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The Intelligent Reader's Guide to the International Monetary Muddle

How the international monetary system developed, and why it doesn't work too well.

The paradox of money, this most practical of things, is that its usefulness depends exactly on the faith we place in it. Money is, after all, a social convention, accepted by all of us in exchange for goods or services precisely because we take for granted that it can be reexchanged at some later date for other goods or services. Undermine this implicit "faith" and you undermine the whole structure of economic activity it supports.

We have nowadays, by and large, become accustomed to the idea that within any country, *domestic money* need not be backed up by some precious metal in order for us to have the necessary "faith" in it. But even the most casual observer of the international scene can see that it would be difficult to carry over this faith to international monies. It is easy to understand, therefore, why even today the international acceptability of any national currency depends largely on the "backing" this currency has. Which brings us to gold.

Gold

Historically, gold and silver have been the traditional supplies of money in the West. But the new production of these precious metals very seldom kept pace with the rapidly increasing demand for money engendered by the economic growth of Western countries. As a consequence, there was a gradual shift away from gold and silver *domestic*

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money toward currency *backed* by gold and silver reserves, which in turn led to today's notion of domestic currency backed largely by "faith."

Internationally, the same pressure led to drastic devaluations of many currencies with respect to gold; over a long period of time, from roughly the thirteenth century to the nineteenth century, the price of gold in terms of most national currencies rose steeply, so that any given quantity of gold was equivalent to a rising quantity of international money.

In spite of all this, the supply of gold proved inadequate, and after World War I it became increasingly common to back up international monies with *reserves which included quantities of some "key currencies," primarily the pound sterling.* Thus the ratio of "key currency" reserves to annual imports, for all countries as a whole, rose from 2 percent in 1913 to 11 percent in 1928, ushering into the international monetary system the gold-(foreign)-exchange standard—*as well as setting the stage for its collapse*!

The basic problem with the gold-exchange standard, *then and now*, is that it works only if the "key currency" countries are willing to let their own reserve positions decline. For instance, in the 1920s, as foreigners accumulated pounds, they acquired claims on London's gold reserves, since pounds were backed by British gold. Because these gold reserves did not grow as fast as the foreign claims on them, Britain's reserve position deteriorated; confidence in the pound, which is what made it a key currency in the first place, also deteriorated, *and with it confidence in the system itself, since the pound sterling was a major component of international reserves.* By 1928 Britain's reserve rates (of gold reserves to foreign claims on them) had fallen to less than 25 percent.

Robert Triffin, the well-known specialist on international monetary affairs, put it this way: "The increasing use of foreign exchange balances as a remedy to world illiquidity under the new gold exchange standard had thus fatally weakened the reserve position of the country on which the system was primarily dependent for its continued operation. The collapse of the major key currency of the system in 1931 inevitably sucked other countries into the whirlpool, and entailed the temporary breakdown, not only of sterling, but of the international monetary system itself" (*Gold and the Dollar Crisis: The Future of Convertibility,* p. 67).

Dollars

Since World War II, the dollar has supplanted the pound as the single most important "key currency," accounting for some 55 percent of the growth in world monetary reserves. And with this rise in importance has come the concomitant pressure on the liquidity of the dollar. Since the end of World War II the United States has been running a chronic deficit in its balance of payments, i.e., spending more abroad than it made abroad.

In the beginning this deficit was considered acceptable on both sides of the Atlantic as necessary expenditures for postwar reconstruction, for aid to the less developed countries, and for the conduct of the Cold War, so that foreign central banks were willing to finance these deficits *primarily* by holding on to dollars they received, rather than "cashing" them in for U.S. gold—in effect, accepting short-term IOUs from the United States. Thus, from 1949 to 1965 the gold stock of the United States dropped by only 33 percent, while its liquid liabilities rose over 300 percent! After 1965, however, a substantial portion of U.S. deficits were due to the escalation of the Vietnam war and American penetration or takeover of European business firms, activities which European nations generally considered far less acceptable reasons for financing a deficit. As foreign willingness to hold dollars declined, the pressure on the dollar,

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and therefore on the whole international gold-dollar system, increased significantly.

The IMF and paper gold

In 1967, the British pound, faced with similar problems, devalued, and set off a world monetary crisis. A stampede for gold occurred as hoarders sought to convert dollars and pounds into gold at a rate that would have stripped Fort Knox within weeks. As a direct consequence, in March 1968 all gold payments from official central banks to the free market were suspended. Since then there have been two kinds of gold (the "two-tier gold system"): that held by a central bank of a government, transferable only to *another* central bank at $35 an ounce;and that held by private individuals or firms, which may be bought or sold on the free market, generally at a price higher than $35.

The two-tier gold system described above is at best a stopgap measure, designed to protect official gold reserves from the onslaughts of the market. In effect it confines these reserves within the member nations of the International Monetary Fund (IMF), since none of the ten major members (The Club of Ten) may buy gold from any nation that deals with the free market in gold. (The exception to the "boycotted" gold suppliers is South Africa, which can sell to the IMF at the fixed parity of $35 an ounce what it doesn't sell on the free market.) Obviously, with each $35 requiring an ounce of IMF gold as backing, and the official gold supply stagnant or increasing slowly, the expansion of world trade would soon be brought to a halt. Thus in 1970, having temporarily stemmed *this* tide, the IMF adopted a new plan to expand world reserves by creating "paper gold."

The basic idea was to create reserve assets, which would then be allocated to IMF members in proportion to their initial contribution to the Fund. These allocations, known as special drawing rights (SDRs), were to be used by members to settle their international balances with one another, thereby supplementing gold and the key currencies as "backing" for international money. Thus, for instance, by 1971 U.S. reserves had expanded by about $1.6 billion in SDRs. Not enough by a long shot, as it turned out!

The beat goes on

Meanwhile, the central problem remained unchanged. At best, the two-tier gold system had succeeded in protecting American gold reserves only from the free market, not from claims by other member nations of the IMF. It therefore relieved the pressure on the dollar only briefly. Similarly, the creation of "paper gold" (SDRs) increased U.S. reserves somewhat, which again took some pressure off. But the growing U.S. deficit continued to pile up more and more dollars in foreign central banks, so that foreign claims on U.S. gold continued to grow. In a short while the United States had more or less used up its "paper gold" in paying off a small fraction of

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these claims, and even its gold bullion reserves began to fall. In 1970 a new annual high in U.S. deficits ($10 billion) was reached, and by the first six months of 1971 the deficit was up to $12 billion, an annual rate of $24 billion. The run on the dollar was on!

Once again stopgap measures were quickly put into effect. In August 1971, the U.S. Treasury stopped redeeming in gold even those dollars held by foreign central banks and in December 1971, the U.S. dollar was devalued by 8.57 percent relative to gold (about 11 percent relative to currencies like the Japanese yen and West German mark, which were simultaneously revalued upward). This stopped the drain of gold from the United States and temporarily eased the strain on the dollar. In addition, measures were taken to cut back U.S. imports (by raising tariffs, and thus making foreign goods more expensive within the United States), and expand U.S. exports (through the wage-price freeze, in the hope that U.S. prices would rise more slowly than foreign prices, making U.S. goods relatively more attractive to foreigners), so that the basic cause of the problem, the U.S. balance of payments deficits, might be ameliorated somewhat. But even the successful elimination of U.S. deficits would hardly solve the problem. After all, if none of the key currency countries ran deficits, world reserves could only grow as fast as *gold* reserves, and it was the inadequacy of gold reserves that led nations to use key currencies as reserves in the first place!

The current muddle

It is obvious that if some countries are running deficits in their balance of payments, others will be running surpluses. The U.S. deficit, for instance, has its counterpart in Japanese and German surpluses, among others. Therefore, one way to reduce U.S. deficits would be for Japan and Germany to *appreciate* their currencies relative to the dollar. If, for instance, the Deutschemark were to cost more dollars than before, German goods would cost more to Americans, and American goods would cost less to Germans. Thus the U.S. deficit would be lessened as its imports decreased and exports increased. Of course, Germany would then be selling less goods to the United States *and* the rest of the world (presuming all other currencies

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stay tied to the dollar)—which would lead to unemployment in German industries, and political problems for the government.

Many countries in fact suspect the United States of being primarily concerned with forcing appreciation on persistent surplus countries, thereby avoiding its responsibility to cut back its own huge deficits. As it currently stands, the U.S. dollar is no longer convertible into gold (since Nixon suspended convertibility in August 1971, during the run on the dollar), so that the U.S. deficits for Vietnam and multinational corporate expansion abroad are not countered by any direct economic pressure to end these deficits. Meanwhile, the surplus countries find that U.S. dollars spent there add fuel to inflationary pressures, so that they must either accept these or let their currency appreciate--which would lessen their trade not only with the United States but with the rest of the world as well!

In spite of these serious differences, all sides agree that there is a basic need for international monetary reform. It is increasingly clear to everyone concerned that the alternative to reform is a collapse of the system itself. But, as history teaches us, it is by no means certain that reform will in fact take place before a collapse.

Directions of reform

At the moment, the United States is very reluctant to restore the convertibility of the dollar into gold, for fear of another run on its reserves. It therefore takes the position that some rules for changing the present situation must *first* be agreed upon before any steps are taken to restore dollar convertibility. This would mean agreement on two major principles: first, on rules which will prevent IMF member nations from running persistent surpluses or deficits, these rules to be backed up by sanctions, if necessary; and second, on a method for *creating* and expanding international reserves at a rate suitable to the growth in world trade. On this second principle the consensus among member nations seems to favor some method similar to the current IMF practice of creating "paper gold" (SDRs), though not all nations agree on "paper gold" as the *only* international reserve, since this would place them at the mercy of the SDR allocation rules of the IMF.

There is little reason to expect that any general agreement will be reached in the next two years. Crises in the system will undoubtedly continue to occur, which may generate pressures sufficient to create a consensus before collapse.

Postscript: the latest crisis

On February 12, as this article was on its way to the printer, the U.S. announced another devaluation of the dollar. Thus in the last fourteen months the value of the dollar has fallen from 1/35th of an ounce of gold to 1/38th in December 1971, and then to less than 1/42nd of an ounce currently. It is a sign of the times that just prior to the devaluation, in an unprecedented move, casino operators in the Portuguese Province of Macao refused to accept American dollars!

The previous devaluation agreement of 1971, hailed by President Nixon as "the most significant monetary achievement in the history of the world," proved to be little more than a palliative. 1972's balance of payments deficit turned out to be in the order of $10 billion and the balance of *trade* deficit was $6.4 billion, the highest ever. As is to be expected, these facts did little to strengthen the credibility of the dollar, and in the first two weeks of February, some 7 billion dollars were unloaded in exchange for German marks and Japanese yen, precipitating the latest devaluation. What happened in the current crisis is basically what happened in the last one, and what most probably will happen in the next. At any rate, these crises certainly do help build up pressure for reform!

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