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Future of Gold and the International Monetary System*

by

John Exter

"Mr. Chairman, Ladies and Gentlemen: You have just heard the gospel according to St. Milton.[1] You will now hear it according to St. John. It is going to be a little different, but after all the writer is different.

"I am even going to use a text, something written by Firdausi, the Persian national poet, who said about a thousand years ago: 'There is a great deal of wisdom in the world, but it is all divided up among men.' It has certainly been divided up among the men you have heard here during the last two days. In fact, about the only wisdom on which we all agree is that we are in a serious international monetary crisis. We disagree on the magnitude of the crisis, the measures to resolve it, and the prospects of their success.

"Why do we disagree? Occasionally, but only occasionally, it is because we reason differently. More often it is because we start from different basic premises, assumptions, or principles. We have different models in our minds of how the economic system works and what can be done about it. We differ most on the role of government. For instance, what I might think a realistic role for government some of the other speakers might think unrealistic. Similarly, they may think me unrealistic.

"I thought it might help you to sort out the speakers in your minds if I told you how I sort them out in mine. Great economists of the past have had very different attitudes toward the role of government in the economy. As far back as 1776 Adam Smith wrote his famous *Wealth of Nations.* He was a great believer in free markets. He wanted to minimize the role of government. He is at one end of the spectrum.

"At the other end I would put Lord Keynes, who wrote his famous *General Theory* in 1936, just as I was being educated as an economist. Keynes and his followers assumed a closed economy, an economy without any transactions with the outside world. A recent manifestation of that assumption is benign neglect of the balance of payments. Keynesians also taught that gold was a barbaric metal. They alleged that it made no sense to dig it out of the ground in South Africa and put it back into the ground at Fort Knox. They also taught that debt did not matter, that in total it never had to be repaid, because we owed it to ourselves. It could go on and on growing. But most important from the point of view of our spectrum, Keynesians advocated strong government interventionism. They thought they could improve on market solutions by intervening in them, particularly through fiscal and monetary policies. No more depressions. In the '60s they even talked of 'fine-tuning.'

"All of us speakers fit into that spectrum at one point or another. I shall start with myself. I am at the Adam Smith end.

. . . . .

"But remember that governments the world over have been influenced far more by Keynes than by Adam Smith. In fact, economic life has become a battle between governments trying to control market forces and private people in the markets trying to get around those controls. Many of you each day make decisions based on what you think the government or the central bank will do. Will the central bank tighten or ease money? Will the rand appreciate further? Will the budget be in surplus or in deficit this quarter?

"But governments do not control economic activity as much as you might think. Neither governments nor economists determine what money is, what money people are going to use and hold. That is determined by people themselves in the marketplaces of the world. On this point I differ with Milton Friedman, who should be placed in the spectrum, for his ideas are very influential these days. He has not yet been mentioned at these meetings.

"He seems to have a dual personality. The major part of his personality, which I like very much, is way over at the Adam Smith free market end of the spectrum, but the money part of his personality, with which I disagree, is toward the Keynes end of the spectrum, for he is a strong government interventionist in money. But only in domestic money. Internationally he believes all exchange rates should float. His lack of concern for a fixed exchange rate system makes him like Keynes, a closed economy thinker. He has no desire to try to restore fixed exchange rates. . . . He does not even call gold money.

Governments are especially strongly motivated to

*This is the major portion of a speech given by John Exter at a meeting of the Institute of Directors on International Monetary Reconstruction, held in Johannesburg, South Africa, on October 2, 1973. Mr. Exter is a Senior Fellow at American Institute for Economic Research.

[1] Dr. Milton Gilbert, Economic Adviser to the Bank for International Settlements, Basel, Switzerland.

intervene in money. They want to decide themselves what money people within their jurisdictions may use and hold. Governments the world over have tried to monopolize the issuance of money within their jurisdictions by proclaiming national currencies and prohibiting anyone but their Treasuries or central banks from issuing them. But they have grossly overissued. Perhaps we should turn the clock back and let private people issue currencies. This is not so far-fetched. Your own [South African] Reserve Bank is still privately owned, but of course there is a great deal of government influence on it, which sometimes dismays me.

"To entrench their monopolies governments customarily pass laws making only their own currencies legal tender for all debts, public and private. They often seek through exchange control to restrict the conversion of their currencies into other currencies. In Kenya, from which some of us have just come, the government, to my surprise, was warning that it was prohibited to destroy Kenyan currency. This makes no sense to me. If each of you held one of my IOUs I should be delighted to have you tear it up. . . .

"My own [U.S.] government has long had a contradictory policy. For many years it was proud that the dollar was convertible into gold at a fixed price, but it would not make it convertible by Americans, only by foreigners. A Greek shipowner could hold gold, but not I. And I still cannot, which I have long resented.

"In the good old days of the gold standard, governments began with grand intentions. They recognized as a fact of life that private people, if left to themselves, would prize certain scarce commodities like gold and silver more highly as money than anything else, certainly more highly than paper. They therefore gave themselves monopoly power to issue the coin of the realm, like sovereigns, or napoleons, or eagles, which they knew the public would accept.

"But no government in the world has been content to restrict itself to the issuance of coins, although my own government has tried. Our American Constitution gives Congress the power only to coin money and regulate the value thereof, and of foreign coin. At out Constitutional Convention it was proposed that Congress be given power to emit bills of credit, the paper money of that day, but, with the disastrous experience of the continental dollar fresh in mind, the proposal was defeated. We still say, 'Not worth a continental.'

"In issuing paper, governments have had an important fact of life on their side. Paper is more convenient than coin. This convenience has become more important as economic life has become more complicated, and the use of demand deposits stored in computers of modern banks more common. So all governments today issue paper. In gold standard days they accepted the restraint on their own issuance of paper that the undertaking to convert it freely into gold at a fixed price imposed. Convertibility was the ideal and in 1944 was written into the charter of the International Monetary Fund.

"In practice, of course, governments have been unable to prevent other things from being used as money, particularly demand deposits in banks, even though they are not legal tender. Central banks have the authority to restrain the creation of demand deposits, but nowhere in the world has any central bank been successful in doing so. Such deposits have grown enormously and their turnover, with the aid of the computer and rapid communications, has grown even more enormously. Nor have central banks been able to prevent the enormous growth of so-called 'near-money,' like Treasury bills and commercial paper.

"And they have been particularly helpless in restraining the growth of Eurocurrency deposits, which are deposits in particular national currencies created under foreign jurisdictions.

"The explosive growth of paper money and near money has brought us the present monetary mess. You should not forget, however, that it is the gold standard under which most of us have lived most of our lives.

"Clearly a world of paper and bookkeeping-entry money is an IOU world, a world of promises to pay. Until March 1968, when the two-tier gold system was established, central banks issuing all major currencies were promising all holders 'I owe you gold at $35 an ounce.' Under the two-tier system the IOU-gold promise was abrogated for private people, and except for the South African and Russian central banks all central banks refused to sell any gold at any price to private people. The IOU-gold-at-$35-an-ounce promise was honored only among central banks and governments and even among them it became gradually more tenuous, until on August 15, 1971, when President Nixon closed the gold window, the IOU-gold promise was abrogated even among central banks.

"Since then all currencies are saying, 'I do not owe anybody anything at a fixed price.' Each says in effect, 'I owe you nothing in the way of any commodity that, because of its scarcity, is good store-of-value money.' All currencies today are IOU-nothings.

"So August 15, 1971, when the last pretense to convertibility was abandoned, was a watershed date. Since then it has become impossible to have a fixed-exchange-rate system. We have entered a floating exchange rate world.

"Our problem today is that IOU-nothing money is being created at explosive rates. Other speakers have not mentioned this point. We have been talking too much about the international monetary system alone and not enough about the explosive creation of IOU-nothing money through central bank acquisition of domestic as well as foreign, or international, assets. This extraordinary money expansion means that IOU-nothing money is losing its value in world marketplaces in terms of the goods and services it will buy. For the first time in centuries, perhaps in history, inflation is world-wide. People every where are wondering what money they can trust as a store of value, the most important function of money. They are fleeing IOU-nothing money and purchasing goods and services, and commodity-money like gold, or sometimes other precious metals like silver and platinum, driving their prices up and up.

"Meanwhile IOU-nothing money serves less and less satisfactorily as means-of-payment money, so people, and even monetary authorities, are everywhere groping for an IOU-nothing money that they can confidently accept, use, and hold. Oil producers are an example.

"We are witnessing in our generation a world-wide attempt by governments and central banks to substitute paper for specie, as John Law attempted in France 250 years ago. His was only a national attempt, and there have been many such since then. This attempt is international, in all currencies, and through the instrumentality of international bodies like the International Monetary Fund and the Group of Twenty, and through a new international paper money called the SDR.

"But, as Dr. Ossola[2] has pointed out, the SDR is not even an IOU. It has no obligor. It is a 'who-owes-you?' Moreover, nothing is owed, certainly not gold, so it is a 'who-owes-you-nothing?' And it has no maturity date, so is a 'who-owes-you-nothing-when?' Surely it is the most preposterous credit instrument ever invented by the mind of man, if indeed we can call it a credit instrument. No wonder it is hard to fix its rate of interest and determine who will pay that interest.

"Dr. Ossola asked for a new name for it. I suggest calling it a 'who-owes-you-nothing?' A few central bankers may accept and hold who-owes-you-nothings instead of gold, but people in the marketplace won't. Yet Dr. Ossola spoke hopefully of banks accepting demand deposits in them as they do in Eurocurrencies. The next step would be to make them legal tender.

"You can imagine the inflationary possibilities of a system of national currencies backed by who-owes-you-nothings. You heard yesterday of the mindless manner in which it was decided to create the first 9½ billion of them. At the appointed time they were created in an instant on an IMF computer.

"There must be a gold miner or two in the room. How long would it take you to dig 9½ billion dollars worth of gold from holes in the ground? I thought Milton Gilbert saw through this SDR nonsense a few years ago when he said he would believe in them when his wife asked for a bracelet of them. But now that he has accepted SDRs as a supplement to gold I begin to think he may have bought her one.

"I want to add to what Milton [Gilbert] said about convertibility. I shall try to define it. Convertibility must mean the obligation and readiness of a monetary authority to convert on demand at a fixed price its own IOU, whether written on a worthless piece of paper or only a bookkeeping entry, into a commodity that has inherent worth because it is both desirable and scarce, a commodity that in and of itslf is good store-of-value money. Scarcity and desirability are the keystones of store-of-value money.

"So SDRs and national currencies cannot be put on all fours with gold as reserve assets. Every central banker I know would prefer to pay out his dollars and SDRs before he paid out his gold, certainly at the $42.22 price. Even Dr. Ossola's Bank of Italy dropped out of the 'snake' on that issue.

"To exchange an I-owe-you-nothing into a who-owes-you-nothing is just exchanging one piece of paper for another, and most likely a less desirable one at that. To call that convertibility is to make a mockery of the word. Convertibility into gold imposes discipline because gold is scarce. Exchange of paper for paper is no discipline at all. I do not have confidence that any international monetary authority would keep SDRs scarce. Much as I like them personally, if Rinaldo Ossola and Robert Triffin were made monetary dictators, I would not trust them to keep SDRs scarce.

"The SDR has been called paper gold because of its gold maintenance-of-value clause. It is that clause, as Dr. Ossola explained yesterday, that has caused it, like gold, to be driven out of circulation by Gresham's Law. If its value is to be completely divorced from gold and based on some arbitrarily selected basket of paper currencies, it will no longer be even paper gold but will become paper paper, and even less desirable than paper gold.

"The questions yesterday indicated that many of you were troubled by the SDR. You can forget your troubles. The SDR in my view is a horse that will not run. It may have left the starting gate, but it will soon drop out.

"This does not mean that we do not have other troubles. We are in an international monetary morass. The confusion and lack of progress at Nairobi[3] were evidence that Keynesian and Friedmanite economics are at an impasse. Market forces have taken over and governments and central banks are at a loss to think of further Keynesian or Friedmanite interventions to break it.

"Where do we go from here? It is not a pretty picture. The big problem today is not exchange rates, or the gold price, or SDRs, or controls of capital movements, or trade policy, or convertibility, or even inflation, bad as that is. It is the excessive burden of debt in the system, both within currencies and between them. We have created far too many IOUs.

"This means many debtors around the world have gone into debt far beyond their capacity to service and repay out of rising production and rising productivity. Worse still, many have borrowed short and lent or invested long, both within and, what is especially distrubing in a floating exchange world, across currencies.

"People ask why governments and central banks do not stop inflation. They do not see that inflation comes to have a life of its own. Debtors cannot increase productivity fast enough to service their debts themselves so they must do so by selling at ever higher prices, or in many cases contract new debts to pay off the old, a massive borrowing from Peter to pay Paul. In the process the central banks are the ultimate Peters, the lenders of last resort. If ever they do not create enough of their own IOUs to keep the debt expansion going the whole process would grind to a halt, for many debtors in each national currency would find themselves unable to apy their debts and would either have to contract their operations by cutting production and reducing work forces or close down. Such a prospect is regarded as politically and socially intolerable. So central banks the world over have now become locked into an expansionism they dare not stop. They are prisoners of their own expansionism. They must keep inflation going. They and their governments may take measures to restrain it or slow it, but never to stop it. Even trying to slow it is an impossible exercise in economic brinkmanship. They get too close to the edge of economic recession.

"In such a world it is idle to think that I-owe-you-nothing money can again be made convertible into gold. I-owe-you-nothings are being created at such a rapid rate in all currencies that it would be impossible for central banks to convert them again into gold at any conceivable fixed price. They would run out of gold. For convertibility to be possible, central banks will have to stop creating their own IOUs by acquiring other IOUs, and this they will not do.

"But fixed exchange rates are not possible without the discipline of convertibility, and I mean gold convertibility, for SDR convertibility is meaningless. It imposes no discipline at all. Since convertibility is impossible in world-wide inflation we must reconcile ourselves to floating exchange rates for a long time to come. A floating-exchange-rate world will be, in general, a world of competitive exchange-rate depreciation, which means competitive monetary expansionism, which in turn means more world-wide inflation.

[2] Dr. Rinaldo Ossola, Deputy Governor of the Bank of Italy.

[3] Nairobi, Kenya was the host city for the 1973 annual meeting of the International Monetary Fund.

"Even in such a world people must pay their debts, but as debt grows ever more rapidly the total debt burden becomes ever more onerous, even though it is denominated in IOU-nothings. The hard fact of economic life today is that some sizeable segment of that debt burden cannot be paid, and must ultimately be liquidated before international monetary reconstruction begins. This liquidation must come in one of two ways.

"In one, people in the marketplace take over early from the authorities. So far we have had only a Penn Central here and a Rolls Royce there. At some point new failures could snowball and in particular the snowball could hit financial institutions that have become overextended by borrowing short and lending and investing long; and the authorities could find it impossible to stop the snowball. We could have a massive liquidity squeeze that would break economic activity and put central banks into a position of pushing on a string instead of tightening or loosening the reins. This is the deflationary way, the 1929-'33 way.

"In the other way, the authorities might somehow manage to keep the volume of debt growing by continuously expanding their IOU-nothings at a rate sufficient to prevent the snowballing failures. In that case, however, the central banks' IOU-nothings ultimately would become worth nothing, as they say, they are—'not worth a continental'—, so all debts denominated in them become worth nothing too. And the authorities must drop zeroes on the old currency or think up a new one and start over again.

"Either way will take years to run its course. So, much as I would like to see a return to the gold standard, I think it will be years before we get it back again. We cannot, therefore, expect a new, higher, stable, official fixed price for gold. What we can expect is a breakdown of the two-tier system and central bank entry into the free market.

"No matter which kind of debt liquidation we get, the price of gold in the free market still has a long way to rise. If central banks are able to keep this world inflation going, it would become runaway in some currencies, and then the price of gold could ultimately go to infinity. If we get the deflationary kind of debt liquidation in some currencies, as I expect in the dollar, at least for a time, we could have a new and considerably higher official price for gold in dollars, but only after the deflation had run its course.

"So 'In gold we trust,' certainly more than in IOU-nothings, and much more than in who-owes-you-nothings. If you must hold IOU-nothings, choose those of the best debtors, for some may pay you nothing. But you can always go for gold. And you in South Africa are lucky. You have so much more than other people, whether in Kruger rand or two miles down a hole."

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