dollar to gold stress the importance of a moral commitment of the United States. The policy statement of the American Bankers Association makes the case as follows: "One of the regrettable features of recent public discussions of the gold problem is the extent to which they have ignored the obligations of the United States to fulfill its commitments to nations which, having accepted official reassurances that our gold policy will not be changed, have helped finance a long string of U.S. deficits by adding to their dollar holdings. A number of nations have thus put their national interest on the line in failing to press for conversions of dollars into gold, although it is noteworthy that a few others have not."

Some observers also regard the existing close link between the dollar and gold as a fundamental requirement for a stable system of fixed exchange rates. The ABA statement, for example, considers the maintenance of gold-dollar convertibility at the fixed price of $35.00 as "the foundation for a system of stable rates of exchange"; any change in this role of gold, it maintains, would be a serious threat to the international monetary system "which has served the world so well since it was outlined at Bretton Woods in 1944." (These sentiments are in marked contrast to the ABA's former position of firm opposition to Congressional enactment of the Bretton Woods Act. In February 1945, the ABA warned that the proposed International Monetary Fund was "unsound," would increase the "grave danger of inflation," "delay fundamental economic adjustments," and "fail to protect the principles and interest of the United States and its citizens.")

It is obvious that one possible way to sever the close link between the dollar and gold would be for the United States unilaterally to allow the dollar to float with respect to both gold and foreign currencies. Although such action should not be ruled out as an entirely unacceptable alternative, it would, of course, represent a radical departure from the present international monetary arrangements and, therefore, should be regarded as a last step, to be resorted to only after close examination of less radical alternatives. One such possibility, should continued gold losses persist to the danger point, for example, would be to preserve the present link between the dollar and gold—in terms of maintaining the official dollar price for gold and United States obligations under the IMF Articles of Agreement—while at the same time eliminating the present commitment of the United States to buy and sell gold freely on the demand of foreign

monetary authorities. This could be done by instituting the so-called "current-account convertibility" status for the dollar—the present status of *all* other "convertible currencies" under the IMF Articles. As will be noted in the concluding section of this essay, one effect of such a change in the convertibility status of the dollar would be to set the stage for the possibility of a further change in the link between gold and the dollar without requiring a radical and unilateral action by the United States.

The term "current-account convertibility" can be defined as a legal status in which convertibility of a currency may be either to gold or to the currency of the country demanding the conversion, at the option of the country making the conversion, and in which conversion may be legally required only in the case of currencies acquired in current-account transactions. However, it should be noted that, although the IMF Articles of Agreement may require only *current-account* convertibility, the actual degree of convertibility of most currencies defined as convertible under that status goes beyond the narrower requirement. Indeed, for this reason the term "current-account convertibility," although a neat and legally valid expression, is somewhat misleading. The principal technical distinction between the convertibility status of the dollar, as compared with that of other convertible currencies, derives from the fact that dollar convertibility is achieved primarily by freely buying and selling gold against dollars on demand of foreign central banks at the fixed price of $35.00 (neglecting service charges), while that of other currencies derives from central-bank intervention in the foreign-exchange markets whenever necessary to maintain their fixed exchange rates (within the narrow range of allowable fluctuation).

As will be discussed below, the adoption of current-account convertibility for the dollar would eliminate restraints imposed on the U.S. Treasury by the physical limitation of the size of its monetary gold stock. At the same time, national and international commitments of the United States, legal and moral, would be left inviolate. Accordingly, to the extent that its international payments difficulties can be equated with a physical shortage of gold, such action should help to "solve" the payments problems of the United States.

This essay will consider the case for adopting current-account convertibility of the dollar. The technical effects of such action on this country's payments situation and the international monetary system will be examined, and the results then considered in terms of the impact on the structure of international monetary power and implications for the future. A selection of various provisions of the IMF Articles of Agreement of particular relevance to this essay is presented in an Appendix.

It should be stressed that the purpose of this essay is to analyze, not

advocate, solutions. This stand is taken because all so-called "solutions" imply political and economic consequences which, in turn, imply costs to some and gains to others. One's judgment as to what should be done, therefore, really depends on one's own goals and prejudices. The goals and prejudices of the author, though dear to him, contribute nothing to the choice to be made.

Obligation of the United States as a Member of IMF

It may be stated at the outset that, as various authors (for example, John Parke Young in a recent essay in this same series) have asserted, there would be no contravention of the IMF Articles of Agreement if the United States decided henceforth to sell or purchase gold only at its own discretion. However, the assertion, as stated, although literally correct, is incomplete and misleading.

The United States, like other members of the International Monetary Fund, is obligated under the Fund Articles to maintain within its territories exchange rates between its currency and the currencies of other members within the limits of plus or minus one per cent of the defined parities of the currencies. (Article IV, Section 3-i.) However, under the second sentence of Article IV, Section 4(b), any member is deemed to satisfy this obligation by in fact freely buying and selling gold (within margins prescribed by the Fund). The United States, unlike any other member of the Fund, has so far satisfied its obligation to the Fund under IV(3)(i), by freely buying and selling gold in accordance with the second sentence of IV(4)(b). This means that if the United States decided no longer freely to buy and sell gold, it would have to satisfy its Fund obligation under IV(3)(i) as other members do, by maintaining exchange transactions in its territories with respect to other members' currencies within plus or minus one per cent of their parities. Thus, even a complete cessation of gold sales and purchases with other monetary authorities would not in itself be a violation of the Articles. However, a violation *would* occur unless the United States then began to buy and sell currencies in its territories as and when necessary to support their parities within the one per cent margins.

Technical Problems of Operating in Foreign Currencies

A switch to supporting exchange rates of currencies within its territories by the United States, instead of maintaining free dollar-gold convertibility, would involve certain technical problems. These problems, while not insurmountable, nevertheless present greater complexities and more of a burden to the United States than is the case for other countries. First, since there is no other national currency with the international

status of the dollar, and since the dollar is actively traded in the exchange markets of all other countries, the United States would have to engage in exchange operations in a proliferation of different currencies. Working balances (reserves) in a correspondingly large number of different currencies would have to be maintained by the Federal Reserve. This is a very different situation from that faced by nonreserve-currency countries, which operate virtually only in dollars (or some other major international reserve currency) to fulfill their Fund obligations. Such countries simply have little or no call for exchange transactions in other currencies. Second, the need for the United States to maintain balances of nonreserve currencies would expose it to risks associated with the holding of currencies less universally acceptable than the dollar and with histories of greater weakness and instability. Other countries generally do not want to hold such currencies. They prefer the dollar, which is backed by the economic strength of the United States and has world-wide acceptability, a long history of a high degree of monetary stability as compared with other currencies, and a world-wide banking apparatus. Third, the fact that the United States would support a foreign currency within its territories at a particular exchange rate, while the counterpart country would support the dollar within its territories at a particular exchange rate for its currency, means that the two rates would have to be closely coordinated. Otherwise, large international currency flows between the two central banks for purposes of arbitrage could be set off. Although such coordination is achievable, it should be noted that the exchange rate of a currency reflects not only official policies, but also changing market forces capable, at times, of shifting with great rapidity. To maintain consistent reciprocal arrangements with respect to the point at which each country would have to intervene in the market could require a multitude of bilateral consultations, all subject to rapid modification to avert undesired reserve or exchange-rate movements.

It may be noted in this connection that maintenance of the exchange-rate obligation under Article IV(3)(i) is territorial. When a given rate relationship between two currencies threatens to move beyond the limit of one per cent from par, there is, from a conceptual viewpoint, a fusion of two territories in which the obligation to maintain exchange stability is applicable. There is, in effect, a single territory (usually noncontiguous) in which two monetary authorities are operating. The necessity for full coordination, and, in the process, for sharing a sovereign function, is obvious and inescapable.

To some extent the existing network of "swaps" between the Federal Reserve and the central banks of some eleven countries represents an example of the type of arrangement that would be particularly useful

under current-account convertibility. However, the swap arrangements presently in force were created under the existing circumstances, in which the United States is not legally committed to maintaining the parities of foreign currencies with respect to the dollar within its territories. Their existence is therefore much less critical than would be the case under current-account convertibility. Moreover, drawings under the swaps require reversal in 90 or 180 days, or sometimes can be extended to 270 days, while the swap facilities themselves can be terminated. As such, they may unilaterally be eliminated or substantially reduced on renewal. This risk would become more urgent under current-account convertibility of the dollar, thus indicating a need for the United States to hold a "permanent" stock of foreign currencies.

It should also be noted, however, that member countries are obligated under the Fund Articles to promote exchange stability and to maintain orderly exchange arrangements (Article I-iii). Article IV(4)(a) also obligates each member to collaborate with the Fund to achieve this end, thus increasing the possibility of avoiding deliberate policies of non-cooperation between IMF members under current-account convertibility of the dollar.

Effects on United States Balance of Payments

Operating in foreign currencies rather than gold would not in itself eliminate deficits in the balance of payments of the United States. Corresponding (European) balance-of-payments surpluses could continue to provide "excess" dollar holdings. A surplus country, say, France, holding excess dollars could (a) present them directly to the Federal Reserve in exchange for francs on demand (the conversion, of course, could still be to gold, but only at United States discretion); or (b) use the excess dollars to purchase some other foreign currency, say, German marks. Of course, France might also purchase gold from the free market, but only if the price were within the limits of the prescribed margins. As will be discussed below, no IMF member would be *obligated* to maintain the gold price. Accordingly, the price could be higher (or lower) than the limits within which gold can legally be purchased or sold by IMF members.[1]

[1] Article IV(2) provides that "The Fund shall prescribe a margin above and below par value for transactions in gold by members, and no member shall buy gold at a price above par value plus the prescribed margin, or sell gold at a price below par value minus the prescribed margin." This theoretically allows countries to sell gold at a price higher than determined by the margin, or to buy it at less than the lower limit of the margin. However, the Fund is opposed to such transactions. Article IV(4)(a) requires members "to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations." This provision has been interpreted by the Fund as the legal basis for a statement

If France chose (a), and if the United States had the francs, international liquidity would be extinguished: United States reserves (francs) and French reserves (dollars) would both decline. (Under the present system, only the former decline: French reserves simply change in composition as between dollars and gold.) If the United States drew the francs from the IMF, France would then, in effect, have traded dollar reserves for a corresponding claim on the IMF, as happens today in such cases. If France chose (b), the marks could be purchased on the foreign-exchange markets in exchange for excess dollars. (No central bank would be obligated to convert dollars to marks on the direct demand of the French central bank, but the German and American central banks would be obligated to support mark-dollar exchange rates on the foreign-exchange markets within their territories.) The total process involving the disposition of excess dollars under current-account convertibility could therefore involve some further increases in foreign official holdings of dollars and claims on the IMF, along with some further depletion of United States foreign reserves, including currencies, drawings on the IMF, sales of gold by the U.S. Treasury (to obtain needed foreign currencies), special arrangements to borrow, and so forth.

It would appear, therefore, that switching to the market support of exchange rates between the dollar and foreign currencies would leave the United States fundamentally in the same position as it occupies today. This is true, however, only with respect to the fact that a given deficit in the United States balance of payments would continue to require financing. In fact, the balance-of-payments problem of the United States would tend to ease as a result of the following considerations:

1. Foreign countries would lose the right they now have of *demanding* conversion of excess dollars into U.S. Treasury gold. Countries henceforth would have to accept their own currencies, if offered, rather than only gold. Under current arrangements the United States, even when it has a deficit in its balance of payments, cannot legally compel any country to sell gold to it in exchange for that country's currency; whereas other countries, even with surpluses in their external payments, can compel the United States to sell gold freely in exchange for dollars.

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issued to members on June 18, 1947 to prevent sales of gold at premium prices. In that statement the Fund deprecated the practice of transacting in gold "at prices substantially above monetary parity," and noted its "considered opinion" that "exchange stability may be undermined by continued and increasing external purchases and sales of gold at prices which directly produce exchange transactions at depreciated rates." (Statement reprinted in the IMF *Annual Report* for the year ending June 30, 1947, pp. 78-9. See also the *Annual Report* for 1948, pp. 39-44, for further expansion of the Fund's position on gold transactions outside the margins.)

Thus the demand for gold from the United States tends to constitute a one-way drain. By changing the United States obligation under the Articles to current-account convertibility, further demands for conversion of dollars, say, by France, could be met by payment of francs to France—thus extinguishing French monetary liabilities, rather than maintaining French official reserves. Or, if the United States drew francs from the Fund, such demands could simply result in an increased (gold-value-guaranteed, noninterest-bearing) French claim on the IMF. To the extent that the current policy of some countries reflects a powerful appetite for gold *per se*, the loss of the available option for gold might mitigate the strength of forces which tend to produce payments surpluses in such countries. In addition, there might be increased interest in maintaining reserves in interest-bearing dollar claims.

This result might be reinforced if the United States converted much of its gold into interest-bearing foreign assets, or used its gold to retire outstanding foreign official balances of interest-bearing dollar claims. It might be noted in this connection that the loss to the United States balance of payments from foregone interest on its $13 billion gold stock (or interest paid out on dollar debt held abroad that otherwise would not exist), at, say, a 5 per cent interest rate, amounts to $650 million per year. In addition, if the United States decided that it would sell gold in the future (to acquire needed foreign currencies) only to the IMF, the effect might be not only further to reinforce foreign interest in maintaining dollar reserves, but also to mitigate the problem of possible invidious comparisons between IMF member countries, with the United States transferring gold to some countries and not to others. (Some working balances in gold might be maintained for international settlements with non-IMF member countries.)

2. Under current-account convertibility of the dollar, IMF members would become legally subject to an obligation under the IMF Articles of making a representation when requesting dollar conversion (into gold or their own national currency) (VIII-4-a). There are two alternative representations, either one of which would satisfy the requesting country's obligation: (a) that the conversion was needed for making payments for current transactions; or, (b) that the dollars were recently acquired as a result of current transactions. This obligation does not now apply to requests for dollar conversion, since the dollar, the only currency *freely* exchangeable on demand for gold, must be converted without limitation on demand of central banks (IV-4-b, second sentence).

Although the requirement for representations under current-account convertibility might tend to reduce the attractiveness of dollars for

continued accumulation as an international reserve asset, the reduction is more apparent than real. Firstly, the representation that the conversion is needed for *current* transactions has not been, and probably cannot be, literally enforced. Instead, the phrase has been taken to indicate broadly that conversion will not be effected except in the event of a balance-of-payments need, that is, the existence of a balance-of-payments deficit. Accordingly, the principal function of the dollar as an international reserve asset would be preserved. Secondly, the representation that the dollars were acquired as a result of current transactions has generally been interpreted broadly, that is, primarily in the sense of timing or "currentness" (for instance, to stabilize outstanding sterling balances), rather than with respect to discrimination between current-account and capital-account transactions. There would be no requirement for the United States to enforce a system of capital controls, or to impose any distinction between current and capital transactions in meeting demands by countries for dollar conversion. It may be noted, in this connection, that the Fund has made no formal interpretation as to the nature of the alternative representations stipulated under Article VIII(4)(a) for effecting the convertibility of balances of a currency. The fact that no formal Fund ruling has ever been necessary is further evidence of the broad interpretation members have given to their legal requirements for maintaining the convertibility of their currency.

Accordingly, current-account-convertibility status for the dollar would obligate countries requesting dollar conversion to make one of the above representations, but this does not mean that the United States would actively enforce this obligation. The fact that the obligations under VIII(4)(a) would now apply to the dollar, as they already apply to all other convertible currencies, does not ensure that countries necessarily would comply. However, the stability of the international monetary system depends primarily on the voluntary cooperation of participating countries, rather than on enforcement. Current-account-convertibility status for the dollar would legally commit countries to rules of the game that are more explicit than under the present arrangements. The test of whether countries demanding dollar conversion were, in fact, complying with the rules would be clearer both to them and to the United States. Having explicitly defined what their responsibilities were, countries might well cooperate more fully.

As a technical matter, it may be noted that the fact that the dollar is an international currency means that dollars can generally be used by a country to finance a payments deficit without having to go through prior conversion. (An exception might arise, perhaps, in financing a payments