ESSAYS IN INTERNATIONAL FINANCE
No. 66, April 1968

GOLD AND THE INTERNATIONAL MONETARY SYSTEM: AN ORDERLY REFORM

EUGENE A. BIRNBAUM

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
Princeton, New Jersey

This is the sixty-sixth number in the series ESSAYS IN INTERNATIONAL FINANCE, *published from time to time by the International Finance Section of the Department of Economics of Princeton University.*

The author, Eugene A. Birnbaum, is Senior Economist, Standard Oil Company (New Jersey). He was formerly Director of the International Finance Division, U.S. Department of Commerce, and has served in various other positions in the U.S. Government, including Senior International Economist with the President's Council of Economic Advisers. From 1946 to 1960 he was a member of the Research Department of the International Monetary Fund. The present issue is the author's second contribution to this series of essays. The views expressed here are, of course, his own and do not purport to reflect those of any institution with which he is or has been associated.

The Section sponsors the essays in this series but takes no further responsibility for the opinions expressed in them. The writers are free to develop their topics as they wish. Their ideas may or may not be shared by the editorial committee of the Section or the members of the Department.

FRITZ MACHLUP, *Director*
International Finance Section

ESSAYS IN INTERNATIONAL FINANCE
No. 66, April 1968

GOLD AND THE INTERNATIONAL MONETARY SYSTEM: AN ORDERLY REFORM

EUGENE A. BIRNBAUM

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
Princeton, New Jersey

Copyright © 1968, by International Finance Section
Department of Economics
Princeton University
L.C. Card 68-28300

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

GOLD AND THE INTERNATIONAL MONETARY SYSTEM: AN ORDERLY REFORM

Controversy concerning the role of gold in the international monetary system has persisted for more than a century. Indeed, 1967 marked more than the centennial of Canada's nationhood. It also commemorated the one-hundredth anniversary of the first worldwide conference on the role of gold in the international monetary system. That first conference opened in Paris in June 1867. It was called by Emperor Louis Napoleon for the purpose of reaching international agreement on the adoption of the gold monetary unit of France as the international standard.

Professor Schumpeter considered the proposals put before the conference by the French as the boldest ever made for a worldwide monetary union. However, at subsequent conferences held in 1878, 1881, and 1892, according to Professor Schumpeter, it was because of pressures brought by the United States that discussion was diverted to bimetallism, and the French initiative defeated. Now the wheel has turned, and it might seem that General de Gaulle is getting divine retribution.

Those who have been following the course of current international monetary developments might find it interesting to consult Henry B. Russell's book entitled *International Monetary Conferences*. Though this book was published in 1898, in many respects it remains dateless. For example, the author comments that the United States, at these nineteenth-century monetary conferences, had reverted to "the old pastime of importuning Europe." He also cites a floor speech delivered on April 1, 1874, by Senator John P. Jones of Nevada:

> Does this Congress mean now to leave entirely out of view and discard forever a standard of value? Did any country ever accumulate wealth and achieve greatness or attain a high civilization without such a standard? And what but gold can be that standard? What other thing on earth possesses the requisite qualities? Gold is the articulation of commerce. It is the most potent agent of civilization. It is gold that has lifted the nations from barbarism. So exact a measure is it of human effort, that when it is exclusively used as a money it teaches the very habit of honesty. It neither deals in nor tolerates false pretense. It cannot lie. It keeps its promises to rich and poor alike. (P. 153.)

The fact that the Senator's speech was made on April Fool's Day is, I think, a pure coincidence.

Times have changed in one hundred years, but not completely. The French still pledge allegiance to the gold standard. The United States, on the other hand, no longer advocates bimetallism. Its interest in silver has waned. Americans still like the idea of a dual international monetary standard, however; this time it would be based on gold and "paper gold."

We may ask why, after a hundred years of international monetary conferences, men still have not resolved their differences. The answer lies in one word—*power*. That is what one hundred years of international monetary conferences have been about. The 22nd annual meeting of the International Monetary Fund held at Rio, where a new facility for creating international liquidity was recommended, is no exception to this general rule.

There is, however, one important exception to this rule—the United Nations Monetary and Financial Conference that took place at Bretton Woods, New Hampshire, near the end of World War II. The nations that participated at the Bretton Woods conference were not primarily seeking to arrogate national preeminence or glory. A spirit of cooperation between wartime allies prevailed at Bretton Woods. Delegates of 44 nations attended the conference to reach agreement on the charters of the International Monetary Fund and the World Bank. These instruments were developed from preliminary documents, prepared primarily by British and American experts, which did not commit their respective governments to the schemes. The final *Joint Statement By Experts on the Establishment of an International Monetary Fund* (April 21, 1944), which formed the basis for the conference, represented a compromise of earlier proposals. The extent of public controversy attending the development of the *Joint Statement*, in the form of semi-official and public discussions, articles, and pamphlets, was unmatched in the development of any other area of postwar planning. The spirit of the conference was strongly influenced by a common ideal—to facilitate postwar reconstruction, international trade, and world economic development. Indeed, the aspirations that led to the Bretton Woods agreements were uniquely noble and idealistic, rather than narrow or nationalistic. It is doubtful if such a unity of purpose ever before or since has characterized the conduct of international monetary negotiations.

The spirit behind the four monetary conferences that France initiated during the nineteenth century resembled the current situation in international monetary affairs. The purely technical objective of these earlier conferences was to standardize world currencies with respect to their value and content: then each national currency could move more freely,

promoting higher levels of world trade and commerce. But the major participating nations had their own notions about the kind of monetary standard the world needed most. According to Louis Napoleon, for example, all national currencies should have a gold content equal to, or an even multiple of, that of the French franc. This would enhance French prestige and avoid a disadvantage in foreign trade with respect to countries then on a silver standard—mainly the East. It would also avoid the humiliation of having to revise the French monetary unit to suit that of some other currency, particularly the pound sterling. The motives of other major countries were not dissimilar from those of the French. Thus, the ostensible purpose of these conferences, namely, a technical improvement of the international monetary system, turned out to be secondary to matters of national prestige and power politics. While any world monetary conference cannot avoid considerations involving national power and prestige, when these become uppermost in the minds of the negotiators, agreement on a system that can achieve major world objectives is hardly possible. Accordingly, the nineteenth-century monetary conferences failed.

At the present time the 107 member nations of the International Monetary Fund are again considering reform of the international monetary system. A new special facility for creating international liquidity, Special Drawing Rights (SDR's), would be formally established through amendment of the IMF Articles of Agreement. An agreed outline of the proposed SDR facility was developed during a long series of closed official and semi-official meetings between the major industrial countries. The negotiations frequently were hamstrung because of major political disagreements between the United States and the continental European countries—primarily France. The vigorous open debate and spirit of wartime collaboration between nations united in a common cause—which led to the Bretton Woods Agreements—stand in marked contrast to the guarded circumstances under which the SDR arrangement was developed and negotiated.

If the world were an Eden in which all countries agreed on matters of importance, there would be no balance-of-payments difficulty. Imbalances of payments between nations—which accountants could measure and define—would remain. But with agreement on the policies that gave them birth, there would be no payments *problem*. The real world, of course, is not an Eden, and there will be disagreements between nations. The wider the disagreement, the more important the question of *power*. For then power alone may determine whose objectives are to be attained and whose are to fail. Accordingly, this essay will introduce a concept of *international monetary power* to be used in its further analysis.

We shall examine two major elements of the present international monetary arrangement: the reserve-currency system, and the gold-exchange standard. Following this is an exposition of the mechanism for liquidity creation and balance-of-payments adjustment originally designed and negotiated at Bretton Woods. The fact is that the International Monetary Fund currently functions *not* in accordance with the system originally designed at Bretton Woods, but rather in accordance with a series of *policies* subsequently adopted by the Fund—beginning with its first annual meeting (1946) at Savannah. The present-day IMF is very different from the institution that had been envisaged at Bretton Woods. Indeed, implementation of the grand design at Bretton Woods has never even been attempted.

Tracing through the effects of Fund policy decisions helps set the stage for a comparative analysis of the proposed SDR facility. *It is the author's view that the SDR facility should be rejected.* It is not so much a problem of technical design; more importantly, the power structure is unacceptable. In addition, if the IMF Articles are amended to incorporate this new facility, any future effort to achieve a truly viable international monetary system will be seriously handicapped.

An alternative course of action involving, in part, the implementation of the originally designed Bretton Woods mechanism will be proposed. This system remains authorized by the IMF Articles of Agreement. It would *not* require legislative action by Congress, or by other governments, to put it into effect. There will also be recommendations dealing with the voting-power arrangement of the Fund, and further modification of the two-tier gold-price arrangement announced March 17, 1968. Adoption of recommendations of this essay would be linked to simultaneous announcement of the phased dismantlement of all balance-of-payments controls and restrictions adopted since 1959—the year "Buy American" was first attached to the foreign-aid program of the United States.

We have lost the excitement of the times when the United States and the United Nations were striving for better days to come—after victory over the Nazi evil. That spirit is expressed by some of Keynes' words when moving the adoption of the Final Act on the last day of the Bretton Woods Conference, July 22, 1944 (cited in Harrod's *Life of Keynes*, pp. 582-583):

> We, the Delegates of this Conference, Mr. President, have been trying to accomplish something very difficult to accomplish. We have not been trying, each one to please himself, and to find the solution most acceptable in our own particular situation. . . . It has been our task to find a common measure, a common standard, a common rule

applicable to each and not irksome to any. . . . And I make bold to say, Mr. President . . . we have been successful. . . . But it is only a beginning. We have to go from here as missionaries, inspired by zeal and faith. We have sold all this to ourselves. But the world at large still needs to be persuaded.

The Concept of International Monetary Power

All modern currencies that circulate within the territories of countries are essentially fiat monies, that is, money established by governmental decree. Sovereign governments also exercise control over the issuance of their national money supplies. However, their *legal* monetary sovereignty does not extend beyond their borders.

A full-fledged international money would require the existence of a supra-national issuing authority. Such money would imply an overriding legal-tender commitment granted by national governments as to its unlimited acceptability for discharging public and private debts within their territories. In this world of sovereign nation-states, a universally accepted international money does not exist: no money circulates freely within and without all national jurisdictions. There are, however, international near-money assets—financial assets which central banks, by tradition and agreement, can use to meet their external monetary and financial obligations. Gold is a form of international near-money asset. A reserve currency is an example of such a near-money asset when used outside its country of issuance. (When the phrase "international money" is used hereafter, this will be short for "international near-money assets.")

The concept of *international monetary power* relates to who holds international monetary assets, and to who controls their form and issuance. These are two distinct, but closely related, considerations. The first relates to the power of a country to purchase more goods and services from other countries than it sells to them during a specified period. It therefore concerns *international purchasing power*—a country's ability to finance international payments deficits. Accordingly, this aspect of a country's international monetary power relates to its stock of international monetary assets, and includes its quick claims to such assets.

The second consideration involved in a country's international monetary power relates to its ability to *influence and control the form and issuance of international money*. No country, however important, can influence the international money supply to the same degree that it controls its own national money. To some extent all countries influence what shall be regarded as international money by what they actually accept from other countries in financial settlement. They also wield international monetary power in international forums, such as the International Monetary Fund.

International purchasing power is transferred when money is passed. The power to control the issuance of international money, however, is more difficult to acquire. The broad foundation of such power derives from a combination of factors. Some of the most important are a country's economic, political, and military strength, as well as the skill of its leaders to marshal these forces effectively. The size of a country's international reserves can also be a source of such strength. It is the combination of all such factors, whether actively or passively applied, which is at the root of the power structure of the international monetary system, that is, the resulting ability of countries to pursue policies that may lead to payments deficits of their own, as well as to influence or control the availability of balance-of-payments financing to other countries.

The IMF Articles of Agreement allocate international monetary power to countries in accordance with the size of the stocks of their monetary gold, convertible (reserve) currencies, and quotas in the Monetary Fund. The United States, holding the largest gold stock and IMF quota of any country, has enormous power to finance its own balance-of-payments deficits. The fact that other countries accept dollars in international settlement and hold them as reserves confers further international monetary power on the United States. Let us now examine this aspect of American power more closely.

The Hypothetical Case of a Pure Reserve-Currency System

A pure reserve-currency system would be a hypothetical arrangement under which there is no need for gold as an international monetary medium and reserve asset—the reserve currency alone would serve in this capacity. Under such an arrangement the reserve-currency country holds no international monetary assets; it simply creates international money (increases its liquid liabilities) to finance external transactions. Balance-of-payments deficits of the reserve-currency country would then be the source of international monetary reserves in the system, and its balance-of-payments surpluses would contract international reserves. (In the real world there may be need for other forms of international monetary asset for financing transactions with countries not participants in the reserve-currency system.)

The concept of a payments deficit or surplus, as normally applied to nonreserve-currency countries, would not fit the situation of a pure reserve-currency country. Nonreserve-currency countries finance payments imbalances with international money balances which, of course, are limited. A pure reserve center's position, however, is analogous to that of a central bank in a closed economy. Its financing involves the issue of monetary liabilities: there is no drawdown of monetary reserves. There

is, however, a limit on the international monetary power of such a reserve-currency country. It is determined by the necessity that its political and economic policies be in general accord with those of the other members of the system. Otherwise, the system might not continue to exist. To maintain the system's stability, therefore, the reserve center may have to forego important policy options—such as adoption of internal full-employment policies, under some circumstances.

Within this constraint, the reserve-currency country can adopt virtually any program to achieve chosen policy objectives, domestic or foreign, without regard to the balance of payments. In effect, the pure reserve-currency country does not incur balance-of-payments deficits or surpluses. There are, instead, increases and decreases of the international money supply. Accountants can, of course, measure balance-of-payments deficits and surpluses for the reserve-currency country, but these, in themselves, have no meaning: they do not suggest the limit on the extent to which the world may desire to increase its holdings of international money. The real limit on deficits of reserve-currency countries is determined by attitude, that is, whether the measured change of reserve-currency balances is desired or not. Indeed, outstanding reserve-currency balances may not change, while the attitude toward them does change. And since different countries can hold different opinions, depending on their individual circumstances, it is hardly to be expected that a uniform view of the matter would generally exist.

In the context of an international monetary arrangement between sovereign governments, every country holds the power to refuse to grant credit to another country for whatever cause, economic or political. This, of course, is one aspect of a country's national sovereignty. However, if the country to be refused the credit is the reserve center itself, a country wanting to refuse to extend this credit would need to eliminate its external payments surplus. Since under a pure reserve-currency system one country's surplus is another's deficit, the question arises how this should be done. From the viewpoint of the world as a whole, it would be inappropriate for the reserve center to eliminate its balance-of-payments deficit—simply to suit the desires of a particular country that did not want to acquire more reserve currency—as this would involve an arbitrary reduction in the growth of the world's money supply. Indeed, even eliminating the reserve center's deficit would not alone ensure the desired result, as the effects could be offset by the balances of payments of third countries. The most efficient and least disruptive alternative would be for the disgruntled country itself to assume the principal responsibility for the adoption of policies to restore its external balance. Failing complete success, the country could at least convert its "excess" international-money balances into other forms of international asset.

The cost of getting along without international money might be too great under almost any circumstances for some countries. However, for sufficiently rich and powerful countries, there is a likelihood that other arrangements, say, bilateral credits, could be obtained as a substitute for international money. Also, the more powerful the country, the less serious would it regard the economic consequences. The principle of the matter is, simply, that as countries grow more prosperous, they can be increasingly independent. In a world of prospering nations, the effectiveness of any international monetary arrangement increasingly depends on the *voluntary* cooperation of all the participating countries.

The fact that the reserve currency would be involved in the payments and reserve positions of all other countries leaves the reserve center vulnerable to misdirected charges of responsibility for international monetary disturbances. For example, even if its record of internal price and economic stability were unsurpassed in the world, there could still be circumstances in which second and third countries incurred large imbalances of payments between them, with one side unloading substantial reserve-currency balances, accumulated from the past, on the other. The fact that these flows consisted of claims denominated in the reserve currency could create the impression that the reserve center was, somehow, responsible. Indeed, in the real world, the picture would undoubtedly be mixed. If the monetary authorities of the rest of the world desired increases in their international-money balances, they might achieve this objective by adopting more stringent monetary policies (provided, of course, that the effects were not neutralized by countervailing action of the reserve center). Thus, by maintaining on average a somewhat higher level of interest rates (or a less efficient capital market), there could be a continuing net rise in external balances of reserve currency. Under these circumstances, it would not be possible to sort out the direct involvement of the reserve center with respect to the change of any particular country's reserve situation.

The fact that the reserve-currency country receives "automatic" financing for its external requirements has been held as analogous to a situation in which a private firm could operate on unlimited overdrafts. However, in view of the policy constraints imposed on the reserve center—even under the hypothesis of a pure reserve-currency system (so as to allow for maximum benefits to the reserve center)—the analogy to a private firm operating on overdrafts is unacceptable and misleading. The question is, who receives the "privilege" that the "overdraft privilege" extends? A private firm operating on overdrafts receives such credits only at its own initiative, whereas the reserve center must accept such capital whether it wants it or not. There is no reason to suppose that the reserve center would always desire such capital. Indeed, it is not as if

it were likely to be a poor country with a compelling need for such capital. On the contrary, a reserve center is likely to have a relative abundance of capital, and generally prefer to be a net exporter of capital to the rest of the world. Yet the reserve center implicitly imports this capital, regardless of its preferences, whenever external reserve-currency balances increase. The reserve center pays interest charges on this capital, and, as mentioned previously, it foregoes important policy options to perform the reserve-currency function. The advantages to the reserve center must therefore be balanced against important disadvantages. In the final analysis, the net gain or loss of a country from the *pure* reserve-currency system would appear to depend on one's biases, rather than on any clear advantage to either side.

The Existing Dual Monetary Standard

The existing international monetary arrangement can be characterized as a type of mixed international monetary standard. It combines a reserve-currency system, based on the dollar, with the gold standard. The international monetary-power structure accordingly reflects not only the power of the United States to incur payments deficits as the principal reserve center, and the international monetary power of those who hold dollars, but also the power of those who hold gold. In addition, the fact that the dollar is freely convertible into gold on demand of foreign monetary authorities means that the international monetary power of the United States, like that of those who hold dollars, partly depends on the adequacy of its reserves—the gold stock of the U.S. Treasury.

When the current international monetary arrangements were negotiated at Bretton Woods, the United States held most of the world's monetary gold stock; indeed, the value of its gold far exceeded that of dollar balances held externally. Under those circumstances, the rigid convertibility link between gold and the dollar could not affect the international monetary role of the dollar: the world seemed to be on a pure dollar-reserve standard. The United States could, and did, adopt programs to achieve major domestic and international policy objectives without concern about the balance-of-payments consequences. Its gold holdings, although very large, had nothing to do with this situation: the world would have accepted dollars even if the U.S. Treasury's gold stock had not existed.

Over the last decade, however, this situation has changed. There is less political unity in the world. This would create problems regardless of the particular type of monetary arrangement in effect. But today's monetary disturbances are made potentially more serious under the dual international monetary system, because external dollar balances have gradually grown to exceed U.S. Treasury holdings of a steadily deplet-