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THE PROPOSED IMF QUOTA INCREASE AND ITS IMPLICATIONS FOR THE TWO-TIER GOLD MARKET

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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SUBMISSIONS

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THURSDAY, NOVEMBER 13, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE
AND PAYMENTS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on International Exchange and Payments met, pursuant to notice, at 10:30 a.m., in room S-407, the Capitol Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representatives Reuss and Moorhead, and Senators Javits, and Percy.

Also present: John R. Karlik, economist, and George D. Krumbhaar, economist for the minority.

Chairman REUSS. Good morning. The Subcommittee on International Exchange and Payments of the Joint Economic Committee will be in order for a hearing to consider the impact of several recent developments on the two-tier gold marketing system and the future of the U.S. gold policy.

The two-tier gold market was established in March 1968 when representatives of the major industrial nations convened in Washington and agreed to suspend all intervention in the private gold market. The representatives agreed that, in view of the prospective creation and distribution of Special Drawing Rights, the existing global stock of monetary gold reserves was sufficient and that official dealings in gold would be limited to exchanges of this given stock at $35 per ounce. Thus, for a year and a half now, the free market price of gold has responded fully to fluctuations in private supply and demand.

Yesterday, the free market price was at something like $37.75, considerably lower than it has been.

Three recent developments prompt the reexamination of the two-tier marketing arrangements at this time.

First, will the increase in quotas in the International Monetary Fund that is projected for next year increase pressures for resumption of official gold purchases on the free market and, thus, probably from South Africa?

Second, does the $100 million of gold purchased from South Africa by official institutions recently with rand borrowed from the International Monetary Fund constitute any kind of threat to the two-tier system?

Third, in view of the decline already noted in the free market gold price during recent weeks, should a drop in this price below the official level of $35 an ounce become eminent, is it wise to make any efforts to safeguard the interests of the gold supplying countries?

Put another way, although we failed to do anything for the developing countries in supporting the price of coffee, cocoa, bananas, and other basic products, should we do something for the leading Communist country, the Soviet Union, and the leading racist country, the Union of South Africa, and grant them price support?

This morning we have with us three distinguished international monetary experts to discuss these issues—Dr. Edward M. Bernstein, former Director of Research of the International Monetary Fund and now a private consultant; Prof. Charles P. Kindleberger of the Massachusetts Institute of Technology; and Dr. Fritz Machlup of Princeton University.

Since the witnesses have not been asked to submit written statements, I would like to have each of you, Dr. Bernstein, Professor Kindleberger, and Professor Machlup, give us your views on where we are now and where we should go on gold. After that, I would hope that we could have some discussion among the witnesses and members of the subcommittee.

I suggest that we insert in the record at this point the questions that were submitted to the witnesses in advance and the data prepared for the subcommittee members and witnesses by Dr. Karlik.

(The information follows:)

QUESTIONS TO WITNESSES FOR NOVEMBER 13–14, 1969, HEARINGS OF THE SUBCOMMITTEE ON INTERNATIONAL EXCHANGE AND PAYMENTS OF THE JOINT ECONOMIC COMMITTEE, U.S. CONGRESS

1. If Fund members are required—as in the past—to pay 25 percent of their quota increases in gold, should the United States encourage nations that do not have sufficient gold reserves for subscription payments to purchase the required amounts from us, rather than modify the two-tier agreement?

2. Does the slightly over $100 million worth of gold purchased since March '68 from South Africa with rand borrowed from the IMF represent a threat to the two-tier system of gold markets? Should the United States attempt to halt such puchases?

3. Does not the South African balance-of-payments position place the United States in an extremely strong bargaining position relative to South Africa?

4. What potential gain might the United States derive from a "compromise" with South Africa?

5. In the absence of major dissatisfaction on the part of other industrial countries with the two-tier system, what is the objective of U.S. negotiations with South Africa on these matters?

6. Do other industrial nations seem to be disatisfied with the two-tier system?

7. Should the U.S. consider withdrawing its commitment to purchase gold at $35 per ounce from foreign monetary authorities that have clearly violated the two-tier agreement?

8. What do you envision will be the international monetary role of gold in 1975? 1980?

9. Should the U.S. consider modifying its gold-purchasing policies for reasons based on the apparent long-run future of gold?

10. Should the United States under *any* conceivable future circumstances agree to support once again a minimum price in the free market for gold?

11. So long as South African rand are included in packages of currencies loaned by the IMF, should the United States approve any South African drawing from the Fund in excess of the 25 percent automatic gold tranche borrowing privilege?

TABLE 1.—*Estimates of possible U.S. gold loss resulting from IMF quota increase*

	Millions
Total anticipated quota increase	$7,000–$8,000
Total gold subscription required	1,750–2,000
Estimated maximum U.S. gold outlay (no "mitigation"):	
Gold subscription payments of other industrial nation[1] (36.1 percent of total)	632–722
U.S. subscription (24.3 percent of total)	425–486
U.S. sales to other countries for payment to IMF	693–792
U.S. outlay	1,118–1,278
Estimated minimum U.S. gold outlay ("mitigation" applied for all nonindustrial countries):	
Gold subscription payments of other industrial nations[1] (36.1 percent of total)	632–722
"Mitigation"	633–724
U.S. subscription (24.3 percent of total)	425–486
U.S. gold sales to Japan (3.4 percent of total	60–68
U.S. outlay	485–554

[1] The 13 member nations the IMF designates as industrial, excluding Japan and, of course, the United States: Austria, Belgium, Canada, Denmark, France, Germany, Italy, the Netherlands, Norway, Sweden, and the United Kingdom. Other industrial members, with the exception of Japan, are apparently willing to make gold subscription payments without purchasing additional amounts from the United States.

NOTE.—The above calculations assume no special quota increases. Such special increases, if approved, would not substantially change the estimates.

TABLE 2.—IMF DRAWINGS IN RAND, MARCH 1968 TO SEPTEMBER 1969

[Millions of dollars equivalent]

	Drawing country	Millions of dollars
1968:		
April	Peru	10
June	France	23
June	United Kingdom	19
November	Peru	10
1969:		
March	Peru	6
September	France	24
September	United Kingdom	10
Total		102

Note. (added by J. Karlik).—Because the South African Reserve Bank apparently prefers to convert rand into gold rather than into dollars, it may be presumed that all rand loaned by the Fund since March 1968 have been used by the borrowing member states to obtain gold.

Source: U.S. Treasury, submitted Oct 8, 1969.

TABLE 3.—SOUTH AFRICAN BALANCE-OF-PAYMENTS DATA

[In millions of South African rand]

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969 I	1969 II
1. Merchandise exports, f.o.b	879	931	952	1,017	1,083	1,064	1,199	1,298	1,495	388	353
2. Merchandise imports, f.o.b	−1,127	−1,022	−1,048	−1,302	−1,595	−1,823	−1,678	−1,974	−1,930	−479	−537
3. Net service payments (−)	−256	−282	−247	−281	−314	−351	−367	−360	−357	−75	−109
4. Transfers (net receipts +)	−5	...	19	26	34	41	65	77	113	23	25
5. Balance on current account, excluding gold sales	−509	−373	−324	−540	−792	−1,069	−781	−959	−679	−143	−268
6. Private capital movements, including errors and unrecorded transactions	−165	−83	−64	−74	−41	162	160	235	372	22	−2
7. Central government and banking capital	12	−13	−56	13	8	96	−11	−66	74	11	39
8. Balance on capital account (net inflow +)	−153	−96	−120	−61	−33	258	149	169	446	33	37
9. Balance on current and capital accounts, excluding gold sales	−662	−469	−444	−601	−825	−811	−632	−790	−233	−110	−231
10. Gold sales	573	490	491	595	775	881	618	811	301	129	263
11. Surplus or deficit on above transactions, including gold sales	−89	21	47	−6	−50	70	−14	21	68	19	32
12. Newly produced gold absorbed in reserves	−43	86	141	93	−39	−106	150	−38	468	87	−73
13. Change in total reserves	−132	107	188	87	−89	−36	136	−17	536	106	−41

Note: Conversion of the above date from South African rand to U.S. dollars would enlarge all figures by 40 percent.

Source: South African Reserve Bank Quarterly Bulletin, September 1969. Prepared by J. Karlik.

TABLE 4.—SOUTH AFRICAN GOLD PRODUCTION AND SALES SINCE MAR. 31, 1969

[In millions of dollars]

	1968				1969		
	I	II	III	IV	I	II	III
1. Level of South African gold reserves	742	974	1,069	1,243	1,367	1,264	1,093
2. Change in gold reserves		232	95	174	124	−103	−171
3. Net South African gold production		276	273	279	302	266	[a] 275
4. Sales = production − change in reserves		44	178	105	178	369	446
5. Cumulative sales since Mar. 31, 1968		44	222	327	505	874	1,320

[a] Assumed.

Note.—At least $200,000,000 of these sales between Mar. 31, 1968, and June 30, 1969, have been to official purchasers. The estimated breakdown of known official purchases is as follows: Purchases by Portugese monetary authorities, approximately $135,000,000; purchases by Peru, France, and the United Kingdom with South Africa rand lent by the IMF, $68,000,000. Thus, during the period from April 1968 through June 1969, South Africa apparently sold over $650,000,000 of gold to private purchasers.

During the third quarter of 1969, official institutions obtained $84,000,000 of South African gold. France and the United Kingdom purchased $34,000,000 with borrowed rand, and South Africa repaid $50,000,000 of its earlier fund drawing in gold.

Source: Lines 1, 2, and 3, South African Reserve Bank Quarterly Bulletin, September 1969, and International Financial Statistics, November 1969.

Prepared by J. Karlik.

Chairman Reuss. Dr. Bernstein?

STATEMENT OF EDWARD M. BERNSTEIN, PRIVATE CONSULTANT

Mr. Bernstein. Congressman, I have a written statement which I will not read but I will give for the record.

Chairman Reuss. Without objection, it will be received and included in the record following your testimony. (See p. 12.)

Mr. Bernstein. I think the role of gold in the international monetary system has been declining steadily. It has declined because the force of circumstances has brought this about. I expect that this will continue. I think the proper approach to all problems related to gold is to see whether these developments fit into the longrun evolution of the international monetary system and to have the International Monetary Fund guide them in that way.

I regard the two-tier gold market as an important stage in the evolution of the internatonal monetary system. It was essential to prevent a breakdown of the international monetary system.

The two-tier gold system has worked very well. I see no reason for being disturbed about it, and no reason for changing it.

Since the opening of the London Gold Market on April 1, 1968, the prices have ranged from a low of $36.70 an ounce, in April 1968, to a high of $43.82 an ounce in March 1969. This morning the price was $37.80 an ounce.

These large fluctuations in the price of gold have mainly reflected confidence in currencies and in the international monetary system. The successive exchange crises, at least until March, heightened speculation and raised the price of gold in the London market. The only basis for such speculation and for the rise in the price of gold was the hope that the monetary price of gold would have to be raised. This hope is, for all practical purposes, dead. People may talk about it, but not many. It was killed by the agreement for the issue of special drawing rights, by the readjustment of the parities of the French franc and the German mark, and by the remarkable strength of the dollar in the exchange

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market, at a time when we had inflation and a seriously deteriorating trade position.

In my opinion, the amount of newly mined gold put into the market has not been a major factor in the fluctuation of gold prices until recently. Obviously, the supply of gold by South Africa does affect the price, but in the past 20 months the supply factor has been overshadowed by the ebb and flow of speculative demand.

I noted around July that there was great stability in the price of gold for a time, despite the pressures in the exchange market. My conclusion at that time was that there was a tap supply of gold being given to the market and that could only come from South Africa. Of itself, a tap means that the price will not rise. It does not prevent the price from falling.

Gold speculation by its nature can only live on a rise in prices. When it becomes generally known there is a tap supply, the price must fall, because no speculator has any interest in retaining gold unless he can expect a rise of close to $4 an ounce per annum at present interest rates.

In this sense, the fact that gold was being offered by South Africa did compel a fall in the price of gold; and therefore I would say that in recent months the supply of gold by South Africa in the free market is an important element in forcing the price down. Here again, it is the effect of this very modest increase of supply on the expectations of speculators which finally brought such a sharp fall in the price of gold.

What is the right attitude of governments toward the two-tier gold system and especially the private market for gold? My opinion is that the right attitude is one of complete indifference. We must get rid of the notion that the prestige of the dollar or the functioning of the international monetary system will be affected by the price of gold in private markets.

In the long run, after the present overhand of gold held by speculators is absorbed, supply-and-demand conditions will set a price for gold which may be a little bit lower than it is now, but that price may have a longrun upward trend very gradually. This is equally true of other metals, where supply-and-demand conditions may result in a gradual rise in price. But so long as the rise is very slow, it cannot be any inducement for speculation, certainly not for holding large quantities of gold merely in the hope of selling it at a higher price in the future.

I do not believe that South Africa can derive any great profit by managing the gold market. That is because the other countries, including the Soviet Union, would share the benefits of a monopolized gold market, and they would bear no part of the cost. And we must remember that at least for the future, the near future, there is a considerable amount of gold held by speculators that might be called forth if the price should be high.

I have said that the private gold market is not of significance to the international monetary system, but the future role of gold is of great significance. So I think the policy toward gold—and that includes newly mined gold—should be made not on any short-run objectives or on an ideological basis, but on a pragmatic consideration of what would be the best development in the international monetary system.

This brings me to the questions that the committee has put before us. The Washington declaration is a statement of the policy of seven central banks. What they said was, in a positive way, that they will not sell gold to the private market. They observe further that they no longer felt any need to buy gold from the private market, in view of the eminent issues of SDR's It is not definitely stated that this includes newly mined gold.

The International Monetary Fund issued a statement in general support of this declaration, but what the statement of the Fund said was this:

The decision is readily understandable—that is, the Declaration of the seven—as a means of conserving the stock of monetary gold which has recently been subject to heavy drains through such operations in the London market.

To the Fund, the essential element in the Washington declaration was that it would conserve gold in monetary reserves. On every other question in the declaration, the Fund merely made the general observation that obligations under the International Monetary Agreement remain as they were.

Now, South Africa has offered to sell gold to the International Monetary Fund under article V, section 6. It states that:

Any member desiring to obtain, directly or indirectly, the currency of another member for gold shall, provided that it can do so with equal advantage, acquire it by sale of gold to the Fund.

This provision is not mandatory on the Fund. I know the history of this and the other provisions very well. In any case, it was not intended to apply to newly mined gold. In fact, we had to add part (b) to this, to satisfy the British, who hoped to remain the central market for the disposal of newly mined gold.

And so the part (b) of the same section states:

Nothing in this section shall be deemed to preclude any member from selling in any market gold newly produced from mines located within its territories.

Not only does the Fund have no obligation to buy newly mined gold, but as this provision states, members do not even have the obligation to offer it. This is the exception to the rule that countries ought to offer to the Fund the opportunity to buy monetary gold they intend to sell in order to acquire currencies they need.

Where countries offer gold for sale to the Fund, it is not mandatory on the Fund to purchase it. There are many mandatory goal transactions in the Fund, one of which is mentioned by the committee, such as subscriptions in gold, payment of charges in gold, repurchases in gold. Wherever there is a mandatory gold transaction with the Fund, the price at which this transaction takes place is $35 an ounce—flat. And the delivery of the gold can be at any depository of the Fund.

There have been very few transactions under article V, section 6(a), but there have been a few, where members have offered gold for sale to the Fund. The Fund did not buy it at $35 an ounce; it bought it at less. In general, it only wanted to buy it in New York; and in one case, Norway, where the gold was in Ottawa, the gold was flown to New York.

The gold transactions were so few, and it was so difficult for the Fund to handle them on a price basis, that finally, the Fund simply notified members not to bother offering gold because the Fund could not natch the price that was offered by the Federal Reserve Bank of New York on behalf of the Treasury.

So the history of gold sales by members to the Fund is that there were few, they were not at any fixed price, they were not mandatory, and the Fund finally found that the provision under the conditions that then ruled could not really be carried out in practice. That is why it informed members, there was no need to offer gold for sale to the Fund any longer.

I said that I would approach this problem from its longrun point of view. I do not hate gold; I do not love gold. Too me, gold is simply another part of the international monetary system. That international monetary system is governed by the Fund. In the rules or statutes of the Fund, the Fund Agreement, there is nothing, it seems to me, which can prevent a country like South Africa from buying foreign exchange from the Fund, provided it needs the foreign exchange for making payments in accordance with the provisions of the Fund. I certainly would not stop it for any reason unless South Africa does not really have a need for this currency to make such payments.

Chairman REUSS. May I interrupt, Dr. Bernstein?

You may say you have no objection to South Africa buying needed currencies—May I ask, with what?

Mr. BERNSTEIN. It buys with its own currency.

Chairman REUSS. Not with gold?

Mr. BERNSTEIN. No. Well, let me put it this way: the next sentence will indicate that in effect it can buy it with gold if it really needs currency. There is nothing in the agreement, I think, to stop South Africa, once the fund holds more than its quota in South African rands, from repurchasing at its own will with gold any holdings of the Fund in excess of the quota.

Chairman REUSS. Newly mined gold?

Mr. BERNSTEIN. The Fund agreement does not say what gold a country would buy its currency with, it says it can buy it with gold. It says a member may repurchase from the Fund, with gold, any holding of its currency in excess of the quota.

Chairman REUSS. Perhaps I am interrupting more than I should but I do want to understand it.

You say this with recognition of the March 1968, two-tier agreement?

Mr. BERNSTEIN. The March 1968 two-tier statement is a declaration by seven of the most important countries of the world, what their policy would be on gold. They cannot alter the Articles of Agreement of the International Monetary Fund by a declaration in Washington.

Chairman REUSS. Was there not an effort made with some success to achieve near universality of adherence?

Mr. BERNSTEIN. Oh, yes. A lot of countries are going to follow the United States, no matter what we ask them to do, and many countries may have followed it not merely because we asked them to do it, but because they think it is a wise policy. That does not make it international law; and it does not of itself alter the Articles of Agreement of the International Monetary Fund. It merely represents a statement of policy by seven of the largest members of the Fund. They may urge this policy on the Fund; nothing prevents them from interpreting what they regard as good policy, as, in fact, consistent with the laws of the Fund. It does not make law.

Chairman REUSS. True.

My question was really this, if South Africa is to deal with the Fund in these various particulars with its newly mined gold, that does violate the spirit and letter of the March 1968 agreement, does it not? That spirit and letter being no new gold in the system?

Mr. BERNSTEIN. No, Congressman. What it violates is our interpretation of what was intended in the declaration. It is not correct that all participants in that declaration regarded the second part of the statement, that there is no neeed for buying gold in the private market, in view of the imminent issue of SDS's, as having been a commitment not to buy newly mined gold.

If you are implying that this interpretation of the declaration is law, let me point out that we have had this problem of newly mined gold and private markets for a long time. In 1947, the Fund issued a statement, within its law, which said central banks must not sell gold at premium prices in private markets.

This was because such sales implied a departure from established exchange rates. It was an implicit exchange rate. The Fund rationalized its statement further by saying that monetary gold should not be sold in private markets to go into private hoards or into speculative hands, but should go into the central reserves; that is to say, the monetary reserves of the governments and central banks. That was its fundamental objective.

I might add that in connection with this, it was not argued that South Africa could sell its newly mined gold at a premium price. On the contrary, it was argued that even the newly mined gold could not be sold by South Africa at a premium price; and, as a matter of fact, South Africa went through the rigmarole of making all sorts of statutes and similar articles with little labor content, practically all the value was gold, which were then sold to the premium market as fabricated gold products.

In 1951, although the price in the premium market was still above $35 an ounce, the Fund issued another statement saying that it would no longer police this obligation not to sell in premium markets, but that it still felt that the interests of the world economy and international monetary system would be better served by having this gold go into central reserves.

Now, I do not think we can swing around on these principles and on these interpretations and argue that the law of the Fund changes as we swing. I think we can argue that the need for policy makes an action on gold wise at one time and a quite different action wise at another time. But I do not think we ought to say that this changes the laws of the Fund.

Chairman REUSS. My question really related not so much to whether this gold policy was a law or regulation of the International Monetary Fund, but to the following issue. I think the March 1968 agreement was right in saying that there should be no further official purchases of newly mined gold because we want all of the newly mined gold to flow unimpeded into the private market and thus prevent the private market price from getting too much above the official $35 an ounce level. Otherwise, when gold goes up in price another dollar, central bankers are tempted to sell gold at a profit in the private market and then perhaps to recoup their gold sales by exchanging dollars at the

U.S. Treasury. The consequences for the international monetary system from this type of activity could be serious.

If the philosophy behind the March 1968 agreement was right, as I believe, why should we not view with alarm, irrespective of what the law may be, arrangements whereby the South African Government and gold mining interests are able to dispose of gold in official circles? Every ounce of gold that they dispose of through official circles means 1 ounce less that they would otherwise have to sell on the private market.

Mr. BERNSTEIN. Congressman, I do not think the declaration of Washington quite says what you said. What it says is simply this, that in view of the imminent issue of Special Drawing Rights, there is no need to buy gold in the private market to be added to monetary reserves. The word "newly mined gold" does not appear in the statement.

Chairman REUSS. The only reason, though, for this whole exercise in Washington was to attempt to channel as much gold as possible to the free market and avoid the unsettling consequences on official transactions of a free market that went up to $50 or $60 an ounce, as some where hoping it would.

Mr. BERNSTEIN. No doubt, there was this fear. It is not the real reason why the meeting was held in Washington. The meeting was called for a single purpose, to relieve the seven members of the gold pool of their commitments under an agreement to supply gold in the market at $35 an ounce.

Nobody who came to that meeting really had any other objective in view. I think myself that the supplementary statement that we do not have to buy any gold for increasing reserves was designed to indicate to the speculators that there was no hope that the monetary price of gold would be raised merely because very little or no gold will come into the system.

But I am afraid I am taking up too much time.

Chairman REUSS. We will return to this.

Mr. BERNSTEIN. I have the same feeling about the use of rands in exchange transactions of the Fund with members. I see no reason why the fund should not sell rands if it has them, any more than it should not sell Japanese yen or Mexican pesos. It is true the rands cannot be used themselves directly in the world market, not for intervention purposes, but they can be converted into gold by South Africa, and they are. But by the same token, the Japanese yen or Mexican pesos are not used for intervention in the market after they have been sold by the Fund. What these central banks do is convert the Japanese yen and the Mexican pesos into dollars.

I do not think that the sale of rands by the Fund and their conversion into gold by South Africa is a threat to the two-tier gold market. I do not think the sale of miniscule amounts of newly mined gold to central banks, who do not want to abide by our interpretation of the declaration of Washington, is any threat to the international monetary system.

We might not like it ideologically. It seems like hanging on to an outmoded prejudice to feel that we must add more gold to reserve holdings. But I think we are exaggerating the significance for the international monetary system of small additions of newly mined gold to the reserves. I do not see how we are going to reconcile this interpretation of the Washington declaration with the position we took in

1947—certainly not, if we try to make it international law. It is another thing if we want to argue that it is a statement of policy and a realistic one.

I do not regard the sales of token amounts of gold to the monetary authorities as having any monetary significance. In practice, I would like to see the newly mined gold sold in the private market as long as the price is above $35 an ounce. I take this view because I do not like discriminatory monopoly prices, not because I think it is a threat to the international monetary system. I do not believe that much newly mined gold will be offered to the monetary authorities. I think South Africa has a big interest in establishing the very thing that you are opposing; that is, at the eligibility of newly mined gold to be incorporated into the monetary stock. Because nobody can tell with assurance whether at some stage the price of gold could drop below $35 an ounce.

But I do not think South Africa really wants to sell very much at that price to the monetary authorities. Because I do not regard such sales as having great monetary significance, I see no need for new sanctions in connection with the Washington declaration.

Our commitment to buy and sell gold for international settlements is an undertaking with the Fund. We can withdraw that undertaking but I do not think we can modify that undertaking to the Fund to say we will buy and sell gold freely except to countries that deal in newly mined gold with South Africa. I really do not believe we can do that and still take advantage of that section of article IV, which has induced us to declare to the Fund that we buy and sell gold freely for international settlements.

My suggestion is that we stop worrying about the free gold market and stop worrying about fluctuations in the price of gold in that market. They are less important to the world economy than fluctuations in the price of copper. Let us not take any rash action on demonetizing gold or changing the policy of the United States on buying and selling gold. I think we can wait for the longrun forces at work in the international monetary system to achieve just what we want. Those forces are going to result in a steadily diminishing role of gold in the international monetary system.

I can tell you how I think the international monetary system will evolve. I think we will probably keep the system of fixed parities, although the present rules may be modified to permit some greater exchange flexibility, one way or another. I think we are going to continue to express par values in terms of gold, as they are today, because gold is a convenient common demoninator for this purpose. It does not imply gold convertibility of currencies—not among most central banks and certainly not the private holders will ever take place.

I think the monetary price of gold will stay at $35 an ounce. I think the United States will stand by its declaration to the International Monetary Fund to buy and sell gold freely. Other countries will maintain convertibility as they do now by intervening in the exchange market with dollars. I think the United States will maintain convertibility through use of SDR's, as well as gold, and I think ultimately it will be through the use of a composite reserve unit, of which gold will be a part.

The nominal role of gold in the system may be little changed in the next decade and many people will be happy to think that we have a gold standard as we have had for a hundred years or more. But in practice, the use of gold, the role of gold, will gradually diminish. We will see that most clearly in the role of gold as a reserve asset. Gold will be a constantly smaller proportion of total reserves. Whether or not there is any newly mined gold added to the system, the principal source of the growth of reserves is going to be special drawing rights. If the new reserve facility works well—I think it will—the SDR's will be about as large a component of monetary settlements. If that happens—and I think there is a chance it will—be a considerably larger part of aggregate monetary reserves.

The very fact that gold will become a smaller part of the monetary reserves will compel changes in the use of reserves in international settlements. Central banks have a strong preference for gold, mainly for historical reasons. I think that preference may become greater and, in fact, there is a real danger that at some stage central banks may regard gold as much too precious to be used in international settlements, If that happens—and I think there is a chance it will—it will impair the functioning of the international monetary system. At best, it would immobilize $40 billion of gold reserves. They would be put at the bottom of the pile of reserves, never to be used except in extreme crises. At worst, it could lead some countries to try to capture gold reserves from others, to cannibalize the gold reserves of other countries.

I think it is going to be difficult to operate a monetary system with multiple reserve assets. I do not think the solution is overwhelmingly difficult technically. The International Monetary Fund can find an equitable way for making sure that all reserve assets are used without discrimination. I might point out that the requirement that different reserve assets be used together is not novel in our international monetary system. Under the Fund agreement, a country must use, if it has more than minimal reserves, an equal amount of its gold and dollars along with drawings on the Fund. The SDR amendment requires countries to use gold, foreign exchange, and their net creditor position in the Fund, in a balanced way with SDR's.

I see no great difficulty in moving on from that to a requirement that all reserve assets—gold, dollars, other foreign exchange, and SDR's—should be used together by deficit countries in the same proportions that they hold them. And that surplus countries would have to take them in the average proportions in which the deficit countries use them. I hope this Fund will study this problem.

I am convinced this is an essential step in the evolution of the international monetary system. This may be the real problem of the future role of gold. I doubt whether the marginal sales of newly mined gold to the Fund or to central banks are really important.

Chairman Reuss. Thank you, Mr. Bernstein.

(Mr. Bernstein's prepared statement follows:)

PREPARED STATEMENT OF EDWARD M. BERNSTEIN

GOLD POLICY AND THE INTERNATIONAL MONETARY SYSTEM

The monetary role of gold has changed enormously in the last thirty years. Most of the changes were not initiated by deliberate action of governments, either individually or collectively. They are the result of developments that governments did not design and, to a considerable extent, could not control. Their cumulative effect, however, has been an evolution of the international monetary system in which the role of gold has gradually declined and will, inevitably, continue to decline in the future. The real question is how these developments can be guided to strengthen the international monetary system so that it can function most effectively in an expanding world economy.

The present international monetary system was established at Bretton Woods. On gold, the Articles of Agreement of the International Monetary Fund did little more than to recognize the *de facto* status of gold and to adapt its uses to the operations of the Fund. The establishment of the Fund was itself a recognition of two important facts regarding gold. First, that most members did not have sufficient gold and dollar reserves for their needs. Second, that the resources of the Fund would be used in conjunction with gold and dollars in financing payments deficits. Because reserves were not adequate, the Fund was concerned about official sales of gold in premium markets which depleted aggregate reserves and undermined existing parities. That was the reason for the two statements of the Fund, in June 1947 and in September 1951, deprecating official sales of gold in premium markets.

Although the international monetary system has worked reasonably well in the postwar period, at least until recent years, it has been necessary to place less and less reliance on gold as monetary reserves. The growth of the monetary gold stock was minimal from 1948 to 1965—averaging about $500 million a year. The monetary gold stock fell slightly in 1966 and fell sharply in 1967 and the first quarter of 1968, mainly because of speculation on a possible rise in the monetary price of gold. From September 1967 to March 1968, speculators absorbed about $3 billion of gold supplied by the monetary authorities of the gold pool countries in a vain effort to meet the speculative demand at $35 an ounce.

The Washington declaration of March 18, 1968, by the seven countries comprising the gold pool, that henceforth gold reserves should be used only to effect transfers among monetary authorities and that they would no longer supply gold to private markets recognized that the sale of gold to speculators was depleting their reserves and weakening the international monetary system. Their further statement that in view of the establishment of the facility for Special Drawing Rights, they no longer felt it necessary to buy gold from the market, was an acceptance of the fact that the only reliable source of reserves for the future was through a new reserve asset issued by international agreement.

THE TWO-TIER GOLD MARKET

The isolation of the private gold market from the monetary gold stock was essential to prevent a breakdown of the international monetary system. In a paper on the gold crisis issued on April 11, 1968, I wrote:

"There are some people who hold the view that a two-price system for gold is inherently unstable. They fear that central banks will be tempted to sell gold from their reserves at premium prices. They even see a possibility that some central banks will act as arbitrageurs, selling gold for dollars at premium prices and using the proceeds to buy gold from the U.S. Treasury at $35 an ounce. These fears are unfounded."

In fact, the two-tier gold system has worked very well. I see no reason for being disturbed about it, and no reason for changing it.

Since the reopening of the London gold market, the price has ranged from a low of $36.70 an ounce in April 1968 to a high of $43.82 an ounce in March 1969. In recent months, the price has fallen more or less steadily and this morning was $37.80 an ounce. These relatively large fluctuations in the price of gold have mainly reflected the state of confidence in the international monetary system. The successive exchange crises were usually accompanied by heightened speculation and a rise in the price of gold. The only basis for such speculation was the hope that the monetary price of gold would have to be raised. This hope is for all practical purposes dead. It was killed by the agreement for the issue of Special Drawing Rights, by the readjustment of the parities of the French franc and the German mark, and by the remarkable strength of the dollar in the exchange markets. I do not believe that the amount of newly-mined gold put into the market has been a major factor in the fluctuation of gold prices. Obviously, the sale of gold by South Africa does affect price, but in the past 20 months the supply factor has been overshadowed by the ebb and flow of speculative demand.

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The private gold market will in time settle down to being another commodity market, of interest because of the historical role of gold, but of only marginal significance for the international monetary system. I hold this view because I expect confidence in the international monetary system to be strengthened in the course of the next few years. That will happen as the inflation in the United States is slowed down and halted, as the pattern of international payments becomes better balanced, and as the SDRs prove to be an effective component of monetary reserves. I am hopeful that we shall see notable progress in all of these fields in the next year or two.

My interpretation of the recent behavior of the private gold market is that it reflects a realization that gold is now a poor speculation. Because of this, speculators are unloading the gold they acquired at $35 an ounce in late 1967 and early 1968. Much of the speculative holdings of gold may have been absorbed in industrial uses and in private hoards, but there is probably still a considerable amount held by speculators who have been late in realizing the changes that have occurred in the international monetary situation. The overhang of this speculative stock will hold down the price of gold for some time. Under these conditions, the flow of newly-mined gold from South Africa and from other countries can have a significant effect on the price of gold in the private market.

The appropriate attitude of governments toward the private gold market is one of indifference. We must rid ourselves of the notion that the prestige of the dollar or the functioning of the international monetary system will be affected by the price of gold in the private market. In the long run, after the present speculative overhang is absorbed, supply and demand conditions may result in a gradual rise in the price of gold, just as supply and demand conditions may result in a gradual long-run rise in the price of other metals. As a gold consuming country, there is a reasonable basis for objecting to an attempt to force higher prices by withholding newly-mined gold from the private market. It is doubtful, however, whether in the long run South Africa can manage the gold market to its profit, particularly as other countries, including the Soviet Union, would share the benefits at no cost to themselves.

FUTURE POLICY ON THE TWO-TIER MARKET

The private gold market is not of significance for the international monetary system; but the future role of gold is of great significance to the United States and to all countries. The policy toward gold, and that includes newly-mined gold, should be made not on an ideological basis or to achieve short-run objectives, but on pragmatic considerations regarding the long-run monetary role of gold. That means, above all, that gold policy should be made by the International Monetary Fund with a view to the future evolution of the international monetary system.

The Washington declaration of March 18, 1968, is a statement of the policy of the seven central banks comprising the former gold pool. The declaration is positive in stating that they will not sell gold to the private market. It merely observes that they no longer feel it necessary to buy gold from the private market and it is not definitely stated that this includes newly-mined gold. The statement of the International Monetary Fund, issued at the same time, gives implicit endorsement to that part of the declaration concerned with halting sales of gold from monetary reserves to the private market. "This decision is readily understandable as a means of conserving the stock of monetary gold which has recently been subject to heavy drains through such operations in the London market."

South Africa has offered to sell gold to the Fund under Article V, Section 6 (a) which states: "Any member desiring to obtain, directly or indirectly, the currency of another member for gold shall, provided that it can do so with equal advantage, acquire it by sale of gold to the Fund." This provision is not mandatory on the Fund and, in any case, was not intended to apply to the newly-mined gold. As part (b) of the same section states: "Nothing in this Section shall be deemed to preclude any member from selling in any market gold newly produced from mines located within its territories." Where a gold transaction is mandatory on the Fund—as in subscriptions, charges, and repurchases—the transaction is at $35 an ounce, and can be made at any of the Fund's depositories. The Fund obviously cannot undertake to buy gold at $35 an ounce, regardless of where and for what currency it is offered. In the few times the Fund has bought gold from members, it was at a negotiated price that was slightly less than $35 an ounce. In fact, the Fund long ago informed members that it could not buy gold from them with equal advantage and that there was no need to offer such gold to the Fund in the future.

There is nothing in the Fund Agreement, however, that prevents South Africa from buying foreign exchange from the Fund with its own currency, where this is necessary to meet its payments, or repurchasing from the Fund with gold any of its currency in excess of its quota, or converting in gold its currency held by other members under Article VIII, section 4 (a). There is no reason why the Fund should not use rands in its exchange transactions with members merely because such rands will be converted into gold by South Africa, just as there is no reason for not using Japanese yen or Mexican pesos which will have to be converted into dollars before the borrowing country can use them in the exchange market. I would emphasize that gold transactions of a member with the Fund are solely a matter of applying the Articles of Agreement in a reasonable way to facilitate the business of the Fund.

There is no threat to the two-tier gold market from the sale of rands by the Fund and their conversion into gold by South Africa. There is no threat to the international monetary system in the sale of newly-mined gold by South Africa to the monetary authorities of other countries. I believe other countries are satisfied with developments in the gold market since the Washington declaration and have no wish to return to official support of the private market for gold. I also believe that many of them regard the U.S. position that newly-mined gold is not eligible for incorporation in the monetary gold stock as ideological prejudice. It is difficult to reconcile our position today with that which we held in 1947 when the Fund first expressed the view that countries should not sell gold in premium markets. At that time the United States was concerned because newly-mined gold was sold in premium markets rather than to the monetary authorities. Now, we seem concerned because minor amounts of newly-mined gold may be added to the monetary gold stock.

As a practical matter, I should like to see newly-mined gold sold in the private market so long as the price is above $35 an ounce. I take this view because I do not like discriminatory monopoly pricing, even for gold. I would not object to having newly-mined gold added to the monetary stock when and if the private market is at $35 an ounce. Although I do not believe much newly-mined gold will be offered to the monetary authorities, whatever is added to the monetary reserves would to that extent make it easier to strengthen the world pattern of payments. I see no need for new sanctions in connection with the Washington declaration. Our commitment to buy and sell gold freely for international settlements is an undertaking to the Fund. We are free to withdraw that undertaking. but I do not believe we can modify it to exclude gold purchases from countries that add newly-mined gold to their monetary reserves.

FUTURE ROLE OF GOLD

The real interest of the United States as of all other countries is in the appropriate role of gold in the international monetary system. That role has steadily diminished because of historical forces. It would be folly to take any action to demonetize gold. The evolution of the international monetary system will of itself limit the future role of gold.

I expect the system of fixed parities to continue, although the present rules may be modified to permit somewhat greater exchange flexibility in one way or another. The par values of currencies will be expressed in terms of gold, as they are today, for gold is a convenient common denominator for this purpose. This does not imply gold convertibility of currencies—not as a general rule for monetary authorities, and certainly not for private persons through official intervention in the private gold market. The monetary price of gold will remain at $35 an ounce and the United States will stand ready to buy and sell gold freely in settlement of international transactions. In practice, other countries will maintain convertibility of their currencies by intervening to buy or sell dollars in the exchange market, as they do now, and the United States will maintain convertibility through use of SDRs as well as gold, and probably ultimately through use of a composite reserve unit of which gold will be a major part.

While the nominal role of gold in the international monetary system may be little changed in the next decade, the practical role of gold will gradually diminish. That has been going on for more than a generation, and is best exemplified by the constantly smaller proportion of aggregate monetary reserves consisting of gold. Regardless of whether or not minimal amounts of newly-mined gold are added to monetary reserves, the principal source of the growth of reserves in the future will be Special Drawing Rights. If the new reserve facility works well, and I am confident that it will, the SDRs will be about as large a component of monetary reserves as gold by 1980, and a considerably larger part of aggregate reserves thereafter.

This will of itself compel corresponding changes in the use of reserves in international settlements. Central banks have a strong preference for gold as a reserve asset, mainly for historical reasons. The preference for gold may diminish in the future, but it is much more likely to be strengthened, particularly if the price of gold in the private market should have an upward trend. As the proportion of gold in aggregate reserves declines, central banks may come to regard their gold reserves as a sort of national patrimony, too precious to be used for international settlements except in extreme crisis. If this should occur, it would impair the functioning of the international monetary system. At best, it would immobilize $40 billion of gold reserves. At worst, it could lead to policies under which some countries deliberately seek to cannibalize the gold reserves of other countries.

There are inherent difficultis in operating any monetary system with multiple reserve assets. That is especially true when the reserves consist of such widely different assets as gold, the traditional money metal; foreign exchange, the liability of a reserve currency country; and SDRs, a new fiduciary reserve asset issued by an international monetary authority. In such a reserve system, there must be rules requiring the equitable use of all reserve assets in the same proportions as they are held by each deficit country and the acceptance of such reserve assets by surplus countries in the average proportions in which they are used by deficit countries.

There is nothing novel in requiring countries to use different reserve assets in equitable proportions in international settlements. The Fund Agreement implicitly requires countries with more than minimal reserves to use their gold and dollars in at least equal amounts with their drawings on the Fund. The SDR amendment requires countries to use their gold, foreign exchange, and their net creditor position in the Fund in a balanced way with SDRs. This may prevent a one-sided use of SDRs while countries continue to hoard their gold and foreign exchange reserves. It would not prevent countries, however, from attempting to shift the composition of their reserve assets from foreign exchange to gold.

Various proposals have been made for requiring the equitable use of all reserve assets without discrimination. The technical differences in these proposals are not of great consequence. My preference is for the earmarking of all reserve assets—gold, foreign exchange and SDRs—in a reserve settlement account denominated in a composite reserve unit and administered by the International Monetary Fund. The composite reserve unit would be used much as gold reserves are used now, except that transfers of reserves would be made by debits and credits in the reserve settlement account. Countries would retain title to the actual reserves they earmark, subject to adjustment for the implicit transfers from cumulative deficit to cumulative surplus countries. I hope that the Fund will study this question. I am convinced that it is an essential step in the evolution of the international monetary system.

Chairman Reuss. Mr. Kindleberger?

STATEMENT OF CHARLES P. KINDLEBERGER, PROFESSOR, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. Kindleberger. I think I first should discredit myself as a witness by saying that I went through my files the other day, under "J," and found a letter I had written to Senator Javits commenting on a speech he gave in February 1968 in which he recommended the two-tier system. I said it would never work. Now I happen to be an enthusiastic supporter of Senator Javits' position, and I am glad to make acknowledgement of his prescience in this regard.

Chairman Reuss. We will convey your feeling to the Senator.

Mr. Kindleberger. I conveyed it to him by writing him a note before I got your invitation to come to this hearing.

I am pleased to present my views on the complications that face the United States in the matter of gold, given the two-tier system, the projected expansion in the quotas of the IMF, and the attempts by the Union of South Africa to undermine the two-tier system and to move the world toward an increase in the gold price. These views have the modest advantage perhaps of lying midway between those of Mr. Bernstein, who is closely attached to the use of gold in world payments, and Professor Machlup, who has in the past advocated strong measures to demonetize it. They suffer, however, from my lack of detailed expertise on the mechanics of the IMF and gold production and distribution, which these colleagues both have in full measure.

Perhaps you will permit me on this account to tackle the list of questions which you sent us in advance, in a broad and general way, and even to add to the list.

Question 8 asks what sort of role I envisage for gold in 1975 and 1980.

I expect gold to go the way of wampum, clam shells, copper, and silver, and to become a commodity, with a changing price, rather than a reserve asset for international adjustment. I see, however, no need to accelerate the process, and some danger in seeking to do so. If the price of gold were to fall far, fast, a number of abroad banks which have made loans to speculators on the basis of gold security might find themselves in trouble. Rocking the gold-price boat hard might lead to bank collapse and deflation.

I do not anticipate such an outcome, but it is a risk which should not be courted unnecessarily. Accordingly, I would be prepared, to set limits to the amount I would let the gold price fall—in answer to your question 10—not at \$35, nor at the old support price of \$34.80, or whatever it was which obtained when the gold pool operated in London before the two-tier system, but well above \$32.50.

The purpose would not be to preserve a role for gold, as raised by question 9—but to prevent possible instability in the gold market from having drastic repercussions on the world credit and money mechanism.

This would not be, to answer your question, doing a favor for the Soviet Union and Union of South Africa, but taking reasonable precautions to safeguard the international monetary system in behalf of all countries.

While gold is headed for ultimate demonetization, as I envisage it, the exact path and the timing are almost impossible to predict. I would not expect much change in the system by 1975, even 1980 may be too early. Well before the end of the century, however, one would expect sufficient demand for gold as a commodity—in electronic work, possibly in jewelry, although that demand may go either way—and sufficient satisfactory and tested substitutes for it as an international money, that the transition from gold to credit as international money, long underway, could be completed.

In the light of this prospect, it seems to me to be useful to steer the two-tier system gradually toward demonetization, but not to move precipitously. In particular, it seems desirable to clear up two ambiguities in the way that the IMF treats gold.

The first of these is the 25-percent gold requirement for quotas and increases in quotas. It is understandable why the requirement was adopted at Bretton Woods in 1944. It makes much less sense today.

Either gold is on its way to demonetization, as I think, in which case the IMF is being loaded up with a poor asset, or gold is undervalued as many distinguished economists like Harrod and occasionally Johnson and others think, in which circumstance the Fund subtracts gold from the world every time its quotas are raised.

It is, of course, possible for the Fund to arrange to repurchase with gold the currencies, the reserves of which are reduced to provide the gold in the first place. Much simpler would be for the central banks and treasuries of the world to pay in foreign exchange on a limited number of acceptable convertible currencies for the so-called gold tranche, which could then become the gold and foreign exchange tranche. I do not suggest that the United States should pay its share in dollars—I have in mind all should pay in gold or foreign exchange, currency foreign to the country in question; nor would I at this moment contemplate a wider list for other countries than dollars, Deutsche marks, Swiss francs, and lire, and at some future quota increase, possibly SDR's. The convolutions which the Fund Agreement puts the system to, to obviate taking the gold needed for the quota increase out of the U.S. reserve, with the danger that the loss be misunderstood in world markets, seems to me unnecessary. Admittedly, it is difficult to alter the Fund Agreement; it sems to me nonetheless desirable.

Let me forestall any impression that I want the United States to hold on to its gold stock because this is a vital national asset. This is not my view. It is a matter of little moment whether the counterpart of a decline in central bank deposits in the United States needed to pay for the gold or gold and foreign exchange tranche is a decline in gold or an increase in the claims on this country of the IMF. There is no balance-of-payments difference, and little banking difference since the IMF deposits are likely to be paid out to IMF borrowers at an early point. It is simply hocus-pocus to have a procedure and then be obligated to mitigate its effect.

With regard to the Union of South Africa, I would again urge caution. The Afrikaners want an increase in the price of gold, and this I oppose. They are struggling to avoid the fate of Midas, who choked on gold, and are having difficulties. The loans contracted in Switzerland seem no longer to be available now that the SDR's are moving ahead on schedule and the price of gold in Zurich is slipping, as foreign exchange rates come into better alinement, and the whole tone of the international monetary system has been strengthened.

Gold hoarding is no longer a reliable outlet for South African production. Nonetheless, I would be unwilling to see South Africa forced into a corner which was too tight. It would seem reasonable to hold out current accession to the two-tier system at any time, regardless of past unwillingness to accept and violation of its spirit. And to exert pressure in this direction by cutting off at least one of the two means of disposing of gold to the IMF.

The rand is either a strong currency or a weak currency. It cannot be both. If it is strong, it is appropriate for the IMF to make it available under French, British, et cetera, drawings, and to allow South Africa to furnish gold for rand, since it has no useful foreign exchange in excess. On one interpretation, this is a de facto violation of the two-tier agreement by France, Britain, et cetera, since they are buying gold at $35 an ounce from a country which refuses to accede to the two-tier arrangement. This fall from perfect purity, however, is understandable if it is agreed that the rand is a strong currency which happens to have only gold, and if this gold is available at $35.

If the rand is weak, it can presumably draw on its IMF quota from time to time, but under the normal restrictions about how much of the quota can be drawn in any 12 months. To repay its drawing in gold when it cannot sell gold otherwise—except to such isolated central banks as the Portuguese—is a gap in the two-tier system, but one left by the IMF articles of agreement. It is not a serious one.

But South Africa and the Fund cannot ask for it both ways, for the rand to be both strong and weak at the same time. The U.S. Director on the Fund would be pushing too hard, I think, if he tried to close both loopholes. Since the two are antithetical, he can insist that the Fund and South Africa must choose.

The Union of South Africa and the Soviet Union must by this time be getting the message that the two-tier system is here to stay and that its abandonment will come not when the monetary price of gold is raised by some multiple, but when no one has any interest in adding new gold to international monetary reserves. If South Africa wants to join the two-tier system, pending demonetization, I would not object, although this might leave a problem of how to satisfy the nonmonetary demand for gold.

But let us not have a repetition of the clash of wills such as was involved in the "Chicken War" with the Common Market some years ago. No one gained a great deal of glory in that fracas. I almost said "fricassee," but I managed to avoid it.

My forecast is demonetization, but in the long run. My short-term recommendation is to close one of the IMF gaps. For the longer run, it would both tidy up the archaic rule about the gold tranche in the IMF articles, find an accommodation with South Africa, and be alert to stablilize the gold price at some level if the roof feel in.

Thank you.

Chairman Reuss. Thank you.

Senator Percy. Mr. Chairman, unfortunately, I must go to the floor. We have a mortgage credit bill that is coming up in just a few minutes down there that I am involved in.

I wonder if I could break in and ask a few questions and possibly we could get started with Mr. Machlup, who so far this morning has been too silent. And if any of the other witnesses disagree with your response, possibly they could just break in. I have just a few questions whose answers would be very helpful to me.

Once gold is put into the IMF as part of the member's increased quota, is there any way in which this gold can be withdrawn or repurchased? Is this gold lost forever for use by industrial or artistic buyers, for instance?

Mr. Machlup. Senator, it is not lost at all, because the IMF can turn around and resell the gold. Indeed, the so-called mitigation procedure that has been agreed upon among the Group of Ten provides exactly for that. There will be payments of gold to the IMF as the 25-percent part of the quota increase, and then the IMF will resell that gold to the central banks that have sold it to the members that needed it for their quota payments.

So, in other words, the IMF will not gain the gold and the central banks will not lose it; and this is just as it ought to be, because the IMF does not need any more gold than it now has.

Senator PERCY. Dr. Kindleberger, can you explain the background as to how the 25-percent figure was selected by the IMF, as the amount of members countries' subscriptions to be paid in gold? Why was not some other figure chosen?

Mr. KINDLEBERGER. Dr. Bernstein can do it a lot better than I, since he played an important role at Bretton Woods and I was not there.

But I take it what they had in mind was the necessity to give the Fund some international assets of indubitable value, to provide it with a reserve of its own. And the best way to do this was to have everybody subscribe to quotas, the first portion of which would be paid in gold. Now, why 25 percent? There was a big argument about quotas, where they should be set. Keynes wanted trade as the criteria, and Harry White national income. This was a British-American dispute. But once the compromise was made between these two different criteria, the size of the quota was related to trade payments, more trade than to capital movements—the 25 percent was derived from the total of all quotas and a notion as to what the gold reserve of the Fund should be.

Senator PERCY. At that particular time, though, 70 percent of world monetary reserves were in gold.

Why wasn't the figure arrived at closer to 70 percent if that was the actual figure in existence at the time?

Mr. KINDLEBERGER. Because it became quite clear in dealing with drawings on the Fund, that people would draw not to add to reserves but for spending, to meet trade deficits. In particular they drew initially largely in dollars. So it was quite well recognized that the Fund needed dollars. In fact, very early, the Fund sold some gold to the United States to buy dollars, which it invested in Treasury bills to get income.

Mr. BERNSTEIN. Let me see if I can help on this.

The very concept of the Fund is that it will extend reserve credit. It can extend reserve credit only by having resources. If the subscriptions had been wholly in national currency, its resources would have been in dollars, sterling, and other national currencies.

Two difficulties would have arisen in the postwar period if subscriptions had been entirely in currencies.

First, as only the currencies of the surplus countries could be used by the Fund, only dollars, but maybe some minor currencies, would have been available for extending reserve credit to members. Second, the right of members to get credit from the Fund would have been very large relative to the usable resources of the Fund. The Fund would have been illiquid. That is why some people wanted to start the Fund's operations by declaring the dollar scarce. I think it would have been a mistake.

Now, the subscription of 25 percent in gold meant that the Fund would have other usable reserves, resources, gold, which it could sell, to get any currency it needed. And the truth of the matter is that the 25-percent gold subscription seemed, together with the dollar subscription, to give us roughly a ratio of 50 percent between the available usable resources of the Fund and the total quota rights of all other countries. We were aiming at a 50-percent ratio. We could have got that 50-percent ratio in two ways, either by an extremely large subscription for the United States to get more dollars, or by having part of all subscriptions in gold.

As Dr. Kindleberger has indicated, the Fund may have collected in its time $6 or $7 billion in gold from its members. It holds around $2.3 billion now, which is a modest amount, and of no great consequence.

It is true that drawing gold from other countries for subscriptions to the Fund is in a sense diminishing the liquidity of the rest of the world. It is equally true that the Fund does pay the gold out in one way or another. It has sold gold to the United States several times to replenish its balance of dollars. It invested in U.S. Treasury bills in order to get a sure income at a time when its transactions were relatively small.

It has in recent years frequently sold gold to countries in the Group of Ten on the occasion of very large borrowings from the Fund. It then used what it had in the way of needed currencies in the Fund; it borrowed some currencies from the Group of Ten, and it sold gold simultaneously. This is the package nowadays. When there is a big loan, say such as to the United Kingdom or to France, the Fund uses the currencies it has; it borrows from the Group of Ten, and then it sells some gold to the countries whose currencies it needs.

Senator PERCY. I would like to try to understand better the future role of gold in international markets. There is an advertising slogan—eventually, why not now. Certainly, the testimony of many of our own Government witnesses indicates that we are reducing our dependence upon gold in the national field. There has always been an analogy drawn between national and international monetary affairs, and yet today spokesmen, Government spokesmen, are very reluctant to recommend the eventual removal of gold from international monetary systems.

In national markets, back in 1934, when we had a 40-percent gold cover, witnesses were then saying when they were testifying for reduction to 25 percent, that eventually we would remove it entirely. That was a radical statement at the time, and yet we moved from 40 to 25, and last year, without really much of a struggle, we removed the gold cover altogether. If that can be done in a national currency, why then, cannot we look forward to the day when you would remove the dependence on gold entirely in the international market?

Mr. MACHLUP. If I may try to answer, Senator; it eventually will happen. The question is only should we hurry it along, should we try to do it immediately, or should we prefer to see gold in the international monetary system fade away like generals?

I think the best idea is to let it fade away without disturbing the many old people who are so fond of gold as the best monetary base and who believe piously that this is terribly important.

Now, some of the believers will not be around in 10 or 15 years, and others will have learned that it really makes no difference whether there is gold in the cellers of the monetary authorities. Thus, at that time people will not cry about it. And since there is no immediate need to do away with the monetary role of gold, why hurt so many people who have nostalgia for the good old times? So I think it is wise neither to hurt the private believers who have this nostalgia nor to hurt some of the central bankers who still have it. Let it fade away and die a natural death.

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Senator PERCY. In other words, like old soldiers, it will fade away——

Mr. MACHLUP. Right.

Senator PERCY (continuing). And General de Gaule is the symbol of those who cling to gold, but eventually, not now, whose influence and those like him will be lessened.

Is there a rebuttal on that?

Mr. KINDLEBERGER. Senator Percy, I find Professor Machlup's sentiments very touching, but I do not think they should govern an important issue like this.

I tried to say in my statement I would worry about a faster demonetization or attempt to rock the boat, and I would remind you that at one point Professor Machlup would lower the price of gold by 50 cents every 6 months, and that struck me as being a deliberate shock to the system, which we do not know enough about to understand how it would respond, and which would be taking, it seems to me, unnecessary risks. I have in mind a great many banks. We do not know what the reaction in the Middle East would be; we do not know what it would mean to India, whether hoarders there will dump gold on the market, or buy more. We just do not know enough about many important aspects. So while I am moved by the plight of old people and their dreams, what we have to do is worry about real problems.

Could I say that Dr. Bernstein wants to end up with gold tucked away in a composite asset and kept going in an effort to beat what is essentially Gresham's law. He is trying to say if two assets, gold and dollars, would not work, try three, SDR's, gold, and dollars. I do not think that will work either.

I think in the long run, Gresham's law presents a very difficult and important problem.

The Group of Ten and the IMF try to handle the Gresham law problem in the SDR agreement by various sorts of funny holding ratios and other gimmicks. A country doesn't have to hold too much, but it must hold a certain amount. If Mr. Bernstein's ingenuity goes much further along this line, countries when they meet a deficit or make a payment are going to have to pay partly in white chips, partly in red chips, and partly in blue chips.

It seems to me for efficiency's sake, one world money is where we are headed in the long run, not an odd collection of different kinds of money. And where we are going is a very important and interesting question.

Senator PERCY. Then could you clarify for me what you feel the role of gold will eventually be in the world monetary markets?

Mr. KINDLEBERGER. Zero; nothing. I think it is going to be demonetized and gradually, as the industrial demand for gold rises, and it rises all of the time. Gold turns out to be a very useful metal in certain industrial uses, that in wages industrial prices rise, as inflation goes on, so their gold becomes cheaper and cheaper relative to other metals in industrial uses. As this process continues, we are going to find we can gradually free the market and let the price go, but without the sort of collapse that would be a shock to the system, which I think is very dangerous.

I think it is always a mistake to give shocks to an economic system. It may be helpful in some cases, but you are talking a risk that I would be worried about.

Mr. BERNSTEIN. I would approach it this way, Senator: In the world today we have $41 billion of gold in the monetary stock, most nearly all held by governments or central banks, a little of it, a little over $2 billion held by the International Monetary Fund. Now, the world needs reserves to settle its international payments. You cannot demonetize this $41 billion of gold without finding some other reserves to replace them. I do not believe the world is prepared to create and accept $40 billion of fiduciary reserve assets.

As I see the situation, it will develop in a way not unlike the silver situation. When the United States went on a gold standard, when France went on a gold standard, both countries held considerable amounts of silver as well as gold. We retained the legal tender character of the silver dollar and France kept the silver 5-franc piece as full legal tender.

There were purists who said this modified the gold standard and they called it a limping gold standard because the reserves were not all gold and some silver coins were legal tender. We kept large amounts of silver in the Treasury, but in time our silver holdings became small relative to our gold reserves. Now, the right approach is to let the growth of reserves in SDR's gradually overshadow the amount of gold which is no longer a dependable source for the growth of reserves.

There is no need to demonetize gold. We cannot replace $40 billion of gold with fiduciary reserves. But if the SDR's work, and they will, then in the course of 10 years we will have just about as much SDR's in international monetary reserves as gold. There will not be any large additions to the monetary gold stock. I rather feel the way Professor Kindleberger does. It does not take much inflationary bias, very little, for the prices of primary commodities, including gold, to creep up. I do not think a trend rise in the private price of gold is going to cause any trouble.

But now, the other part is that as we keep this limping standard, if you wish, the international monetary system will have multiple reserve assets. A good part of the reserves of the world will consist of gold. A very considerable part will consist of dollars and other foreign exchange. Some, and ultimately the greater part, will consist of SDR's. I do not really know how central bankers will view these different reserve assets. I agree with Professor Kindleberger, it is not easy in an unstable world to have everybody's attitude toward these different reserve assets the same.

I am not in favor of having every reserve transaction done with a mixed bag of assets, with the International Monetary Fund standing over your shoulders to see that you have really followed the rule that gold, foreign exchange, and SDR's must be used in appropriate ratios. On the contrary, I think such a system is too complex and even unworkable. I would prefer to see the different reserve assets earmarked with the International Monetary Fund in a reserve settlement account. Countries would be given a credit, equal to what they earmarked, in a composite reserve unit, and transfers of reserve would then be made by debiting and crediting the reserve settlement account. The techniques of using reserves would not be changed and countries would not transfer a mixed bag of reserve assets. Of course, every time there was a credit or debit to the reserve settlement account there would have been an implicit transfer of all of these earmarked reserve assets.

Gold is not going to disappear from the international monetary system unless we get something like a repetition of the silver situation. How long did it take for silver certificates to disappear from our monetary system?

Senator PERCY. But what has happened to silver; it is in the overall use of silver, taking into account the industrial uses that we must look at the problem of demand for silver.

Mr. BERNSTEIN. It is much greater than the current output.

Senator PERCY. Could I then draw a comparison between silver and gold, having spent a quarter of a century in an industry, the photographic industry, that was a huge silver user. My competitors in Rochester with the yellow box always had larger silver reserves than the Treasury of the United States, it seemed to me. As we reduced our silver usage in coin, it did not seem to adversely affect use in industry. The industrial use is tremendous.

Now, lest we crack the market on gold and start a wave of selling it short, in the last 10 years gold industrial use has gone up about 300 percent.

What do you foresee the use if it is a diminishing factor in the international monetary field? What do you look forward to as the industrial and artistic use of gold? Certainly, just electronics and space alone have opened up whole new uses for gold that we never envisaged before.

What is the outlook if we increase usage 300 percent in 10 years; what is the outlook in the future for industrial and artistic use of gold?

Mr. MACHLUP. Senator, with all of these growth rates, we must realize that anything that starts very small can grow by very large percentages. So the fact that the industrial use of gold has grown by enormous percentages is due to the fact that it started from practically nil.

Now, it still grows, no doubt, and it has been estimated that it grows by 10 percent a year or, as some people think, by 20 percent a year; but these growth rates will eventually come down. That does not mean that eventually the industrial use may not be large enough to absorb the entire new gold production.

When this time comes, gold will no longer play an important monetary role; when all newly produced gold is absorbed in industrial and artistic uses, monetary authorities may feel inclined to reduce their gold holdings. Until very recently, they have always been ready or eager to increase them, but one day they will be prepared to begin selling them.

Just when this will come, we cannot say. The guesses vary. Some believe that by 1975 the industrial and artistic demand for gold will have caught up with the supply from new production. Others think that it may take longer. But it does not really matter whether this comes in 1975 or in 1979; it will come.

Senator PERCY. Mr. Chairman, do I have time to switch to one last question, with the indulgence of my colleagues?

I would like to get to a substantive sort of a nitty-gritty question on where we are going. It really relates to a debate on the floor of the

Senate this morning. We have two opposing views, one view presented by Senator Javits and myself that we are concerned about the nation of Japan as an industrial and economic giant today, but having a trade policy that looks as if it were a developing nation, and restrictive on imports of capital and goods. And I mentioned the very strong comments that I made in Japan last month to Mr. Aichi and others, about what would happen if they continued to export steel to us in unlimited quantities and then prevented that very steel coming back to them in the form of cars or refrigerators, or whatever it may be, because of their restrictive policy on the import of goods. Moreover, Japan does not permit any manufacturers to come in and invest capital in Japan.

Right at this moment, Strom Thurmond is on the floor, I understand—that is what makes me nervous about being here—he is asking for restrictions on textiles and 70 Senators have joined in asking for restrictions on shoes. I see in a period when we need to free up and keep the channels of trade open, I see a growing restrictive attitude and a nationalistic feeling. I have come from Europe and pleaded with the Commissioners of the Common Market that if they imposed an import tax on soybeans and soy products, that U.S. retaliation would harm them tremendously.

So we are worried now about being able to maintain trade balances. And I would just like to read a sentence that Dr. Hendrik Houthakker gave as a conclusion on the elasticity of demand for imported products.

He said:

> Even if all countries grew and inflated at the same rate the trade balance of some countries would still be subject to improvement or deterioration because of disparities in income elasticities of demand for imports. Such disparities are most marked in Japan, the United Kingdom and the United States, and may help explain these countries' balance of payments developments during the postwar period.

With regard to the United States, Dr. Houthakker predicted a deterioration in our trade balance with the world industrial countries—and we have seen ourselves move from a surplus of $7 or $8 billion down to where we have almost wiped out that trade surplus today—which he stated would "be of special importance in our financial relations with them. Unless the industrial countries become steady exporters of capital to the United States there will have to be differences in relative growth rates or in inflation, or exchange rates will have to be adjusted."

My question would be whether you accept these conclusions by an eminent member of the Council of Economic Advisers and of the three solutions which he has suggested for stabilizing our balance of trade; that is, differences in relative growth rates, differences in inflation, or adjustments of exchange rates. Which do you see as the most realistic and which do you consider the most desirable?

That is a pretty long-winded question.

Mr. Machlup. It does not take me long to make up my mind on this question. I certainly would oppose the United States reducing its growth rate in order to get into external balance. I would also oppose the United States pursuing a policy of deflation. A mere retardation of demand inflation or price inflation would not suffice to get us into external balance. So it is definitely the third of the three solutions that I would buy; that means, adjustment in exchange rates.

I may add, Senator, that I believe the analysis of the Council member to be correct: these differences in income elasticities do make for continual disalinements of exchange rates, and thus for imbalances in the external positions of the countries. But I submit that it would be an exaggeration to say that these differences in income elasticities of demand for imports alone could explain the present dilemma of the United States, that is, the enormous deterioration of our trade balance. This deterioration in our trade balance has several more significant causes. One cause is that during the last few years we have had relatively more demand inflation and price inflation than the other large industrial countries. Another cause is, that we have drastically reduced our capital exports and this also usually effects the trade balance.

To repeat, the deterioration of our trade balance cannot be explained alone by the differences in the income elasticities of demand for imports. But, to come back to your question, I am without reservation in favor of the third solution.

If I may also comment on your previous statement, I deplore, as you do, the tendency toward restrictions on trade and restrictions on capital movements, and I deplore Japan's backwardness in its policies in these areas.

Japan has developed enormously and has made rapid strides, but there has been a cultural and political lag. The country has not yet developed that outlook toward foreign relations that normally goes with industrial development and economic growth. I can only hope that the Japanese will soon wake up and know that noblesse oblige and also that their own interest lies not in restriction, but in a gradual but fast abolition of the restrictions that they have been imposing on imports of goods and of foreign capital.

Senator PERCY. I wish I had had you with me when I was with Mr. Aichi. I simply charged that he was letting the foreign economic trade policy be set by MITI which is controlled by domestic interests, and if he would like the same thing to occur here, let the shoe industry, let the textile industry, even let the photographic industry set our trade policies, would see his markets shut off so fast they would not know what hit them. Japan had better number the days that it can continue to exploit our markets without ending what I consider to be a ridiculous policy on their part.

They have nothing to fear from opening their doors. I know enough about that Japanese market to know it is very hard to penetrate it; it is exceedingly difficult; they are exceptionally strong, and the fact they spend less than 1 percent of gross national product in defense alone means their tax load is so much less it is very hard for us to compete.

But they are now hypocrites, really, in the way they are handling their trade policy and they had better realize it. And I have been a good friend of theirs for many years.

Mr. MACHLUP. But, Senator, I do not know whether to threaten is the right policy. Policies of retaliation and threat have never worked out satisfactorily.

Indeed, if we threaten to give more protection to our shoe industry or textile industry, we may give such additional strength to these protectionist movements in the United States that we will not be able to contain them. I would say, the right stance would be to tell the Japanese that for their own good they should give up their restrictionist and protectionist policies. But we should not give any aid and comfort to the domestic pressure groups here that want to push us toward increased protection for American shoes and textiles.

Senator PERCY. Call it a threat or whatever you want to call it. I have tried to tell it as it is over there to the business community and to the government and everyone else. But they just totally undercut our arguments, those who believe in freer trade, by their trade policies that are so utterly unfair and uncharacteristic.

Thank you very much.

Does anyone else like to comment on that?

Mr. KINDLEBERGER. I want to associate myself with every statement that Professor Machlup made, except the flexibility of exchange rates. I cannot go that road.

This means that I end up with a differential rate of inflation, which I think is happening to the Italian and Japanese and German rates of inflation. Ours is not yet under control, but theirs is equally out of control, or more.

Mr. BERNSTEIN. I would say this, I think the statement of the different elements that can lead to balance-of-payments problems is correct. I think the very slow growth in Germany in the last 5 years, has led to a relatively small increase in their imports. Their exports have not increased much more than those of other countries. The consequences of that has been a very large balance-of-payments surplus in Germany. Part of that is due to the big inflation we have had. I think inflation, differential rates of inflation, are a cause of payments problems.

In the case of Japan, which has a very rapid growth, wage rates are far too low for productivity and that has held down export prices below what they should be. When I say Japanese wages are too low for their productivity, I do not mean in comparison to wages other countries pay. I mean in comparison with the share of the product that workers get. Japan has the lowest proportion of consumption to the gross national product of any large industrial country, despite the fact that the Government does not have much expenditure on defense. I interpret that to mean that in Japan wages are too low for productivity.

Now, as for remedies, first, there is a good reason for stopping inflation to the extent that one can, quite apart from balance of payments.

Second, one cannot change rates of growth to adjust them to the balance of payments; but what a country can do is to adjust the rise in wage rates to the differential rates of growth. A country like Germany ought to have higher wages because its demand for the world's goods has increased less than the world demand for its goods.

We finally come to the fact that all of these traditional ways of adjusting imbalances do not always work so well. And the question then becomes, should we have flexible exchange rates. I believe that there is a great deal of merit in having fixed parities, that is, the system we have today. But fixed parities have to be adjusted relatively promptly to changes in the international economic position of a country. I think that if inflation is going to be a way of life, it inevitably will have differential effects on the balance of payments of different countries. In that case, we may have to have more flexibility in exchange rates.

I would not go to freely fluctuating exchange rates; I think they can be very unbalancing and have seriously disruptive effects. But I think we can find ways within the present system of providing greater flexibility in the exchange market.

Senator PERCY. Thank you very much, indeed. I appreciate your courtesy, Mr. Chairman.

Chairman REUSS. Dr. Machlup, while you have had an opportunity to express yourself on some of the points, I would not like to ask you to proceed to touch on that which you have not yet covered and then we would like to ask you all some questions.

STATEMENT OF FRITZ MACHLUP, PROFESSOR, PRINCETON UNIVERSITY

Mr. MACHLUP. Thank you, Mr. Chairman.

I envy my colleague, Professor Kindleberger, who was able to start his statement by retracting a previous one, which he now considers to be wrong. I envy him because a witness usually enhances his credibility by admitting and retracting an error.

Unfortunately, I cannot think of any serious error that I have made recently. I apologize, but I know it is only to my disadvantage.

Perhaps I may make a few comments on some of the things that my colleagues here have said; one of the issues is the demonetization of gold.

This word has so many meanings that it is very hard to say what a particular person means when he uses the word "demonetization." Let us remember the demonetization of silver by the so-called crime of 1873, when we stopped the free coinage of silver. This did not mean, however, that we immediately sold all the silver in the Treasury. It has taken 100 years to sell that silver.

Thus, if someone says that not buying gold is demonetization of gold, he perhaps has the sanction of history, because of the case of silver. But if demonetization of gold is to mean a clearance sale of all official gold holdings, then I am not in favor of immediate or instant or rapid demonetization of gold.

Chairman REUSS. How about nonremonetization?

Mr. MACHLUP. This is precisely our position, yes. Nonremonetization of gold, or nonmonetization of new gold. It is a splendid expression, and this is what we want.

I did not, however, want to rock the boat by disturbing the price of gold greatly. It is true that in 1960 I proposed small reductions in the price of gold. I think it was by no more than 3 percent a year, or even less, and for a few years only. I still believe that, if my proposal had been accepted in 1960 or 1961, it might have prevented several of the shocks and crises that we have had since then.

I still do not want a crash in the gold market. Last year I wrote in my book on the SDR's—its title was "Remaking the International Monetary System"—that I do not want the price of gold to fall so much that people get unnecessarily hurt. Indeed, I said there that I would be quite in favor of governments coming to the aid of the holders of gold by preventing its price from falling too rapidly and too low.

I am quite willing to accept Kindleberger's suggestion of a support price of $32.50, or the recent proposal by the physicist Davies of a support price of $30. I would not even mind if it is $35. The exact figure really is not important, and there would be no great harm to the international monetary system if that price were actually supported by occasional purchases of gold, if necessary, by national or international monetary authorities.

But I do not think such purchases would be necessary for very long, because, as I said before, there is a good chance that private demand for gold by processors, not just speculators, will in the next 6, 7, or 8 years increase sufficiently to absorb the entire output of new gold.

Of course, there may be changes in gold technology and that would be a different matter. If the technology of gold mining or refining became very much cheaper than it is now, then we would have to abandon our benevolence toward gold holders and since it would be very wrong to accelerate inflation by continuing a policy of supporting the present price of gold when its production cost is lower.

Now, Mr. Chairman, I would like to address myself to some of the questions that you put to us by correspondence.

Let me say first of all, that the occasional official gold purchases from the Union of South Africa do not worry me very much. These purchases are estimated to have been about $100 million worth of gold, chiefly through borrowings by the South Africans from the International Monetary Fund which they could later repay with gold.

But what is $100 million worth of gold? It would be very much for me to be sure, but it is not very much for the world or for the parties concerned. It is 10 percent of the annual output of the Union of South Africa. I have no gripes about it. I admit that I do not like their apartheid policy, but I do not think it would be an appropriate punishment if we made it harder for them to sell their gold. I doubt that it matters much if the IMF has to buy 10 percent of their annual output. And it would not even matter if we had to take 15 percent of their annual output.

The question was also raised, Mr. Chairman, whether we should try to come to a compromise with South Africa regarding official gold purchases. I do not see that there is any advantage to it. We have nothing to gain and nothing to lose by making or not making a compromise. The people who really want such a compromise are, of course, the South Africans. They want to dispose of their surplus gold in the official market, so that they can continue to get a higher price in the free market. I believe that we should leave any initiative to them and, if they press us very hard, I think we might agree to some concessions only because some of the other industrial nations seem to be rather anxious to give in, at least to some extent.

It is not worth making enemies; it is not worth causing an international fracas; and so it would not break my heart if there came about an agreement that the International Monetary Fund or some national monetary authorities would occasionally take some of the surplus of South African gold production. This surplus is still quite considerable and the fact that more of it has been offered in recent months for sale in Zurich has led to a strong decline in the market price of gold.

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The question was asked whether the other industrial nations seemed to be very dissatisfied with the two-tier system. I have not noticed any such dissatisfaction; on the contrary, most of the seven nations that joined in the agreement of March 1968 are as happy with that two-tier system as we ourselves are.

There was a question, Mr. Chairman, whether the United States should consider withdrawing its commitment to purchase gold at $35 an ounce from any foreign monetary authorities that have clearly violated the spirit of the two-tier agreement. I believe there are many ways in which the two-tier agreement could be circumvented. We might not even know which bank was doing what, for, if two or three central banks played it in cahoots, we could not very well enforce any measure against the real culprit. Again I think it is not important enough whether one or two of the smaller central banks really do something that violates the spirit of an agreement to which they were not even a party.

I wonder whether we are not sometimes too much aroused about these issues because we allow our sentiments about the South Africans to influence our considerations. We are angry with them, I suppose, for three different reasons.

One of the reasons, I am sure, is their apartheid policy. The other is their complicity with, or encouragement of, the gold lobby and the campaign that led to unwholesome speculation in the gold market and to serious disturbances in the international monetary system. Many of us resented these activities.

But there is a third reason. I may mention, however, that Mr. Bernstein on one occasion disagreed with my statement of this reason.

I consider the gold policy of South Africa a policy of price discrimination. The fact that they are willing or eager to sell gold at $35 an ounce to monetary authorities, but like to get a premium price in the free market is what I call price discrimination. It means selling at a higher price in one market but accepting a lower price in another market.

Monopolistic price discrimination is a practice which at least those who agree with the objectives of antitrust legislation do not like. I think this is the third reason why we may be angry with the South Africans as they attempt to sell to monetary authorities more of their output at $35, so that they can more easily withhold gold from the free market and collect there a premium price. But no matter how strongly we dislike the policy of price discrimination, we should not get too nervous or excited about it. And we should not cause a big international imbroglio on an issue of so small importance.

Mr. BERNSTEIN. I think I should explain where we differ on the question. I think that South Africa's purpose in wanting to sell monetary gold, its selling such a little bit, it is to establish the very thing we are talking about—the eligibility of newly mined gold for incorporation in the monetary stock.

Why do they want it? Well, they want it for different reasons. One, of course, is the fear of what may happen to the price; it may go below $35, and they want a floor.

The second, I think, is that someday there may be a reversion of attitude toward gold, maybe the monetary price could be changed, and they want to be eligible to sell their newly mined gold at the higher price.

I think there is in the mind of some gold mining interests the feeling that South Africa can exploit the differential market, although I do not believe so. That is the difference between what Fritz believes and what I believe. It is whether and to what extent South Africa can exploit this dual market. My own opinion is that it is wrong to have discriminatory pricing; but I doubt very much South Africa can gain from it if they try. I think there are many others who would share in the benefits, those who do not have to sell gold at the monetary price, including private persons holding gold. South Africa must lose on every ounce it sells to the monetary authorities, at least, it is an opportunity cost. They are going to bear all of that cost. The others will share the benefits with them.

But whether or not I am right in this analysis, I agree, discriminatory pricing is not the right way to do it.

Mr. MACHLUP. Good.

Chairman REUSS. Thank you.

May I ask now a rather specific question about the upcoming quota increase in the International Monetary Fund. As I see it, there are two sufficient reasons for wanting a quota increase; one is to get more hard currency so we will be in a better position to make loans; the other is to adjust some disparities in the voting power of the members which have gotten a little askew since 1945.

In order to achieve these useful ends, the International Monetary Fund people seem to be embarking upon an adventure very like that discussed in the fable about the discovery of roast pig, where in order to get a pork roast, the natives used to burn down the entire house, the pig with it.

The IMF seems to be moving toward a necessary improvement in its supply of hard currencies, but also toward an unnecessary restriction of its holding power by maintaining the absurd and archaic 1945 requirement of putting up 25 percent in gold. Maybe there will be some mitigation or with some other fancy scheme, although we have not yet been told about that.

My question is then, isn't this a rather childish way to proceed? Why doesn't the IMF determine what it wants and then move straight forwardly in that direction, without endangering the monetary stability in the future by creating some sort of a pressure to get new gold into the system?

Let us go across the board on that one.

They have to agree on something anyway, why not agree to shake off the archaic 1945 requirement that you have to put up 25 percent in gold. The monetary world has gone in just the opposite direction since then and said in Washington, at least the leaders said, no new purchases.

Mr. BERNSTEIN. I think that if the world in 1945 had been as it is today, with the Fund having access through the general arrangements to borrow, so that it could keep its liquidity by borrowing, we would not have put the gold subscription provision in the fund agreement.

Second, it is quite true that this is now archaic, but it takes an amendment to the Articles of Agreement to change it. There are far more important topics on which the Articles of Agreement might be amended than this gold provision.

I, myself, look forward to the time when the use of gold by the Fund, as well as by the members, will be replaced by the use of a common reserve unit; and I have explained in a paper how the Fund would use gold in the future.

I look at this as a pragmatic problem. The Fund has taken in $6 or $7 billion of gold from its members. It has distributed that gold again through various operations. I have no fear that the mitigation provisions will put pressure on us or pressure on the United Kingdom or on any other country. The gold from other countries will move in small amounts to the Fund. The gold bought from us will be deposited by the Fund with the United States. Ultimately the fund will disburse the gold through the purchases of currencies as it needs them in its operation.

So, while I think the logic of the argument you have given is correct, I think its practical significance is small. We have much more important things to think about in connection with the Fund and gold and with countries and gold than to bother to use the complex amendment procedure for such a minor matter.

Chairman REUSS. Would you agree that Congress—which will have next year, I would think, the task of approving or disapproving the proposed increase—that Congress should hesitate before going right ahead and approving that quota increase? Unless it receives assurance somehow or other that in reasonably foolproof form the damaging effects of the 25-percent gold payment will be obviated, either by mitigation, by this new triangular device, or by everybody agreeing de facto to sit still for putting SDR's or hard currencies rather than gold into the 25-percent "gold" subscription. Whatever the arrangement, should Congress not satisfy itself against these adverse effects?

Mr. BERNSTEIN. I do not think there is any need for Congress to go that far to satisfy itself. The truth of the matter is, the Treasury would never approve a vast increase in quotas when it must expect that the gold part of the subscription of other countries would in large part be purchased from us, unless it had the assurance you are asking. In short, I am saying the Treasury has the assurance that you are suggesting Congress request.

Chairman REUSS. Well, what you are saying is that, when we ask this question next year at the hearings, the Treasury will be able to give an ironclad answer?

Mr. BERNSTEIN. Yes.

Chairman REUSS. Would either Dr. Kindleberger or Professor Machlup like to respond?

Mr. KINDLEBERGER. I have spoken already on this in my statement, but I would add a question on what I think is implicit in your question. You think gold is very valuable. You are worried about losing gold to the International Monetary Fund. You are worried that our most valuable asset may be threatened. I think the thrust of the testimony of the three of us is this, in the long run, gold is going to become less and less an important part of the system.

Now, I would accept the fact that a big loss of gold by the United States as people come to us to run down dollars, to buy gold to put into the Fund, might be subjectively disturbing. While it does not affect our balance of payments, nor affect us as a bank, it still may be misunderstood.

But I do not want you to think for a moment when I am in favor of mitigation, I am in favor of mitigation because I think we want to hang on to the gold at all costs. The value of the dollar is what the dollar will buy, not gold.

Chairman REUSS. What you are afraid of is that if people to whom these things matter, read that the U.S. gold supply has gone down—and theoretically it could go down as a result of the quota increase by more than a billion dollars if everybody took their gold from the United States—this decline then could be unsettling. That is your consideration; is it not?

Mr. KINDLEBERGER. But at the moment, sir; I am anxious that the Joint Economic Committee not be concerned by it on objective grounds. It is sensible to be concerned. But let us not succumb subjectively ourselves. We all have a miser's instinct in us, economists not the least, perhaps most, and we feel if we are losing gold that it is vital. That instinct should be corrected. Gold is not a very important asset, and if we were to lose gold by some silly IMF regulation, we should not get too upset about it. That is my point.

Chairman REUSS. Indeed, would you suggest it might be good business for the American taxpayer to find people around who still want to pay $35 an ounce for official gold, when the movement, if any, is likely to be in another direction?

Mr. KINDLEBERGER. If I thought public opinion was sufficiently sophisticated; yes, but I am afraid it is not.

Chairman REUSS. Senator Javits?

Senator JAVITS. Well, I think Professor Machlup might want to coment on this question. I do not think he has had a chance to do so.

Mr. MACHLUP. Senator, I agree fully with what my two colleagues at this table have said. I agree it is not important, really, how much gold we have; at least it is not important from any economic point of view. It may be a symbol for some people and some people may take foolish actions for merely symbolic reasons. But I would consider it a mistake if Congress or one of its committees supported and reinforced the view that our gold holdings are an important asset of the United States. I would be much happier if it were clearly stated that the gold is not important to us at all.

Senator JAVITS. I have stated that, but I have been a very lonely voice for a long time. However, it looks as if I am gathering allies. And my assistant tells me that Dr. Kindleberger was very gracious in referring to his correspondence and mine of some time ago when I first suggested that we did not have to feed the London gold market.

I had a question to ask of you gentlemen, which is a little bit broader than the rather specialized focus of gold. All of you have been identified with some other concept of the world's monetary base, and, of course, that includes also the famous concept of a link. That is, what shall we do about using these unbelievably useful pieces of paper that we have, unlike the Communists, to give the developing areas a better chance?

I would like to ask you each in turn, if you would feel that within this context you could comment as to what you see happening now, in terms of the development of the world monetary system; also, what else you would urge us to favor, bearing in mind that we now have a two-tier gold system, not necessarily permanent, but in any case an accommodation for the situation, and that we are beginning the issue of SDR's.

Now, of course, the only missing member from that point of view is Professor Triffin, but I am sure you are all very well acquainted with his views.

So I wondered, starting perhaps with Mr. Bernstein—who is a very old friend of mine, by the way—if we would not within this context have some concept of where we are going and what you would like to see us support.

Mr. BERNSTEIN. I think that we have been going and will continue to go in a direction in which the role of gold will pass from one of predominant importance to simply another reserve asset, quantitatively less important in time than SDR's.

I should like the system which is now developing so many different reserve assets—gold, dollars, sterling, and SDR's—to move toward a kind of unification through the establishment of a reserve settlement account in which all of the reserves would be earmarked. Deficit countries, when they sell reserves, would use all of the reserves, without discrimination, in the proportions in which they hold them. The surplus countries would accept all reserve assets, they would have no choice, in the average proportions in which they are sold by the deficit countries.

I would like to see transactions in reserves come to be no more than changes in debits and credits on the books of a reserve settlement account administered by the Fund. To my mind, this is a logical development. It is almost certain to come; it will become more important to move in this direction as the amount of SDR's becomes very large.

Now, on your other question, Senator, about the link; that is, the link between aid and the creation of reserve, I need not argue that aid to the less-developed countries has never been very large. The richest countries, like ourselves, give a very small proportion of their income, of their product, to the less-developed countries. And some of the countries that talk most about aid give the least.

It seems to me that one of the hindrances in giving aid—and that has been true for us—has been the fear of its impact on the balance of payments. That is why we have tied aid; that is why we have been using technical devices in which the aid funds remain outside our balance of payments until they are used. These are costly devices to the countries that get aid; they do not get the most for the money.

I think as reserves are created through SDR's, the whole problem of maintaining international balance will to some extent be eased. I do not think countries can give away the reserves they get while they retain whatever obligations are involved in accepting them, but I do believe they can be more generous. Distributing the new reserves to the less-developed countries, say in the proportion in which their quotas are in the Fund today—which may or may not be fair—would not insure us against an adverse effect on our payments.

The general assumption that we could earn back the same proportion of SDR's as we give away is not correct. Japan, which does a lot of business with the Asian countries, would in fact earn far more than the share it now gets of the SDR's. France and the United Kingdom might be very close to the same. The Germans would be much less and we would be considerably less. That is to say, our proportion of the exports of the Group of Ten to the less-developed countries is less than our share of the quotas in the International Monetary Fund.

But I do not see why we should not do what India's Governor suggested at the last annual meeting of the International Monetary Fund. He said that Mr. McNamara will not fail to remind all of the rich countries that now with the SDR's being added to their reserves, they can be more generous and much bolder in providing for the less-developed countries.

These difficult questions regarding the linking of aid with SDR's must be approached gradually until we see for sure what the effects are. I would like to see countries voluntarily increase their aid when they get SDR's before we move on to the concept that all of the new reserves that are created should be distributed to the poor countries. Let all countries take cognizance of the fact that they are now in a better position to give aid.

Incidentally, the Minister of Finance of Italy said that his country may unilaterally decide to take a considerable part of the SDR's allotted to it to increase its aid to the less-developed countries.

Senator JAVITS. Thank you very much, Dr. Bernstein.

Mr. KINDLEBERGER. Senator Javits, you asked a difficult question; it is hard to put together, synthesize, and answer immediately, because like those of many academic people, my views are fairly involute and do not lend themselves to simple summary statements.

I think that the international monetary system functions at two levels. One is very much ad hoc, worked out by business and banking institutions throughout the world, and by central banks in dealing with practical problems. The other is the formal world resulting from agreements, including the IMF, the Group of Ten, SDR's, and the rest.

The ad hoc international monetary system, which evolved rather than sprang full blown from the brow of international economists has two main components. One is the Euro-dollar market, the other is the swap network which grew out of the Basel agreement.

There is some doubt in my mind whether the ad hoc international monetary system of the Euro-dollar market and the Basel arrangements is not the real one, and the IMF, G–10, SDR's, and so forth, function within the system as a sort of shadow play, on the periphery rather than at the center.

In a sense, the two systems are in competition, although there are many links running between them. In the long run, the world needs a single currency and a single world central bank. It might evolve from the IMF, the G–10, and SDR's. It might possibly—and I tend to think more probably—from the Bank for International Settlements at Basel and the Euro-dollar market. We may gradually regulate international monetary and credit conditions by open-market operations in the Euro-dollar market. The beginnings of such a system are represented by the action of the Swiss National Bank and the Federal Reserve Bank of New York at the yearends of 1967 and 1968 putting dollars into the Euro-dollar market cooperatively to prevent a yearend squeeze. The Bank of Italy conducts open-market operations in Euro-dollars, and so does the Bundesbank of Germany. If we coordinate these sufficiently, I see a rudimentary world bank evolving at this important connection among national money and capital markets.

It is more and more difficult for an individual country to have an independent monetary policy in today's world of free capital markets and in a world where capital restrictions are less and less effective.

So I see the development of the international monetary system into a single integrated one over the years ahead, possibly through the IMF, possibly through the Basel arrangements and the Euro-dollar market, possibly through some merging of the two systems, through some sort of working arrangement between the IMF and the BIS, getting them together, making a world bank out of them. I do not know the path but that is where we have to go in the long run.

Senator JAVITS. Thank you.

Mr. MACHLUP. I shall address myself to the question regarding the link; and by "link," of course, we mean a formal link between the distribution of SDR's and aid to underdeveloped countries.

There is an informal link, which consists in the fact that the issuance of SDR's may lead to a liberalization of policies regarding capital movements and trade; such liberalization would be indirectly helpful to developing countries. It can be very significant and I hope that this will actually be the case.

About the formal link, I once wrote—I think it was in 1964—an article in which I discussed the economic, political, and moral implications of such of an arrangement. My answer was that one really could not in all honesty come out either one way, favoring or opposing it without reservations. There are sound arguments in favor of establishing the link and equally sound arguments against establishing the link.

Concerning the politics of the situation, my analysis was chiefly this: by an issuance of the SDR's, directly by the IMF to the developing countries, one could make it possible that a transfer of resources takes place from the richer countries to the poorer countries, without any decisions of the legislatures of the donor countries, that is, without the consent of Congress as far as the United States is concerned.

Now, is this good or is it bad? The answer depends on how much you want foreign aid to be more generous. If Congress is too stingy, or ungenerous, or, to put it in a different way, if Congress is opposed to an expansion of foreign aid, then you could thwart the will of the Congress by making a link arrangement. If you like the United States to be more generous, than the Congress is willing to be in its appropriations, then you would welcome a system, by which the aid is given through an issuance of SDR's by the IMF without requiring a Congressional appropriation. On the other hand, if you prefer Congress to have its way, then you would be opposed to the link.

To repeat, it is a question of our political philosophy; we may favor foreign aid more generous than Congress wants it to be or we may prefer that the Congress has its will. There is no obvious answer; no clearly right decision for or against the link is possible.

The same statement can be made about the moral issue. You could say that, if countries were willing to pay with their exports for accumulating a pile of gold that serves no real purpose, then they should be just as happy to allow such exports in exchange for SDR reserves—so-called paper gold—plus the good feeling that developing nations will be helped thereby.

You might even regard it as immoral for a country to be willing to give the products of its industry to people digging useless gold out of the ground but to refuse the product to people building roads and hospitals in developing nations.

From this point of view, our moral judgment should favor acceptance of the link. Yet, the link is a devious way of achieving your end; we would make the decision without regard to the moral judgment of the people, the voters, and this seems politically immoral.

However you turn it, there is not a clear verdict in favor of a formal link, nor is there a clear verdict against it; and this makes it so difficult to come to an unqualified answer to your question.

Senator JAVITS. Thank you very much, gentlemen. It has been very illuminating.

I would just like to add one word—and I have to go and vote—as food for thought.

I do not think any of you took into comtemplation what I considered to be very stern political reality, and that is that on the whole, the world will no longer accept the individual judgment of individual nations, no matter how powerful, as their standard of value, or as determining their level of national investment. And I think for that reason, if not for the technical reasons and the highly professional reasons you have given, we will have to move and move quite quickly to an international system of control. Whether that will be IMF or some international Federal reserve, I do not know; but in any case, I can assure you that the world simply will not live congenially with the idea that our dollar or the unilateral desires of our Congress or the arrangements made at Basel or any such considerations are going to run the destiny of their hundreds and hundreds of millions of people.

So if we want world peace, we are going to have to move, I think, very quickly in the international control direction.

Chairman REUSS. Thank you very much, Senator Javits, particularly for your observations.

I would like to spend a little more time, gentlemen, on the question, what if the price of gold starts going below $35 an ounce?

First of all, leaving aside the question of any possible agreement with the Union of South Africa, I take it from what you gentlemen have said that some central bankers either now or in the future may become worried that the reduction in the free gold market price of below $35. They might become upset because whereas they thought they had an asset that was worth $35, not only internationally, but also privately. Now, as the price pierces the 35-percent level on the down side, it turns out that they do not.

Would it disturb any of you if the International Monetary Fund on a sort of "be kind of central bankers" basis, said, "Don't worry, gentlemen; if the price should go below $35 an ounce, we would agree to buy up your distressed merchandise, gold, at $35, and let us socialize the risk, instead of having one individual central bank bear the risk."

If such a declaration became necessary—and I do not know that it is—is there anything wrong with the International Monetary Fund making such a declaration and thus easing the disquiet of central bankers?

Mr. BERNSTEIN. I am not sure, Congressman, that I got the full implications of your question. Your concept must start with the proposition that countries will not buy newly mined gold hereafter. Therefore, all newly mined gold goes into the private market; that in this private market, at some stage, the price falls below $35 an ounce, but even at that stage, no central bank will buy newly mined gold or privately held gold.

Is that the essence?

Chairman REUSS. Yes.

In other words, the March 1968 philosophy, let us say, is observed. I do not know whether this is a real problem or not, but there is much discussion of it. If it is a real problem, wouldn't a IMF declaration such as I have described be a simple way out of it?

Mr. BERNSTEIN. I do not think it is a real problem, but nevertheless, it is a contingency that could occur and there is certainly no harm in thinking about it.

I would like to express the opinion that if all newly mined gold has been sold in the private markets in the past, before we had so much inflation, before the growth of industrial demand, the probability is that the price of gold would have been well below $35 an ounce. That is to say, it was the monetary demand which until recently, possibly even now, keeps gold at the price of $35 an ounce. Nobody thought it was strange for monetary authorities to buy gold at this price, which was not based on ordinary economic considerations—that is, cost of production or supply and demand in markets—but was based on a theory of an international monetary system. I myself feel that it is still not desirable to let the price of gold fall below about $35 an ounce in the private market.

But on the assumption that this is what has been decided, and my advice is then asked, my suggestion is that it would be desirable to assure that until some other arrangements are made on gold—and I may mention one of them—that the price of gold among monetary authorities remain at $35 an ounce. If there are central banks that are reluctant to buy it from other central banks, then I see no objection to having the Fund, directly or indirectly, absorb the gold.

I have no objection to giving such an assurance. I do not think it is necessary, because I think it is inherent in the Articles of Agreement that certain payments to the Fund must be taken at $35 an ounce—out of the monetary stock, certainly.

But if it would reassure anybody, I see no harm in the Fund issuing a statement that its own policies, its own regulations, its own rules, all serve to maintain the equivalence of gold and dollars at $35 an ounce in international settlements and that it will continue itself to deal in gold on that basis.

Chairman REUSS. Would you differ, Dr. Kindleberger?

Mr. KINDLEBERGER. It seems to me the trouble may lie in dishoarding in the central banks, but in dishoarding on the part of the Middle East and on the part of India; and this may become panic dishoarding if the price decline goes far.

The question is, How far you want to let the open market price go down? In order to prevent the possibility of panic of this sort some limit ought to be set to price declines. The question is, What limits and set by whom?

Suppose gold dishoarders sell through Swiss banks; should the Swiss take all of the burden? Suppose they were selling for dollars;

should the United States take it? Could we in fact expect the International Monetary Fund to do something, adusting among various countries, to determine where the burden fell?

Let me remind you that we have failed to recall 1937, and what was called by Whittlesey and Graham the Golden Avalanche. At that time we had a dishoarding on an enormous scale because people thought the price of gold would fall. Central banks speculated in gold then, as they have done the other way in the recent past; and it was only, it seems to me, the courage of Morgenthau and Harry Dexter White, who hung on during this period and did not leave a mess here.

Mr. White was a controversial figure, and not a lovable man, but he ought to get high marks for the strength of the U.S. position in this period. And somebody ought to stabilize the gold price now more broadly, it seems to me, than just one country.

Mr. BERNSTEIN. I should emphasize a point that Charlie has made. It is inherent that when the Fund buys gold for currencies, it depletes its holdings of a currency. Therefore, in order to replenish its holdings, the Fund would sell gold to central banks. That is already in the Fund Agreement and it is mandatory on members to buy gold from the Fund when that is necessary to avoid a scarcity in the Fund's holdings of their currencies. Thus, the gold bought by the Fund would then be distributed either in proportion to the surpluses that countries have in international payments or in proportion to that part of their surpluses which are financed by borrowing from the Fund.

I would not want to leave the impression that the Fund somehow prints money, issuing various currencies to pay for the gold it takes in, in the same way as the Treasury issues dollars for the gold it takes in.

Chairman REUSS. Of course, in the future if the Fund wanted to, it could perfectly well print money, money as SDR's, and come to the Bernstein proposal, in fact.

Mr. BERNSTEIN. Actually, I have proposed that under a reserve settlement account, if there is to be any dealing of gold as a separate reserve asset, it should all be done through the Fund, and I do provide for the Fund buying them with SDR's. I will leave a copy of this proposal, not for the record, it would only burden the record, but for your private reading, Congressman.

Chairman REUSS. Fine. But let me decide whether it will burden the record or not; I may have a different view.

(The analysis referred to follows:)

HOW THE RESERVE SETTLEMENT ACCOUNT WOULD OPERATE

SUMMARY AND CONCLUSIONS

The activation of the Special Drawing Rights will add a new type of reserve asset to existing reserves of gold and foreign exchange. In an international monetary system with multiple reserve assets, it is essential that all reserves be used without discrimination in international settlements. The preference for gold as a reserve asset is great and growing. Under these conditions, there is a danger that the preference for gold will disrupt the orderly working of the international monetary system. This danger can be avoided by establishing a Reserve Settlement Account in which countries would earmark their gold, foreign exchange and SDRs in return for an equivalent credit in a composite reserve unit (CRU). Transfers of reserves would thereafter be made by debiting and crediting the CRU account. Every change in the CRU account would involve an implicit transfer of gold, foreign exchange and SDRs in an equitable proportion. At regular intervals, the Fund would inform all countries of the status of their CRU accounts and the resulting implicit transfers of the different reserve assets. Actual transfers of gold, foreign exchange and SDRs, however, would be made only when a country withdraws and its CRU account is settled.

A country would retain title to the gold it earmarks in the Reserve Settlement Account, subject to the obligation to settle for implicit transfers if it is a cumulative deficit country. The International Monetary Fund would also earmark its gold holdings in return for CRUs. Thereafter, transactions with the Fund that would otherwise be in gold would be in CRUs. Once the RSA is established, countries would not engage in gold transactions. The RSA, however, would be authorized to deal in gold with non-participating countries and to buy newly mined gold. The gold transactions of the RSA would be outside the earmarked accounts of its members.

Participating countries would also earmark their foreign exchange reserves with the Reserve Settlement Account. The foreign exchange reserves would become fixed fiduciary reserves, neither increasing nor decreasing, apart from the growth of working balances. The RSA would exchange the dollars and other currencies earmarked with it for non-negotiable notes with a guaranteed gold value, convertible on demand into the respective currencies, and bearing interest at an agreed rate. Once the RSA is established, balance of payments surpluses and deficits of the reserve currency countries would be settled in CRUs, thus leaving aggregate reserves unaffected.

When allocations of Special Drawing Rights are made, they would be earmarked with the Reserve Settlement Account in return for CRUs. The SDRs would be the only form of reserve asset that would increase substantially, and they would be issued at a regular rate to meet the need for the trend growth of reserves. The procedures contemplated for the use of SDRs would not be basically changed. Countries that transfer CRUs would automatically be using their SDRs in a balanced way with all of their other reserve assets as required by the SDR amendment.

The Reserve Settlement Account cannot make all reserve assets equally attractive, although it might moderate the preference for gold. The RSA would have a single reserve asset, the CRU, composed of gold, foreign exchange and SDRs, to be used in all reserve transfers. It would thus free the international monetary system from the disruptive effects of a competitive scramble for gold.

How the Reserve Settlement Account Would Operate[1]

DIVERSITY OF RESERVE ASSETS

The new reserve facility in the form of Special Drawing Rights will soon be activated and SDRs will be issued in the amount of $3.5 billion in the first year and $3 billion a year in the second and third years. Thus, in a relatively brief period of three years, the members of the International Monetary Fund will add $9.5 billion to their aggregate reserves through allocations of SDRs. This is no small amount of a new fiduciary reserve asset to be issued in such a short time. Ultimately, the SDRs will become a major component of monetary reserves. It is of the utmost importance that the new reserve asset should function properly in conjunction with existing reserve assets—gold and foreign exchange.

The need for a new reserve facility is premised on the view that the growth of reserves could not be dependent on the uncertain availability of newly-mined gold in competition with private absorption and speculation, and that it should not be dependent on the vagaries of the U.S. balance of payments on an official reserve basis. To facilitate the maintenance of a balanced pattern of payments, the international monetary system must have an adequate amount of reserves which grows at a regular trend rate. In this way, all countries that maintain a balanced payments position over an average of good and bad years could add to their reserves without depleting the reserves of other countries. Of course, countries would still gain reserves when they have a surplus and lose reserves when they have a deficit. That is essential for balance of payments discipline in a system of fixed parities; but measures taken by deficit countries to adjust their balance of payments would not be hampered by a shortage of aggregate reserves or an inadequate growth of reserves.

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[1] This paper is written in response to a letter from Milton Gilbert, Economic Adviser of the Bank for International Settlements, suggesting a more detailed discussion of the operations of the Reserve Settlement Account and its possible effects on the functioning of the international monetary system.

In an international monetary system with multiple reserve assets—gold, foreign exchange and SDRs—it is essential that all reserves should be used and accepted in international settlements, without discrimination. This is not likely to happen if countries are free to change the composition of their reserves, giving preference to retaining gold reserves and to using foreign exchange reserves and SDRs. The preference for gold is great and growing. As the amount of gold reserves is virtually fixed, this preference cannot be met except by depleting the gold reserves of other countries. Because of the preference for gold, it is much more difficult to induce countries to hold foreign exchange reserves merely by paying high interest rates. The SDRs are a new reserve asset with attractive features, but they are new and untried, and confidence in them can be established only by experience. Under present conditions, it is inevitable that countries will not regard all reserve assets as equally attractive. On this, the annual report of the BIS states: ". . . one waits to see by experience if Gresham's law will operate and, if so, what bad money will drive out what good—gold, dollars or SDRs." Unfortunately, it would be dangerous to risk this experiment, for it might result in a disruption of the international monetary system.

No one can predict with assurance how the competition among central banks to build up the most attractive composition of reserves would work out. Because of their traditional preference for gold and the fact that gold reserves will no longer increase, central banks might regard their gold reserves as inviolate—not to be used except in extreme emergencies. They are conscious of the fact that once depleted it will be difficult to rebuild their gold reserves as other countries will be well supplied with SDRs and dollars to meet balance of payments deficits. If gold is not used in international settlements, the effect will be to regard the gold reserves as a national patrimony. Thus, the usable reserves available to countries will be their dollars and SDRs. Far from being adequate, aggregate reserves will suddenly become much too small relative to world needs. And when a country does use gold in international settlements, it may become the signal that it has come down to its final reserves and precipitate or intensify a crisis.

Nor can one be sure how the dollar will fare in this competition. Countries that have long felt that their gold reserves were far too small, particularly in comparison with those of Europe, might decide that with the issue of SDRs the need for restraint in converting dollars into gold has been lessened. Furthermore, countries that have in the past added to their dollar reserves when they had a payments surplus might feel that hereafter conversion of their net actual of dollars into SDRs would be a better policy. Those who believe that the United States can finance large payments deficits indefinitely through continued increases in the holding of dollar reserves are probably mistaken. The real danger is that existing holdings of dollar reserves will be reduced, particularly in a time of political or economic crisis, by deficit countries drawing down their dollar reserves which surplus countries would then convert into SDRs and gold.

The provisions on SDRs give some assurance that they will be used only to finance balance of payments deficits and not solely to change the composition of reserves as between SDRs and the total of all other reserves. Deficit countries are required to "pay due regard to the desirability of pursuing over time a balanced relationship between their holdings of SDRs and their holdings of gold and foreign exchange and their reserve positions in the Fund." This can be done only by using other reserves as well as SDRs in settling deficits. In designating surplus countries to which SDRs will be transferred, the Fund is required to "promote over time equality in the ratios of the participants' holding of SDRs in excess of their net cumulative allocations to their official holdings of gold and foreign exchange." This is a recognition of the principle that all surplus countries should acquire SDRs and other reserve assets on the basis of an equitable formula.

These provisions are essential for assuring an appropriate role for SDRs in the international monetary system. To implement them, however, the Fund must continuously police the transfer of SDRs and other reserves from deficit countries and their distribution among surplus countries. Moreover, these provisions do not remove the danger that the international monetary system will be disrupted by the great and growing preference for gold or by a large and sudden conversion of outstanding dollar reserves. The way to avoid this danger is to require countries to use not only SDRs, but gold and foreign exchange in a determinate relationship in all international settlements. The most equitable rules for this purpose can be summarized briefly as follows:

1. Each deficit country should use its different reserve assets in settlement of its deficit in precisely the same ratios as it holds these reserves—gold, foreign exchange, and SDRs.

2. Each surplus country should acquire the different reserve assets in settlement of its surplus in the averaeg ratios of gold, foreign exchange, and SDRs used by the deficit countries, so that all surplus countries would acquire the different reserve assets in precisely the same ratios.

RESERVE SETTLEMENT ACCOUNT

The Fund could, of course, adopt these two rules in connection with its administration of the SRDs. The application of the rules would, however, involve considerable inconvenience. Thus, every transfer from deficit to surplus countries would have to consist of a mixed bag of reserves, by itself a complex procedure, with continuous calculation and intervention by the Fund. There is the additional difficulty that unless the rules are applied on a cumulative basis, a country will find that the composition of its reserves has been changed as it moves from deficit to surplus. Thus, when in deficit, a country would use its reserves in the proportions in which it holds them, which may include a large proportion of gold and a small proportion of dollars and SDRs, while when in surplus it would acquire reserves in the average proportions in which all deficit countries hold them, which may include a small proportion of gold and a large proportion of dollars and SDRs. The rules should be applied on a cumulative basis, so that if a country has a balanced payments position over a period of years, the composition of its reserves would not be changed merely because of intervening deficits and surpluses.

These technical difficulties could be solved very simply if countries were to hold their reserves in a Reserve Settlement Account administered by the Fund through which all transfers of reserves would be made. Each participating country would earmark its gold, foreign exchange and SDRs in the RSA in return for an equal credit denominated in a composite reserve unit (CRU). The CRU would be a unit of account for reserve transactions equal to one dollar and would have a guaranteed gold value. Transfers of reserves among participating countries would be made solely by debiting and crediting the CRU account. A country would retain title to the precise reserves it earmarked, subject to the qualification that if its CRU account is less than its earmarked reserves, it would implicitly have drawn on each type of reserve in the precise proportions in which it earmarked them. Similarly, if a country's CRU account were more than its earmarked reserves, it would implicitly have added to its reserves in the form of gold, foreign exchange and SDRs in the average proportions in which they were earmarked by the deficit countries. Whenever a country's CRU account is precisely equal to its earmarked reserves—whether one year or ten years after the RSA is established—the composition of its reserves will be unchanged. No actual transfer of gold, foreign exchange and SDRs would be made until a country withdrew from the RSA.

Transfers of CRUs between central banks would be made by cable to the RSA, requesting the debiting of the account of one country and the crediting of the account of another. Thus, a central bank requiring dollars would sell CRUs to the Federal Reserve Bank of New York, just as it now sells gold. Similarly, a country converting dollars into CRUs would draw down its dollar balance at the Federal Reserve Bank of New York, just as it does now when it buys gold. Countries having currencies widely used in international payments could undertake to convert their currencies in CRUs, although obviously because dollars are the currency with which central banks intervene in the exchange market, such conversions would be minimal except for the United States. Thus, the RSA would retain in every respect the present method of international payments with the one qualification that transfers of reserves would be exclusively in CRUs.

At regular intervals, but not less than once a month, the Fund would inform all members of the status of their CRU accounts and the resulting implicit transfers of reserves. A country whose balance in the CRU account is precisely equal to its earmarked reserves would have had no implicit change in its reserves. A country whose balance in the CRU account is less than its earmarked reserves would be a cumulative deficit country, and its reserves would have decreased implicitly in each reserve asset precisely in the proportions in which they were earmarked. And a country whose balance in the CRU account is more than its earmarked reserves would be a cumulative surplus country, and its reserves would have increased implicitly in each reserve asset in the average proportions in which the different reserves were earmarked by all cumulative deficit countries. The calculation is simple, involving no more than adding up the implicit changes in each type of reserve of the deficit countries and dividing the different reserve assets among the surplus countries in proportion to their cumulative surpluses.

IMPLICIT CHANGES IN RESERVES OF DEFICIT AND SURPLUS COUNTRIES

[Million CRU's or million U.S. dollars]

Country	CRU balance	Earmarked reserves				Implicit transfers			Implicit holdings		
		Total	Gold	Exchange	SDR's	Gold	Exchange	SDR's	Gold	Exchange	SDR's
D-1	500	600	360	120	120	—60	—20	—20	300	100	100
D-2	560	840	210	540	90	—70	—180	—30	140	360	60
D-3	2,880	3,200	2,000	900	300	—200	—90	—30	1,800	810	270
D-4	5,700	6,000	4,000	1,600	400	—200	—80	—20	3,800	1,520	380
Total transfers from deficit countries:[1]						—530	—370	—100			
S-1	900	800	300	400	100	+53	+37	+10	353	437	110
S-2	1,600	1,400	500	750	150	+106	+74	+20	606	824	170
S-3	1,700	1,400	900	300	200	+159	+111	+30	1,059	411	230
S-4	6,000	5,600	3,600	1,700	300	+212	+148	+40	3,812	1,848	340
Total transfers to surplus countries[2]						+530	+370	+100			

[1] The implicit transfer from each deficit country is in proportion to each type of reserve in its earmarked account.
[2] Implicit transfers to surplus countries in each type of reserve assets are in the same proportions as the average in the earmarked accounts of deficit countries—53 percent gold, 37 percent foreign exchange, and 10 percent SDR's.

The RSA would not involve any major change in the method of showing reserves in central bank reports. The central bank would show its holdings of gold, foreign exchange and SDRs in its earmarked account with the RSA. It would also show the net balance in its CRU account, compared with the earmarked account, as reserves due from the RSA for a surplus country or as reserves due to the RSA for a deficit country. The specific reserve assets could be shown in the customary detail.

RESERVE ACCOUNTS OF THE NATIONAL BANKS OF COUNTRIES S-1 AND D-1

[Million U.S. dollars]

	Assests	Liabilities
Country S-1:		
Reserves:		
Earmarked account with RSA	800	
Gold	300	
Foreign exchange	400	
SDR's	100	[1] 100
Due from RSA [2]	100	
Total	900	100
Country D-1:		
Reserves:		
Earmarked account with RSA	600	
Gold	360	
Foreign exchange	120	
SDR's	120	[1] 120
Due to RSA [3]	—100	
Total	500	120

[1] Allocations of SDR's.
[2] At the end of the month, the reserves due from the reserve settlement account consisted of $53,000,000 gold, $27,000,000 foreign exchange, and $10,000,000. SDR's.
[3] At the end of the month, the reserves due to the reserve settlement account consisted of $60,000,000 gold, $20,000,000 foreign exchange, and $20,000,000 SDR's.

GOLD IN THE RESERVE SETTLEMENT ACCOUNT

The principal reason for establishing a Reserve Settlement Account is that it would avoid a competitive scramble for gold that would disrupt the international monetary system. The RSA would at the same time facilitate the orderly growth of reserves by minimizing the fortuitous influx of reserves into and from the international monetary system. The Washington declaration of March 17, 1968 by the gold pool countries states that they will not sell gold in private markets. This protects the existing stock of monetary gold from depletion. The declaration also states that in view of the creation of SDRs, the amount of gold in monetary reserves is adequate. In any case, with the present premium on gold in private markets, not much is likely to be sold to the monetary authorities. Whether and how any gold could be added to the monetary stock is considered below.

The existing gold reserves would be earmarked with the RSA, but participating countries would retain title to their earmarked gold. Countries would be free to earmark their gold in any depository of the Fund, with the BIS, or in their own central banks. The reasons for earmarking the gold reserves of a country are to provide a basis for calculating its implicit transfers when it is a cumulative deficit country and to assure fulfillment of its obligation, if any, at a time of settlement when it or another country withdraws from the RSA. The first purpose could be served without earmarking if a country would present a certified statement to the RSA of the amount of its gold reserves and would undertake not to engage in transactions that affect its gold reserves. The second purpose could be served by having a country earmark a modest part of its gold reserves, so that the RSA would hold sufficient gold on earmark to cover the obligation of the country for any implicit transfers. Thus, a country having certified its gold holdings to the RSA could earmark $100 million. If it later has a cumulative deficit that would result in implicit transfers of this amount of gold, it would earmark an additional $100 million. If it later has a cumulative surplus sufficiently large, it could withdraw the gold it originally placed on earmark with the RSA.

A participating country would undertake not to engage in gold transactions apart from the implicit transfers resulting from the debits and credits in its CRU account. This limitation is necessary to avoid competition by participating countries in buying gold outside the RSA or depleting aggregate reserves by selling gold outside the RSA. As some gold transactions may have to be undertaken with nonparticipating countries, this would be done by the RSA on behalf of all members. It would be hoped that some non-participating countries, for example, Switzerland, would agree to use CRUs in their reserve transfers. Nevertheless, there will inevitably be some transactions in gold with non-participating countries, and there might be occasions when it is desirable to acquire non-monetary gold.

The RSA would buy gold from or sell gold to non-participating countries in return for CRUs. For convenience, the United States or other countries would be authorized to buy or sell gold for dollars or other currencies as the agent of the RSA. Thus, if the Soviet Union wished to sell gold to finance imports, it would ordinarily be expected to do so by selling gold in the free market. There might be occasions, however, when it would be in the general interest to buy gold from the Soviet Union. Similarly, if Switzerland decided not to use CRUs in reserve transfers, it would be necessary to engage in gold transactions with that country. Finally, if and when an agreement is made with South Africa on the sale of some of its newly-mined gold for monetary purposes at the monetary price, it could best be done through purchases by the RSA for CRUs.

Gold transactions made directly by the RSA with non-participating countries or with South Africa would be in CRUs. Thus, the aggregate amount of outstanding CRUs would be affected by the purchase or sale of gold by the RSA. This would also be true if the purchase or sale of gold were made by a participating country acting as the agent of the RSA. Thus the sale of gold for dollars by the United States would reduce the outstanding amount of CRUs as that country would have to acquire the gold from the RSA in return for CRUs. Similarly, the purchase of gold with dollars by the United States would increase the outstanding amount of CRUs as that country would give the gold to the RSA in return for CRUs. A country acting as agent for the RSA in buying or selling gold for its own currency would not find its reserves affected by the transaction, unless the purchase or sale were the by-product of its own surplus or deficit.

In order to keep the earmarked gold of participating countries intact, the gold bought or sold would be handled through the gold account of the Fund or through a special account set up for outside transactions. It would be expected that gold sales and purchases of the RSA would be about balanced, particularly if satisfactory arrangements are made with South Africa to acquire some newly-mined gold for monetary purposes. Obviously, if the net transactions are relatively small, their effect on aggregate reserves could be ignored. If the net transactions are relatively large, the participating countries could decide, on the recommendation of the Managing Director of the Fund, to increase or decrease any subsequent issue of SDRs to offset the effect of gold transactions on aggregate reserves.

The Fund is a large holder of monetary gold. The Fund acquires gold from its members through quota subscriptions made in gold, through repurchases (repayment of reserve credit) in gold, and through payment of charges in gold. The Fund is also authorized to buy gold from members for currencies, although such transactions have been rare. The gold holdings of the Fund are used to acquire any currencies it needs for its reserve credit operations. If the RSA is established, the members of the Fund would no longer be able to undertake gold operations, as all transfers would be in CRUs. This should not present any difficulty for the Fund. It would earmark its gold holdings, including gold in its investment account, with the RSA in return for CRUs. When the Fund needs any currency for its reserve credit operations (the General Account), it would acquire the currency by selling CRUs to that member, just as it now sells gold. That part of the quota subscriptions that would ordinarily be in gold would be made in CRUs, repurchase obligations that would ordinarily be in gold would be met in CRUs, and charges would be paid in CRUs. So far as the General Account of the Fund is concerned, the CRU would perform all of the functions of gold in the operations it undertakes.

FOREIGN EXCHANGE IN THE RESERVE SETTLEMENT ACCOUNT

The most volatile component of aggregate reserves has been and will continue to be foreign exchange, unless some way is found to integrate such reserves in a Reserve Settlement Account. The stock of monetary gold is now virtually fixed. The issue of Special Drawing Rights will be at a regular rate designed to meet the trend need for the growth of reserves. On the other hand, it would still be possible for reserves in the form of foreign exchange to increase or decrease suddenly with undesirable consequences for the international monetary system. The volatility of foreign exchange reserves can be seen in the changes in official dollar holdings that have occurred in the past six years. From January 1, 1963 to December 31, 1967, official dollar holdings increased by \$5.3 billion. From then until June 30, 1969, official dollar holdings increased by by about \$3.5 billion.

Once the SDRs are activated, it will be neither necessary nor desirable to depend on continuous deficits of the reserve currency countries to provide any significant part of the trend growth of reserves. On the other hand, a large and continued reduction of the amount of outstanding foreign exchange reserves would create difficulties for the reserve currency countries, if it occurred because of conversions, or for other countries, if it occurred because of large and prolonged surpluses in the reserve currency countries on an official reserve basis. In brief, while foreign exchange must remain a part of aggregate reserves, it is essential to avoid either a large increase or a large decrease in such reserves. The practical solution is to make foreign exchange reserves a fixed fiduciary component of aggregate reserves, neither increasing nor decreasing in the future except under specified and agreed conditions.

Technically, any foreign currencies held by the monetary authorities are foreign exchange reserves. In practice, some holdings are really the counterpart of credits extended by some central banks to others. The foreign exchange that is held as reserves is concentrated in dollars, held by virtually all countries, sterling held by the sterling area, and French francs held by the franc zone. These currencies would be eligible for earmarking in the RSA to the extent that they are held as reserves by the monetary authorities of participating countries. Each country would, of course, retain sufficient funds in these currencies for its working balances.

It may help to discuss what would be covered by the earmarking of dollars in the RSA. All of the demand deposits of foreign central banks in the United States, except working balances, would be placed in the earmarked accounts.

All time deposits and negotiable CDs, U.S. Government securities including Roosa bonds, and all other money market paper would be placed in the earmarked account. Dollars held as the counterpart of swaps, which are reserve credit, would not be placed in the earmarked account. All private holdings of dollars assets would be excluded. It should be noted, however, that private holdings of dollars have greatly increased in the past year because of high interest rates in the Eurodollar market. Some of these private holdings will be sold to the monetary authorities at a later date and allowance should be made for the subsequent earmarking of these abnormal private holdings in the RSA.

Official holdings of dollars by foreign monetary authorities [1]

[Million dollars; as of June 30, 1969]

Short-term and liquid holdings	$9,097
Demand deposits	2,038
Time deposits except negotiable CD's	1,976
U.S. Treasury bills and certificates	3,821
Other short-term liabilities, including negotiable CD's	874
Obligations payable in foreign currencies	388
Nonmarketable U.S. Treasury bonds and notes	3,269
Payable in dollars	1,416
Payable in foreign currencies	1,853
Other official holdings, estimated	2,444
Time deposits of 1 year or more	(3)
Government securities other than Treasury obligations	(3)
Total, dollar holdings of foreign monetary authorities [2]	14,810

[1] Includes Bank for International Settlements and the European Fund.
[2] Excludes holdings in Eurodollar accounts or other accounts not an obligation of U.S. Government, banks or money market to foreign Governments and monetary institutions.
[3] Not applicable.

Source: "Treasury Bulletin," August 1969, pp. 94 and 100, and "International Financial Statistics," September 1969, p. 15.

In earmarking their foreign exchange reserves, other than working balances, the participating countries would deliver to the RSA the precise foreign assets they hold, receiving in return a credit in CRUs. The RSA would exchange these assets with the United States, or any other country whose currency is placed on earmark, for non-negotiable notes, convertible on demand into dollars, with a guaranteed value in gold, and bearing interest at an agreed rate. The United States would make arrangements to see that the earmarking of these funds would not upset the domestic money market, presumably keeping the deposits in the banks that hold them. A country earmarking dollars would retain title to dollars, and a country earmarking another currency would retain title to that currency. If a participating country withdrew, it would receive from the RSA the same amount of dollars it had earmarked, subject to any net claim to or from the RSA for its cumulative surplus or deficit. The United States would, of course, convert the non-negotiable notes into dollars to enable the RSA to settle with a withdrawing member.

Once the foreign exchange reserves are earmarked, except for working balances, participating countries would not accumulate these currencies except as additions to working balances. Of course, working balances would have to increase with the growth of world trade and investment, and the RSA would agree with participating countries on the appropriate addition to their working balances. Official holdings of dollars or other currencies derived from swaps would be regarded as a temporary addition to working balances. Similarly, dollars acquired from drawings on Fund quotas or accumulated to make repurchases would be regarded as a temporary addition to working balances. Private holdings of dollars would be unaffected by these arrangements and would continue to increase or decrease in response to the operations of the money and capital markets.

After the present official holdings of dollars become a fixed fiduciary reserve by being placed on earmark with the RSA, the surplus or deficit in the U.S. balance of payments on an official reserve basis would be accompanied by corresponding changes in U.S. reserves—i.e., its balance in the CRU account—except for additions of dollars to working balances. On a liquidity basis, however, the United States could still have a surplus or deficit without affecting its reserves, provided there were an increase or decrease in private holdings of dollars. Thus, the growth of reserves would no longer depend on the U.S. balance of payments, and with an adequate growth of reserves through the issue of SDRs, the U.S. payments position would not be affected by the competition of other countries to acquire additional reserves.

As a fixed fiduciary issue, the dollars earmarked with the RSA would remain unchanged. Provision could be made, however, for the retirement of some of the earmarked dollars when the U.S. balance of payments is exceptionally strong. Thus, if a dollar scarcity should recur, so that the U.S. balance of payments is in persistent surplus and U.S. holdings of CRUs are exceptionally large, the RSA could request the United States to retire some of the dollars in the earmarked account, using the CRUs for this purpose. As aggregate reserves would be reduced by the retirement of earmarked dollars, arrangements could be made for an extraordinary issue of SDRs in an equivalent amount. This extraordinary issue would replenish the reserves of other countries. The total amount of oustanding CRUs would be unaffected, although the counterpart in the earmarked accounts would consist of less dollars and more SDRs.

SDR'S IN THE RESERVE SETTLEMENT ACCOUNT

With the earmarking of gold and foreign exchange in the Reserve Settlement Account, these two components of reserves would be virtually fixed and would remain fixed. Any increment of monetary gold would be acquired by the RSA outside the earmarked accounts of participating countries, and presumably would be relatively small. Similarly, the dollar and other foreign exchange reserves would become a fixed amount of fiduciary reserves, as the normal growth of working balances would be outside the earmarked accounts of participating countries. Special Drawing Rights would be the only form of reserves that continues to grow at a regular rate.

Under the amendment to the Fund Charter, the SDRs will be recorded on the books of the Special Account of the Fund, transfers being made by credit and debit entries in this account. The earmarking of each country's allocations with the RSA, therefore, involves no significant innovation. With each new issue made by the Fund, the amount of SDRs allocated to each participating country would be added to its earmarked account in return for a corresponding credit in CRUs.

The only change in the contemplated procedure is that under the RSA specific transfers would not be made in SDRs, although implicit transfers would be made whenever a country's CRU account is debited or credited. Countries that transfer CRUs would automatically be using their SDRs in a balanced way with their other reserves. There would be no need for designation to assure that surplus countries acquire SDRs and other reserves on an equitable basis. That will happen automatically when reserves are transferred in the form of CRUs. There will be no need to apply the reconstitution provision unless and until countries have used 70 per cent of their earmarked reserves. Thereafter, the transfer of reserves in CRUs would be implicitly in gold and foreign exchange, without SDRs. At some time in the future, the Fund could decide that the rules for designation (Schedule F) and reconstitution (Schedule G) are automatically fulfilled if a country participates in the RSA.

There is a far more important way in which the RSA would facilitate the functioning of the Special Account of the Fund. The procedure for issuing SDRs requires the Managing Director to make a finding on the amount of SDRs to be issued over a basic period—normally five years, but initially three years—in order to have an adequate but not excessive trend growth of aggregate reserves. Under present conditions, such a finding should involve an allowance for the growth of reserves in other forms. While it may safely be assumed that no significant change will occur in gold reserves, this cannot be assumed regarding foreign exchange reserves. The consequence is that decisions on the amount of SDRs to be issued will probably be conservative. It is doubtful whether any allowance will be made for the possibility that the outstanding amount of foreign exchange reserves will fall; and there will be a tendency to make an excessive allowance for the possibility that outstanding foreign exchange reserves will increase.

A conservative policy on the issue of SDRs, particularly in the initial years while countries acquire confidence in the new reserve asset, is not of itself objectionable. A persistent bias toward inadequate issues for the appropriate trend growth of reserves would be unfortunate. It would cause on a smaller scale the same tendency by some countries to seek surpluses at the expense of other countries in order to acquire additional reserves, not merely in the form of SDRs, but in gold and dollars as well. The United States particularly would be adversely affected by such a tendency. The very concept of having an adequate but not excessive trend growth of aggregate reserves requires the Fund to be able to predict with assurance what the increment of reserves will be. That is possible only if the amount of gold and foreign exchange reserves is fixed and the increase is entirely in the form of SDRs. In this important sense, the RSA, with the earmarking of gold and foreign exchange reserves, would contribute to the effective operation of the SDRs.

The withdrawal and liquidation provisions of the RSA would be different and distinct from those governing the Special Drawing Account, but they would not affect these provisions on SDRs (Articles XXX and XXXI). A surplus country that withdrew from the RSA would receive the gold, foreign exchange and SDRs it earmarked. The remaining balance in the CRU account would be its cumulative surplus. A determination would then be made of the implicit transfers of different reserve assets from each of the cumulative deficit countries. If the surplus country accounted for one-fifth of the total cumulative deficits at the time of its withdrawal, each deficit country would settle one-fifth of its cumulative deficit in the different reserve assets in the proportions in which it earmarked its reserves. Its earmarked account would be correspondingly reduced. If a cumulative deficit country withdrew, its earmarked reserves would be returned in the proportion of its CRU balance to its earmarked account. Thus, if a deficit country's CRU balance were four-fifths of its earmarked account, it would be returned four-fifths of the gold, of the foreign exchange and of the SDRs that it placed on earmark with the RSA.

The RSA does not involve the creation of new credit facilities but the use of existing reserves. For this reason, settlement with a withdrawing country should be made promptly when it terminates its participation in the RSA. If it is a surplus country, it will receive all of its own reserves that it earmarked plus its share of the implicit transfers made by the cumulative deficit countries in gold, foreign exchange and SDRs. If it is a cumulative deficit country, it will receive all of its own reserves that it earmarked less that portion of the gold, foreign exchange and SDRs that it has implicitly used in settling its deficit. Precisely the same rules would be followed if it were decided to liquidate the RSA. The settlement with each country would be made promptly in gold, foreign exchange and SDRs in the amount appropriate to its earmarked account and its CRU balance.

Withdrawal from or liquidation of the RSA need not involve withdrawal from or liquidation of the Special Drawing Account. If a country withdraws from the RSA it would receive its earmarked SDRs plus (for a surplus country) or minus (for a deficit country) the implicit transfers of SDRs in its CRU account. The SDRs would be credited to its Special Drawing Account. Similarly, if the RSA is liquidated, all countries would receive their earmarked SDRs adjusted for their position in the CRU accounts and the SDRs would be credited to their Special Drawing Account. If a country also withdraws from the Special Drawing Account, or if the Account is liquidated, settlement for the SDRs would be made in accordance with Schedule H or Schedule I, under which net credit or debit positions would be settled by agreement or in ten semi-annual instalments. The RSA would in no way modify the rights and obligations on SDRs as established in the amendment to the Fund charter.

EFFECT OF THE RSA ON ASSET PREFERENCE

The purpose of the Reserve Settlement Account is to assure the equitable use of all reserve assets in international settlements. The need for the RSA arises from the fact that countries do not regard the different reserve assets as equally attractive. There is a great and growing preference for gold, and if this preference were permitted to affect decisions of central banks on which reserves to hold and which reserves to use, it would disrupt the international monetary system. The establishment of the RSA would not materially affect the asset preferences of most countries, although it would probably tend to moderate them to some extent. This would contribute to an improvement in the functioning of the present international monetary system.

There are several reasons why central banks have a strong preference for gold. First, it is traditional for many of them to keep their reserves in this form. They may rationalize this preference by saying that the holding of foreign exchange reserves encourages the reserve currency countries to delay adjustment in their balance of payments. Second, the holding of gold reserves may be regarded as a matter of prestige and few countries are entirely indifferent to this status symbol. On the other hand, the holding of foreign exchange reserves may seem a symbol of economic dependence, and this view is heightened when countries are classified as dollar countries, sterling countries, etc. Third, gold reserves involve no economic risk in the sense that its monetary price is unlikely to fall in terms of alternative foreign exchange reserves, while there is always the possibility of loss from the devaluation of the currency in which foreign exchange reserves are held.

The RSA requires countries to give up the right to change the composition of their reserves, except as this occurs for surplus countries through the acquisition of gold, foreign exchange and SDRs through implicit transfers. What are the benefits that countries derive from giving up this right? The view that all countries can, in fact, change the composition of their reserves to satisfy their preference for gold is illusory. There is simply not enough gold, or enough growth in gold reserves, to enable all countries to increase the proportion of gold in their reserves. Of course, some countries could increase their gold holdings and run down their other reserve assets, but only by forcing a decrease in the gold holdings of other countries. As a radical change in the composition of reserves would disrupt the international monetary system, it is in the general interest to agree on measures that would avoid it.

Insofar as the preference for gold reflects a fear on the part of some central banks that they will be left behnd in the race to acquire gold, the RSA eliminates this risk entirely. A country cannot increase the gold component of its reserves; but neither can any other country. Insofar as the preference for gold reflects a view that gold holdings and gold settlements are necessary to impose balance of payments decipline on the reserve currency countries, this will be accomplished by establishing a RSA. The foreign exchange reserves will become fixed fiduciary reserves, the total amount of which cannot be increased except for working balances and then only within agreed limits. Thus, balance of payments surpluses and deficits of the reserve currency countries, on an official reserve basis, will be accompanied by a corresponding change in their reserves.

On the positive side, the RSA would help to minimize the differences among the various reserve assets far more effectively than is possible under present conditions. As all countries would earmark their reserves with the RSA and transfer them in CRUs, the distinctions between reserve currency and non-reserve currency countries, between gold holding and foreign exchange holding countries, between dollar and sterling countries and other countries, would disappear. The SDRs have a gold value guarantee and that tends to minimize one of the distinctions between it and gold reserves. In the RSA, the present foreign exchange holdings would become fixed fiduciary reserves. The fixing of their amount should add to their attractiveness as they will become relatively scarcer as aggregate reserves grow. Furthermore, the foreign exchange reserves earmarked in the RSA would also have a gold-value guarantee. Thus, the establishment of the RSA would of itself tend to bring about a greater degree of equality in the attractiveness of the different reserve assets.

The traditional method of making reserve assets equally attractive is through the payment of interest on fiduciary reserves and this principle would be retained in the RSA. The Fund will pay interest to each holder on the amount of its holdings and charge interest at the same rate on the amount of its allocations of SDRs (Article XXVI). Initially the interest rate will be 1½ per cent per annum, although within certain limitations the rate can be changed at the discretion of the Fund. The payment of interest by net users and the receipt of interest by net accepters of SDRs have a justified economic basis. SDRs are a fiduciary reserve asset. The net users receive real resources, including capital assets, from the net accepters in return for the SDRs. This is basically an extension of credit through the holding of a fiduciary reserve asset. As the SDRs have a gold-value guarantee, the interest rate paid on net use of SDRs should be relatively low.

The foreign exchange in the RSA would also bear interest. Although such earmarked foreign exchange reserves would have a gold-value guarantee, the interest rate should be higher than on SDRs. The relationship of the holders of foreign exchange reserves to their debtors, the reserve currency countries, is not precisely the same as with SDRs. The SDRs represent an undertaking for the mutual extension of reserve facilities in the sense that every participant not only receives an allocation of SDRs but is obligated to accept them. The foreign exchange reserves, on the other hand, are an extension of reserve facilities only to the reserve currency countries. For this reason, it is appropriate to have a higher interest rate on foreign exchange in the RSA than on SDRs. A differential of about 1 per cent per annum would seem to be reasonable.

No interest would be paid on gold earmarked in the RSA. This is in accord with the principle that such reserves involve no extension of credit, as gold is itself a real asset. Ultimately, it may be found convenient to make no distinction among the assets earmarked in the RSA, simply paying to all holders of CRU balances a rate of interest which would be a *pro rata* proportion of the interest received from allocations of SDRs and from the foreign exchange earmarked in the RSA. Such a step, however, would have to await a general recognition that the RSA has in fact succeeded in establishing the equal attractiveness of all reserve assets and an agreement to regard all of the earmarked reserves as a common reserve for the CRUs.

The RSA is essential in order to assure the use and acceptance of all reserve assets without discrimination. There is no intention of implying that the RSA will make all reserve assets equally attractive; but it can prevent the preference for gold from degenerating into a competitive scramble for gold. The RSA is a logical step in the evolution of the international monetary system. The agreement on SDRs is a recognition of the principle that the orderly growth of reserves at an adequate rate cannot depend on the uncertainties of gold production and gold hoarding and should not depend on the accident of the balance of payments of the reserve currency countries. An agreement on the RSA would be a recognition of the principle that all reserve assets should be used in an equitable way in international settlements.

Chairman REUSS. This question I just asked was in a way preliminary to the question I want to ask, which is: Is there any earthly reason why the United States either directly or through the IMF should make any kind of agreement with the Union of South Africa to support their gold sales at $35 an ounce? We have already established there are ways in which the IMF can relieve anxiety on the part of central bankers, but what is all of this I read in the papers about the alleged desirability of negotiating something with the Union of South Africa? What could we possibly get out of it, other than it would be nice to South Africa?

Mr. KINDLEBERGER. I would think there is certainly no need for the United States to be the leader in this. And if after a while the Midas choking on gold that South Africa is experiencing in its unhappy way, leads it to approach us and try to join the two-tier agreement, and to sell gold at $35 an ounce this, I would be willing to contemplate as I suggested in my statement, because I see no reason to isolate and punish or to put aside and try to treat as pariah, a poor country in the world system, and in particular I am most anxious, most of all, not to provide a tremendous upset.

Chairman REUSS. I would agree, and it would be fine if South Africa would joint the March 1968 two-tier agreement. But why should we pay any price for it?

Mr. KINDLEBERGER. We should not.

Chairman REUSS. Then it would be your testimony, Dr. Kindleberger, that the United States should not make directly or indirectly agreements with South Africa to put a floor under the sale of their gold?

Mr. KINDLEBERGER. I would welcome an approach to the Group of Ten, if they wanted to make it of South Africa to join the system, but otherwise, I see no necessity for this country taking the lead.

Chairman REUSS. How about you, Dr. Machlup?

Mr. MACHLUP. I associate myself completely with this point of view. It is not in our interest to take the lead. If there is pressure from our partners in the Group of Ten, then we may discuss the issue. I certainly do not believe that the United States should bear the chief burden; that is, we should buy the gold, but I suppose this is not what the South Africans really want. I suppose they would be quite satisfied if we gave up our resistance to their dealing with the International Monetary Fund.

Chairman REUSS. But my question is: Should we give up our resistance? This is the way we have construed the Fund's regulations for more than a year now, we may get outvoted by other countries, that is a possibility, and if so, we must abide by it.

But why should we go along with other countries, in the Group of Ten or elsewhere, who choose for reasons not discernible to me, to plump for a useless thing? Therefore, should we not vote "no" and if we get outvoted, splendid, then we are good soldiers and submit to the betterment of democracy.

Mr. MACHLUP. I suppose our position is really, as long as the free market price is above $35, we are not willing to give up our resistance to large purchases of newly mined gold by the IMF.

The question then is whether we should change our mind about taking new gold if the free-market price falls below $35.

Chairman REUSS. And you feel we should not?

Mr. MACHLUP. Well, I would say that it is not an important economic question; it is a political question. Is it worth putting up a hard fight or is it better to agree and accommodate people, especially if it serves also the purpose of not hurting too many people who have invested in gold at higher prices? So I would not seriously object if the price were supported not far below $35. I would prefer that such support purchases be made only at a lower price than that, but I would not be unhappy if the United States gave in, as I believe Joe Fowler was eventually willing to do, by allowing the purchases of gold at $35 minus some handling charge.

Chairman REUSS. Why should not you be unhappy though, if the thing is neutral from the standpoint of international money, and economics? Why should you not be unhappy that the taxpayers of this country and other Groups of Ten countries would be asked to use real resources to take gold out of one hole in the ground and put it in another hole in the ground?

Mr. MACHLUP. I grant you that this is a waste from an international economic point of view. But the question is how much of a waste is it, how costly is it to the world, how much is it in relation to the national products of the countries that have to exchange the products of their industry against useless gold.

This is the question, and I think the relative size of the waste is such that we need not seriously worry. It would be a serious worry if production were to rise considerably, but since I do not expect production to rise rapidly, I do not think we should worry at this point.

Chairman REUSS. But you would say that we should neither undertake unilaterally to put a floor under South African gold, nor in international agencies of which we may be a member, vote for it?

Mr. MACHLUP. That is correct.

Chairman REUSS. All you are saying is if we get outvoted the world will not come to an end; is that a fair statement?

Mr. MACHLUP. That is a fair statement of my view.

Mr. KINDLEBERGER. I would like to add one consideration which I think may need bearing in mind, but is difficult to evaluate. It seems to me any serious collapse of gold production in South Africa right away would be very serious for a large group of 700,000 black people who work in those mines. I would think that the best way to handle this is certainly not to raise the price of gold. We should let inflation lower the price of gold more and more and gradually move those men out. They are committed to mining and get an income from it. If this income were suddenly stopped, you would have a most serious social situation of the kind we have had tragically in other parts of the world.

I want to see the activity wither on the vine rather than suddenly knocked on the head.

It seems to me that what in the long run the world needs to do, is to transfer these men into useful occupations in industry and other types of mining. The notion of suddenly punishing the country involves also punishing these people with whom we have great sympathy and concern.

Chairman REUSS. Is it punishing them, though, to refrain from affirmative action in the way of a subsidy?

Mr. KINDLEBERGER. No, sir.

Chairman REUSS. That does not seem to me a punishment.

Mr. KINDLEBERGER. I was saying only that I am concerned about the grave instability of price in the gold market, about what it might do to the financial system. This other consideration, I thought, was worth simply mentioning.

I would be interested in having a floor under the fund to stabilize this commodity, as I would like to stabilize coffee and cocoa and other commodities which you mentioned. The purpose is not to change the direction, but in the long run to move toward the equilibrium level or trend. We want to hold to the trend but should worry about short-run instability. This goal happens to be more important for gold than for coffee, because gold is a more important asset, which many more banks have loaned than they have on coffee.

I would not expect to see a financial collapse from a 10-cent drop in the price of coffee. It would be very serious for Brazil and for the people who grow it. If the price of gold were to drop by 20 percent, however, you might have a panic in Zurich, panic in the Middle East, panic in India, and a panic in South Africa, and I think that would be serious.

I want to stabilize the price to prevent that. That is not trying to help our friends; it is trying to be reasonable in the management of the international economy.

Mr. BERNSTEIN. Let me answer your question in the narrower framework, much narrower framework in which I approach it. I do not think the United States has to negotiate with South Africa. I believe there is a problem of the sale of newly mined gold by South Africa to the Fund and to the monetary authorities. I think one could put up a good argument that so long as South Africa can sell gold at $35-plus an ounce in the free market it does not really need currencies from the

Fund to make payments that are in accord with the provisions of the Fund agreement.

If the Fund wanted to say that, I would have no objection, the concept being so long as they have newly mined gold that can be sold in the free market, they do not have a balance-of-payments problem that has to be solved by borrowing from the Fund.

But I do not think the United States has any special reason for taking the leadership in enforcing one or another dogma on the Fund. I think most of the Group of Ten do not see eye to eye with us on the second part of the Washington declaration. I think they are astonished to discover that newly mined gold is what is meant in the sentence which does not contain that word at all.

We have a lot of things to do with the Group of Ten. They are very important. They include the question of how much the SDR issues should be, the liberalization of the use of SDR's and the use of SDR's as an alternative to gold in convertability, and so on.

These are quite apart from the longer range problems that are not so immediate, but which may involve a reserve settlement account or some equivalent.

To my mind it would be a mistake to use too much of our prestige in fighting with the Group of Ten on this minor issue, whether the Fund and other central banks should take $100 or $200 million of gold, when we have so many more important questions. If we could get them to cooperate much more generously on these qustions, as they are on quotas, I would let them have their way on buying token amounts of newly mined gold.

I know that ideologically, it sounds primitive to be digging up gold and buying it for the monetary stock, inflating and deflating the world economy on the basis of how much gold is added to reserves, but this is now a thing of the past. Not much gold is being added to reserves. The gold that is being produced is being used for industrial purposes, some of it is being hoarded, but that is what people want, so let them do it.

I would concentrate on the future role of gold in the international monetary system, and see that the international monetary system evolves along those lines. To my mind, ideology about gold and the gold standard is a very small part of this. I am not offended by putting gold into the international monetary system. I am not frightened by not having it in the system.

Mr. MACHLUP. Mr. Chairman, may I make an additional comment about the United States negotiating with South Africa? It is true that the South Africans chiefly want to have it declared that they have the right to sell their gold to either the Fund or to national monetary authorities. But there is another way of helping them if help is needed to avert a collapse of the price of gold in the free market.

If there should be such an excess supply of gold in the free market, that its market price were to fall drastically, there is a way in which we could help them without buying their gold; namely, we could allow citizens of the United States to buy gold at their heart's desire. Thus, not the Treasury would buy it, not the central banks would buy it, but we would permit these foolish people who want to have some gold to buy it if they wished.

Now, this might be a way of making a concession to the South Africans. It would be a concession in the form of removing a restriction, a restriction that the United States imposes on its citizens while similar restrictions are not imposed on the citizens of many other countries.

Chairman REUSS. The suggestion certainly does not bother me, and the world may well, in my judgment, be ready for a repeal of the "No U.S. citizen may buy gold" law of 1934, but what is it we are supposed to get from the South Africans in exchange?

This is it.

Mr. MACHLUP. Nothing.

Chairman REUSS. It is the most idiotic negotiation I have ever heard of. The other side comes around and asks us to make concessions. I have not been told what we are supposed to get for it. What are we supposed to get, outside of love and affection from the particular central bankers and finance ministers who happen at the day to be the fellows on th Group of Ten, but they are fleeting—what is the value of getting their smiles?

Mr. KINDLEBERGER. My only concern in all of this is insurance, insurance against what I regard as a small possibility not a probability or a small probability, 0.1 or 0.15, of real trouble.

I am not ready to move until trouble gets closer. I do not see any reason to take any action now, at all.

South Africa is hurting, and waiting for the other shoe to drop. The open market price is down, people and wages are being sold out now. What I am concerned about would be the hurt to the international monetary system of a banking and financial panic, which I think is a small probability.

That is what we get out of it, prevention.

Chairman REUSS. You would like an adaptation of the suggestion made by Dr. Machlup. What about Congress passing a law saying that the 1933 prohibition on the private ownership by U.S. citizens of gold may be suspended at a finding by the President of the United States that the decrease in the free market or the price of gold below $35 an ounce has come to such a pass that if he wants to, he can bolster the market by letting the U.S. citizens buy gold?

Mr. KINDLEBERGER. I do not see anything in this particular idea produced by Professor Machlup's usually fertile brain that is much good. If the world thinks that gold is no good, then Americans will think that gold is no good. You would not be likely to get stability out of it.

Mr. MACHLUP. Then it would surely not do us any harm.

Chairman REUSS. Not all Americans, there are living Americans, living in their lonely attic with checking accounts, who I think would, no matter how silly, be buying gold if we let them.

Mr. BERNSTEIN. Actually, letting Americans deal in gold might depress the price. Before you know it, we would have a forward market on gold and naturally Charley's Americans would be big forward sellers in this environment.

Mr. KINDLEBERGER. It seems it is ingenious and interesting, but not very serious, so I would not worry about it.

Chairman REUSS. Gentleman, does anybody have anything additional to add to the material which we have gotten from you?

If not, thank you all very much for contributing to another very useful hearing of this subcommittee.

We stand adjourned until 10 o'clock tomorrow morning.

(Thereupon, at 1:05 p.m., the hearing was recessed, to reconvene Friday, November 14, 1969, at 10 a.m.)

THE PROPOSED IMF QUOTA INCREASE AND ITS IMPLICATIONS FOR THE TWO-TIER GOLD MARKET

FRIDAY, NOVEMBER 14, 1969

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON INTERNATIONAL EXCHANGE
AND PAYMENTS OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The Subcommittee on International Exchange and Payments met, pursuant to recess, at 10 a.m., in room S-407, the Capitol Building, Hon. Henry S. Reuss (chairman of the subcommittee) presiding.

Present: Representative Reuss.

Also present: John R. Karlik, economist, and George D. Krumbhaar, economist for the minority.

Chairman REUSS. Good morning.

The Subcommittee on International Exchange and Payments of the Joint Economic Committee will be in order for a further hearing into various gold problems which occupied us yesterday, such questions as the gold effect of the proposed International Monetary Fund quota increase, the position of the Union of South Africa, and the loan of South African rand by the International Monetary Fund.

We are honored to have before us this morning Under Secretary of the Treasury for Monetary Affairs Paul A. Volcker. Mr. Volcker has the complete confidence, I think, of the entire committee. He has been not only a very dedicated occupant of the important Under Secretary position but has been most zealous to keep us informed at formal sessions and on an informal basis. The purpose of this hearing is for a further continuing exchange of views.

You have a prepared statement, Mr. Volcker, which, under the rules and without objection, will be admitted into the record.

Would you now proceed, either by reading your statement, summarizing it, going beyond it, or in any way you choose.

You might also, if you will, introduce for the record your associates here this morning.

Mr. VOLCKER. I have Mr. Dale on my left, Mr. Chairman, who is our U.S. Executive Director in the International Monetary Fund, and on my right is Page Nelson and George Willis, who are with me in the Treasury directly.

STATEMENT OF PAUL A. VOLCKER, UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS; ACCOMPANIED BY WILLIAM B. DALE, U.S. EXECUTIVE DIRECTOR, INTERNATIONAL MONETARY FUND; GEORGE H. WILLIS, DEPUTY TO THE ASSISTANT SECRETARY FOR INTERNATIONAL MONETARY AFFAIRS; AND T. PAGE NELSON, DIRECTOR, OFFICE OF INTERNATIONAL GOLD AND FOREIGN EXCHANGE OPERATIONS

Mr. VOLCKER. I wonder whether I might best expedite things, Mr. Chairman, by breaking into my statement about the time where I begin specifically to talk about the two-tier gold market which was the specific subject, or one of the specific subjects, of the hearing?

Chairman REUSS. You said some kind things about the subcommittee on the first page, and that will be included in the record following your testimony. (See p. 61.)

Mr. VOLCKER. I say well-deserved kind things which perhaps I ought to repeat out loud.

Chairman REUSS. We will let you get right into the meat. Thank you very much.

Mr. VOLCKER. But I also say some things about recent actions by other countries in the market generally, and I do think we are in a little calmer period here, and I think that is important for some very important reasons ranging from the better performance of the United Kingdom, the smoothness of the French devaluation, certainly the German revaluation, and I think, as I say here, the backdrop of the widespread agreement on the SDR question which expresses a broad international consensus about an important matter, and the fact that that consensus was reached and moved ahead has properly been a calming influence on markets.

I just note briefly, too, that we are now moving forward within the framework of the Fund itself to a study of these questions of limited exchange rate flexibility that this committee and others have been interested in over time.

The series of crises and near crises in international financial markets that have been characteristic of recent years have been a prod for constructive change. And, as I indicated earlier, I think we are seeing some of those constructive changes. We can also take some satisfaction from the fact that massive speculative flows have been absorbed and contained without rupturing the basic international financial structure or impeding the growth of trade. Our defenses have been tested, and they have stood firm.

Nowhere has this been more striking than with respect to the new gold marketing arrangements introduced in March of 1968—the so-called two-tier system. In essence, the decisions taken at that time separated dealings in gold among national authorities from the vagaries of industrial and speculative demands and new production in the private markets. The immediate result was to break the link between currency disturbances or speculation and a drain of gold from official stocks into private hoards—a link that, in practice, had become self-reinforcing. Instead, speculation in gold now spends itself in fluctuations in the price in private markets. The process is self-limiting, as the rising price of an asset that yields no return simply increases the risk of subsequent loss.

Since the two-tier system was introduced, we have, in fact, seen the private price move over a considerable range in the leading markets. The upper end of that range, at about $44 an ounce, was reached in the course of the first year—a period when the market was growing accustomed to the new arrangements even while the supplies of newly mined gold released to the market were unusually light. Since March of this year, the trend has generally been downward. The current price happens to be close to the lowest point since the two-tier system was established.

At least to those not actively participating in the market, the forces pushes pushing the price in one direction or another at a given time are often obscure. But what is important is that fluctuations in the private price have increasingly come to be viewed as a characteristic of what is essentially a commodity market, with limited significance for the monetary system. Indeed, the private market reacted only slightly, if at all, to some of the more severe currency crises of the past year. The price movements that have developed in response to private force and interests only seem to reinforce the wisdom of separating our basic monetary arrangements from the vagaries of the market.

The existing national stocks of some $39 billion of gold of course remain the most important single element in official world reserves, accounting for somewhat over half the total. I believe gold will continue to have an important role in the monetary system as far ahead as we can foresee. The institution of the two-tier system recognizes that, relative to other reserve assets, the role of gold will decline over time as the need for total reserves grows. Indeed, operation of the two-tier system must assume the creation of acceptable reserves in other forms.

In this sense, the SDR is a natural complement. Within 3 years, the volume of SDR's will be the equivalent of, roughly, one-fourth of the entire official stock of gold.

On the basis of performance, I believe the two-tier system must be judged a success. This is true despite the fact that it has not been possible so far to reach an understanding with the world's largest gold producer—South Africa—as to appropriate means by which it might wish to handle its newly mined gold within the framework of the generally accepted arrangements. Normally, South Africa accounts for almost 80 percent of all new production outside of the Communist countries.

South African authorities have indicated that, as a practical matter, a substantial portion of this production has been channeled to private hands at premiums over the official price. Unlike other gold producers, however, South Africa has also chosen to withhold a portion of its potential supply from the private market. The manner of handling South African gold has, of course, been a recurrent element of market uncertainty that I doubt is in anyone's long-term interest. That is why I remain hopeful that an understanding can ultimately still be reached as to the appropriate methods of handling South African sales within the framework of the best interests of the system as a whole.

Consistent with the basic premises of the two-tier system, I am aware of no attempt by official institutions to profit from the higher price of gold in private markets by official sales. Moreover, the collective judgment embodied in the March 17, 1968, communique that there is no need to add to reserves in the form of gold from the private markets has been reflected in the abstention of all major countries from purchases of South African or newly mined gold, apart from certain transactions arising from the normal mechanism of the IMF.

The exceptions to this practice, to the best of my knowledge, have been confined to a very few small countries. These purchases seem to me to have been distinctly unfortunate. Obviously, the amounts of gold involved have not, in themselves, impaired the effective operation of the two-tier system. Nevertheless, all countries and all central banks seem to me to share a common responsibility for maintaining the health of the system as a whole, from which all benefit. In this instance, the proper expression of this common responsibility seems to me a willingness to abide by the generally accepted implications of the two-tier system.

In a world of more than 100 countries, misunderstandings of the purpose and importance of the new arrangements are, of course, possible. In those few instances where some question has come to our attention, we have, naturally, communicated our views directly to those concerned. On this basis, I feel confident that the basic principles inherent in the two-tier system are increasingly well understood.

In announcing these hearings, you, Mr. Chairman, correctly noted that new gold has entered the monetary system from South Africa as a byproduct of certain IMF transactions. Some $100 million of South African rand have been drawn from the Fund since the beginning of the two-tier system. In addition, as reviewed earlier in an exchange of letters between Representatives Reuss and Widnall and Secretary Kennedy published last spring, in certain circumstances South African drawings from the Fund may be repaid in gold. A total of $50 million was involved in such repayments last summer.

These transactions follow longstanding IMF procedures, and the United States has not felt it necessary or desirable to raise questions about these particular applications of established procedures so long as no clear record developed of their repeated use simply to divert gold from the private market. This has not been the case so far. The use of rand in drawings has not been out of proportion to the use of other currencies, on the basis of established criteria. So far as the South African drawing in the spring was concerned, Secretary Kennedy noted, in his letter to the chairman, that:

> * * * We have long supported the concept that gold tranche drawings be virtually automatic; and we continue to believe that no doubt should be cast on the ability of a country to mobilize these funds promptly should it deem a need exists. I am convinced that should experience show that the privilege is being abused by repeated drawings and repayments unrelated to the basic objectives of the IMF, adequate means exist to effectively halt such practices.

In your announcement, Mr. Chairman, you also raised the question of what plans there might be for handling the gold portion of the payments required in connection with the anticipated increase in IMF quotas. The problem arises essentially because the Fund articles—drafted 25 years ago—require that 25 percent of any increase in quotas must be made in the form of a single kind of reserve asset—namely, gold. Because some countries hold very little gold, the potential arises for a large conversion of dollars into gold, presumably at the expense of U.S. reserves, simply to enable those countries to make necessary quota payments.

One effective and straightforward way of averting this incidental—but quantitatively large—potential drain of U.S. reserves as a result of quota increases would be to permit SDR's to be used as well as gold. As a result of the initial activation of SDR's in January, virtually every country would then be equipped to make the necessary payment from its own reserves, just as major countries, including the United States, are prepared to pay in gold. Moreover, this procedure would further demonstrate the essential equivalence of gold and SDR's as reserve assets.

Unfortunately, the amendment to the articles of agreement providing for SDR's failed to include such a provision. I believe many foreign officials would now share the regret expresed publicly by Emilio Colombo, the Italian Minister of the Treasury, who was a principal in the SDR negotiations, over this omission. However, I think we must recognize the difficulty of amending the articles at this time for this purpose.

In any event, other techniques are available to forestall the so-called secondary impact of quota payments on our own reserve position. These techniques are more cumbersome. They essentially entail a series of transactions by which countries with insufficient gold would initially obtain the gold from one or more other countries; the gold is then paid into the Fund; and the Fund, in turn, repurchases with equivalent gold needed currencies. In the end, the Fund will be adequately supplied with usable currencies, or perhaps SDR's, without impairing the reserve position of any country. I believe in concept the need for such an arrangement is widely accepted, and there is every reason to expect that the Executive Directors will propose a fully acceptable and technically sound plan.

The Executive Directors are now shaping a proposal to the Governors as to the size and distribution of quota increases themselves. The United States welcomes this prospective addition to the Fund's resources, which I anticipate will be reasonably in line with the growth of the world economy. In a sense, this prospective addition to the supply of international credit is a natural complement to the inauguration of SDR's, which provide an expanded reserve base.

The task of achieving a distribution of quotas that fairly reflects the relative needs and circumstances of various member countries is a delicate process. In balancing the various considerations involved and to facilitate the negotiating process, the United States has indicated a willingness to accept a slightly smaller percentage increase in its own quota—now at $5.2 billion—than seems likely for the average member. Nevertheless, we anticipate that, for the first time since the Fund was founded, the United States, in addition to its share of a general increase applicable to all members, will accept a portion of the additional selective increase to which it would be entitled on the basis of commonly used formulas calculated to reflect relative economic growth and weight. This decision may raise the further question, in the light of previous practices, of whether we are prepared to increase in approximately the same proportion our capital subscription to the World Bank. Both the quota and any possible increase in the World Bank subscription would, of course, require legislation.

All of this, as I suggested at the start, suggests progress in dealing with the problems of the international financial system. But we must also recognize there is one area—fundamentally more important than any other I have touched on today—where the needed progress has been all too slow.

I am referring, of course, to the related problems of our balance-of-payments positions and our internal inflation. The preliminary third quarter payments' figures show a seasonally adjusted deficit on the so-called liquidity basis of some $2½ billion, only a bit below the average of $2.8 billion during the first two quarters of the year. Moreover, on the official settlements basis, where we had a sizable surplus in the first half of the year, a deficit approaching $1 billion developed in the third quarter.

That has offset just a part of our earlier surplus on that basis.

It would be misleading to focus too closely on precise numbers. The conventional measure of the liquidity deficit continues to be distorted by some transient factors of little real economic significance, including a sizable reversal of so-called special receipts. Outflows related to speculation in the German mark, which subsided only at the end of the quarter, probably had some impact on both measures of our payments position. Conversely, a reflow of funds from Germany, the apparent need for many corporations to repatriate funds to conform to the direct investment regulations, and other factors should work toward some improvement during the current quarter.

Nonetheless, any analysis makes it plain that, beyond short-run distortions, we face a major challenge. The nub of the problem is perfectly clear. If we expect to invest freely abroad, to provide aid, and to carry our military responsibilities, we must, over time, provide the bulk of the resources through a strong trade and current account position. Instead, we have permitted, over recent years, an erosion in our international competitive position, and overheating has sucked in imports. By 1968 our traditional large trade surplus had almost vanished.

In recent months, there have been some glimmerings that the process of restoring that favorable trade balance may have begun; at the least, the deterioration has been stemmed. A vigorous business climate abroad should provide a clear opportunity for improvement in the year ahead. But it is plain that the full job of restoring our competitive position can't be accomplished easily or quickly.

What is essential is that the signs of underlying progress are plain. The most important sign of all will be a dampening of our internal inflationary pressures.

I know this kind of plea is familiar, and I have no new approach to recommend other than the tough and painful—but also indispensable—course of fiscal and monetary restraint. I repeat these words today only because it is always too easy—in the euphoria of the moment, intrigued by the intellectual challenge of developing one monetary mechanism or another—to lose sight of this fundamental. The size and distribution of Fund quotas, the performance of the two-tier system, the effects of the German revaluation, even the major accomplishment of the SDR and the potential for some limited flexibility of exchange rates will be of limited consequence if we do not meet our own responsibilities for a reasonable degree of price stability.

In the end, world monetary stability rests on the stability of the dollar itself, and, failing that, Mr. Chairman, I would be in no position to report in the future the same grounds for confidence that I see today.

Chairman REUSS. Thank you, Mr. Volcker.

(Mr. Volcker's prepared statement follows:)

PREPARED STATEMENT OF HON. PAUL A. VOLCKER

This Subcommittee has come to play a most valuable role in the never-ending task of keeping our international financial arrangements abreast of the needs of the times. You have promoted informed public discussion of important issues too often considered the preserve of experts, prodded practitioners to seek new and better solutions, and—not least—provided leadership and support when the need for change has been demonstrated. I am pleased to assist in this process this morning by discussing U.S. policies related to the proposed increases in International Monetary Fund quotas and the two-tier gold market arrangements.

I am doubly pleased that we can consider these matters against a backdrop of relative calm in international financial markets. The recurrent stresses and strains characteristic of recent years have been symptoms of underlying imbalances within and among national economies, as well as of some shortcomings in international financial arrangements. It would be too much to claim these problems are all behind us. But I think we can se some tangible and significant progress toward dealing with a number of the principal sources of uneasiness.

The evident strengthening of the external position of the United Kingdom, the ajustment of the French franc parity without serious disturbance, and the wise and courageous action of the new German Government in revaluing the mark have together removed the main sources of immediate speculative tensions. More than that, I believe they have helped establish a solid footing for moving ahead to deal simultaneously with remaining external and internal imbalances.

For instance, by making imports relatively cheaper and dampening strong incentives to divert current production into foreign markets, the revaluation of the mark should—at one and the same time—assist the German Government in dealing with emerging inflationary pressures at home and significantly improve the prospects of achieving a better equilibrium in external trade flows.

Accompanied by effective, sustained policies of internal fiscal and monetary restraint, the new exchange rate for the franc provides a basis for orderly restoration of the French competitive position. In weathering the strains of the past year—and with clear signs of basic improvement now showing through in recent trade and balance of payments data—sterling need no longer be a focus for speculative pressure.

The sense of greater stability fostered by these recent developments in particular countries had been strongly reinforced, I believe, by the multilateral decision at the IMF meeting to move ahead with the creation of Special Drawing Rights in the sizable volume of $9.5 billion over the next three years. This decision has been clearly presaged by intensive preliminary discussion through the Summer. Nevertheless, the formal activation decision—taken with only one abstention—emphasized the extent of the consensus to move forward into a new era of managed reserve creation. More broadly, this wide agreement about so sensitive a subject as international money creation seems to me the best possible omen of our capacity to deal cooperatively with the problems in other difficult and complex areas.

Indeed, this process of monetary cooperation is now reflected in the fact that, as a result of discussions by the Governors of the Fund at the Annual Meeting, the Executive Board is now preparing to examine carefully and systematically the possible usefulness of introducing a somewhat greater degree of flexibility into the exchange rate mechanism. Study of this matter will take time. A wide variety of points of view must be brought to bear, many of which stem from the basically different economic circumstances in which various countries find themselves. It is far too soon to pronounce judgment on what, if any, specific proposals will pass the test of practicality and widespread usefulness. Certainly, we want to be imaginative in seeking ways to eliminate rigidities that inhibit the adjustment process or tend to build up incentives to speculation. But we also want to take prudent care that, in making changes, we do not undermine the broader stability and disciplines of the system as a whole—stability and disciplines that provide an essential base for expanding trade and orderly planning and investment decisions. I can assure you that the United States will be actively participating in this joint effort in this spirit.

Chairman Reuss. In your statement, you referred to the fact that the gold market reacted only very slightly to the severe currency crises of this year.

I have noted that over the past 6 months particularly, South Africa has apparently sold not only all its newly produced gold but substantial amounts of its accumulated reserves, mainly in the private market.

To what extent do you think that that increase in South African sales was responsible for the recent decline in the price of gold in the private market?

Mr. Volcker. I would preface any response to a question of that sort, Mr. Chairman, with some confession of ignorance. What is going on in the gold market is not always completely clear to an outsider, as I suggested in this statement. So, I would not want to pretend that I can explain to you with accuracy the reasons for every fluctuation in the private price. I think, unquestionably, however, some gold from South Africa, directly or indirectly, was reaching the market over this period. I would think another factor operative in the market fairly continuously is the reaction of speculators or hoarders to external events, they view them. And I think there have been a number of developments over these recent months that might be discouraging to speculative interests.

Chairman Reuss. You have testified that you believe "The two-tier system must be judged a success." And that "This is true despite the fact that it has not been possible so far to reach an understanding with the world's largest gold producer—South Africa—as to appropriate means by which it might to handle its newly mined gold within the framework of the generally accepted arrangements," to quote you.

Would it not be more appropriate to say that the success of the two-tier system is largely due to the fact that no agreement has been reached with South Africa?

Mr. Volcker. No, sir. I do not think it would.

Chairman Reuss. The two-tier system has worked very well and has, apparently, broken the attempt of South Africa to withhold gold from the private market by standing firm.

Mr. Volcker. Well, this would depend, I suppose, upon what kind of an agreement you have with South Africa. I think of an understanding that would be fully consistent with the best interests of the two-tier system, but in the absense of such an understanding, I think this does represent something of a loose end, an element of uncertainty that is undesirable in itself, unnecessary from our viewpoint, and I do not think really necessarily in South Africa's interest either. I think if we could have an understanding as to the appropriate method by which this gold would be handled over time, it would be desirable.

Now, whether or not it is desirable, obviously, depends upon what the nature of the agreement is. And that is where I am afraid we have been stuck. We are only interested in an agreement that conforms fully with what the interests are of the two-tier system.

Chairman Reuss. I take it that any agreement made with South Africa would be required to be submitted to Congress for its approval; would it not?

Mr. Volcker. It would not require any legislation.

I have not been thinking in terms of the kind of agreement that would require any legislation, just as the two-tier understandings themselves—the basic understandings—are not a matter of direct legislation. They are certainly a matter of congressional interest, and I would certainly anticipate that the Congress would be informed.

Chairman REUSS. Well, the two-tier arrangement was one that had been discussed at some length for some years before March 1968, and it was not a treaty or firm agreement. It was a statement of principles.

Mr. VOLCKER. That is right.

Chairman REUSS. But I would think that anything approaching an agreement with South Africa on a minimum price that we or the IMF is going to pay for their gold would require some congressional approval.

Mr. VOLCKER. Well——

Chairman REUSS. I mean an agreement that would commit us; that would commit our Government to a given course of action, and I would think it ought to be approved.

Mr. VOLCKER. I certainly would think the Congress would want to be informed about what the circumstances were, but what we are seeking here is nothing in the nature of a treaty. We would like an understanding as to how South Africa is handling, and plans to handle, its gold sales. This is not a matter that necessarily directly involves the United States in the sense that we are involved in any transactions. I would not anticipate that that would be the case.

This is an understanding which I would hope could be reached, if it is reached, in the interest certainly of the system as a whole but not necessarily something that directly involves any action by the United States as such.

Chairman REUSS. Well, what is it that we want to gain from the South Africans?

Would it be correct to say that what we would want to gain from the South Africans is some commitment on their part not to act like monopolists and withhold their gold from the free market? After all, such withholding caused the free market to go to a higher price than would otherwise be the case and thus tempts central bankers to evade the two-tier system?

Mr. VOLCKER. I think there are elements of that kind of a problem in the situation. That is certainly an element in the problem, and we would not think it is in South Africa's long-term interest to really play that kind of game against the rest of the world, so to speak. We think it is in the interest of the two-tier system if we could get an understanding, in a sense, consistent with the kind of considerations that you suggest.

Chairman REUSS. Is it not a fact, though, that without any understanding the South Africans have found that their game of withholding gold from the market was impossible to maintain and that they thus had to sell considerable quantities?

Mr. VOLCKER. Oh, I do not think there is any question about that, Mr. Chairman. Gold is a major export for South Africa, and they cannot go along year after year without selling gold. And they sold some, as I said, in the past year, and I expect them to continue to continue to sell gold, but the procedures have not been regularized. They are now surrounded by a little hocus-pocus, and it would be desirous to eliminate this residual uncertainty. I think the system will work without it. I do not present this as a vital matter to the continued performance of the two-tier system.

But if you ask me whether I would prefer to have an agreement or not to have an agreement, of an appropriate kind, I would prefer to have the agreement that would regularize and make the process more orderly.

Chairman REUSS. But you would agree to two facts: (1) that South Africa apparently cannot get by very long playing a monopolist and withholding its gold from the free market, because its foreign exchange position suffers and (2) that with SDR's in place, there is a good answer to any monopolist attempt, namely, the international monetary system is not going to grind to a halt because of the lack of new gold reserves——

Mr. VOLCKER. There is no question about that, Mr. Chairman.

Chairman REUSS. Don't these two factors reall make South Africa's nuisance value, if one can call it that, very slight?

Mr. VOLCKER. Well, I do not think South Africa by any means is in any position to upset either the two-tier system or the general fabric of the international monetary structure. And I do not want to leave any impression that I think that kind of cataclysm is at issue here. It is a much more limited kind of question. We can live without an understanding. We have, successfully; and we can continue to do so. But if we could further regularize the procedures in the market, I think it would be desirable.

Chairman REUSS. If one could acquire for nothing a commitment of South Africa to be a gentleman about all of this and not to try monopoly practices, that would be fine. I take it, though, that when you talk of an agreement, you are talking of the rest of the world, including the United States, giving something to South Africa, some consideration, for their agreement.

Mr. VOLCKER. I would prefer, I suppose, the words "mutual understanding" as to what procedures they might choose to follow. You say "giving something." I do not think it is a question of giving anything that in any way would detract from the institution and viability of the two-tier system.

I think there are degrees of uncertainty on both sides that could be well eliminated.

Chairman REUSS. One reads in the press the thought of giving South Africa, either through the IMF or through various central banks, a floor price on its commodity, gold, at $35 or perhaps something under that. Since we do not bail out the developing countries who have problems with their basic commodities of coffee, or cocoa, and of metals. even though they have argued for price-stabilization schemes in UNCTAD and other forums. If we paid that kind of a price for South Africa's being a gentleman and not being a monopolist, this would be a very considerable price to pay, would it not?

Mr. VOLCKER. Well, I do not think it would be appropriate for me to try to get into detail this morning of what might or might not in a precise way be desirable as part of an understanding with South Africa. I am not sure that international commodity agreements are entirely unknown, but I do not think that that particular issue is necessarily a great stumbling block, from my point of view.

Chairman REUSS. Well, suppose if the United States either directly or as a member of the IMF proceeded to buy South African gold, for which the private-market price was only $30, instead at $35. This action would have an impact on the taxpayers in this country and in the other participating nations equivalent to supporting the price of coffee or cocoa, or any other developing-country commodity at over its free-market price; would it not?

Mr. VOLCKER. I am not quite sure what kind of an arrangement you are visualizing. I cannot conceive of an arrangement that is going to affect the American taxpayer; no, sir.

Chairman REUSS. Well, I read in the papers about a possible undertaking in South Africa that either the central banks of a number of countries or the IMF would stand ready to purchase their gold at $35 an ounce even though the free-market price of gold was below that. This would mean that if we, the United States, did it, the American taxpayers would be subsidizing a leading export of South Africa. If it is done through the IMF, the risk would be socialized a bit, but all the members of the IMF would be paying for that excess-price support.

And I am just wondering, since we balked, for reasons good or bad, at the UNCTAD request to support the basic commodities of the developing countries, whether we should single out South Africa and, to a degree, the Soviet Union, as the special beneficiaries of such a price-support plan?

Mr. VOLCKER. Well, I do not want to prejudice the basic issue. I am still not sure it costs the taxpayers anything because of certain historical and maybe vestigial conditions. I do not think the purchase of gold by the IMF is going to cost the taxpayers anything, if the gold tends to get monetized, for instance, or if it was purchased by the United States or other countries.

Chairman REUSS. If the IMF buys a desk for its office over here for $200 that it can get down the street for $150, that is bad business, and I would expect Mr. Dale—I would be confident that Mr. Dale would object to such indirect spoliation of the American taxpayers' dollars. Equally, if the IMF buys a $30 commodity, gold in our scenario, for $35, I would think that they ought to get a new purchasing agent, that that is not very good business.

Mr. VOLCKER. They may need a new purchasing agent, Mr. Chairman, but I think if they put it in their balance sheet it does not depreciate in their balance sheet, and it does not cost anybody anything in the terms in which you are thinking of it.

Now, I think one might argue that to the extent the price of gold is artifically held up, it is costing the real resources of the world something, but those resources are fundamentally, I suppose, spent by South Africa rather than by the IMF. It is not going to affect the IMF wealth or position over time, whether they put gold in their balance sheet.

Chairman REUSS. Well, I think, as you have just said, it does mean that the non-gold-producing world has to sweat and strain in order to find the real resources to make up the difference between the subsidized price and the price that willing buyers and sellers would have used.

Mr. VOLCKER. There is some real resource implication. I would accept that.

Chairman REUSS. I do not want to prolong this, but I do note the zealousness of the Joint Economic Committee, its Chairman, and Vice

Chairman on down, against getting into a position that would cost America, either directly or indirectly, more than it would have to pay in a free market.

Mr. VOLCKER. I understand, I think, your basic concern, Mr. Chairman, and I think I would share it, certainly to a degree. I simply think that no particular issue of this kind could be judged out of the context of the entire problem that we have here.

Chairman REUSS. Turning to the matter of the IMF quota increase, I note the pleasure of what you say in your statement that a much better way to have done this would have been to have permitted the use of SDR's in lieu of gold to pay the 25 percent gold subscription requirement.

Why is there such a difficulty in amending the articles so as to provide for this use of SDR's? After all, the quota-increase proposal will require what kind of a vote?

Maybe I should ask Mr. Dale.

Mr. VOLCKER. Eighty-five percent, I guess, now as a number of other decisions do.

Chairman REUSS. Eighty-five percent.

What does it require to amend the articles?

Mr. DALE. Eighty percent of the voting power and 60 percent of the members which is a very much longer process.

Mr. VOLCKER. Technically, it could be done. There is no question about that.

Chairman REUSS. Well, why don't we circulate a little amendment? If we get the 85 percent for increasing quotas, it should be possible to get less than that, 80 percent, for removing an archaic, dusty 1945 provision that really makes no sense in this new era of SDR's.

Mr. VOLCKER. Obviously, the difficulty does not lie in our ability to circulate a little resolution or amendment. The difficulty lies in the fact that this decision, for better or for worse—and I think people tend to regret it now, as I suggested—was taken explicitly as part of the SDR amendment process. And I think you would find some who would be reluctant to amend that amendment, reverse a decision that was made consciously only recently even before, as they would say, the ink is dry on the amendment.

Now, that does not say it cannot be done.

Chairman REUSS. During the time the ink was drying, I might point out, the governments of two of the leading monetary countries, France and West Germany, have changed. Another leading signatory, Italy, was very enthusiastically backing such an amendment. I should think the developing countries who make up two-thirds, in number, of the IMF would be very keen on ridding the 1945 Bretton Woods agreement of what is essentially an archaic provision, one that is going to cause most of them trouble, because they have not got the gold.

Mr. VOLCKER. I am sympathetic with what you are saying, Mr. Chairman. At the same time, while exploring that avenue, I think we are in the position of having a perfectly acceptable, useful technique available to us that would essentially accomplish the same result. It is a little more cumbersome, but we are not in the position where failing this agreement, we have an unsatisfactory result. It is a question of: By which means do we get the result?

I think it is more desirable, more straightforward to have the kind of amendment which you are suggesting, and I would think someday we are going to have it. But it is not an essential matter right now. I think we have to admit it is not an essential matter.

Now, given that it is not essential—highly desirable but not essential—is it feasible or desirable to press ahead and attempt to change the agreement in this respect at this time?

Chairman REUSS. You know, up here in Congress, we have a device that when one introduces a bill that comes from somebody else, he can put the words "introduced by request" on it. I wish you would consider introducing by request such an amendment into the IMF proceedings. Let the members stand up and vote on it.

Mr. VOLCKER. Don't misunderstand me.

Chairman REUSS. No hard feelings.

Mr. VOLCKER. I have discussed this. I have had conversations about this particular matter. I do not think it is a closed issue, but I do not think it is a vital issue either at this particular stage.

Chairman REUSS. Well, I am glad to hear it is not a closed issue, and I know you will exploit the possibility of tidying up the 1945 agreement.

Let's now go to the second part of this—your feeling that there are other ways of assuring the 25 percent gold input requirement of the quota increase, if that provision is continued, that it will not result in any impairment of the March 1968 two-tier agreement.

I would regard it as very unfortunate if the necessity of ponying up about \$1.8 or \$2 billion worth of gold—is it something like that—resulted in member countries having to acquire gold outside the system.

Is it your feeling that you can come to Congress next year when the quota increase will be before us with a fairly ironclad arrangement showing that this will not be the case and that triple-entry bookkeeping, or whatever you are going to use, will take care of the nagging little gold problem?

Mr. VOLCKER. These matters are definitely unrelated, in my opinion. The two-tier system and how South Africa handles its gold in that respect is a problem different from this question of gold payments to the Fund. I do not think we should mix up the two. I think this problem will be resolved without the kind of complication that you suggest. I do not think there is any question about that.

Chairman REUSS. Just so I am sure I understand you: You are saying then, Mr. Volcker, that fancy bookkeeping, however denominated, will enable the countries to put in the \$1.8 billion worth of gold without actually putting in any gold? It will all be flushed out of the IMF back to the national reserves of the contributing countries so that they will not have to go outside the system to comply with the 25 percent gold requirement?

Mr. VOLCKER. In general terms, yes. I do not accept necessarily all the language with which you have surrounded this description. I should make clear here that I think we are talking about the so-called secondary impact when we talk about the gold being passed back into the system.

Chairman REUSS. As opposed to the United States——

Mr. VOLCKER. That is right. The United States and other countries who have adequate gold would be expected to pay gold into the Fund in the normal course.

Chairman REUSS. Our gold contribution, our primary gold contribution, would be about \$800 million?

Mr. VOLCKER. It depends upon how big our quota increase turns out to be. We are not talking of amounts that large. Subsequently smaller than that.

If our quota, for example, turned out to be an increase of roughly 30 percent, this would be a billion and a half, roughly, if I am doing my arithmetic correctly, and 25 percent of that would be less than $400 million.

Chairman REUSS. It is a fact, is it not, that the United States has, in the last year, acquired a considerable amount of gold?

Mr. VOLCKER. Yes.

Chairman REUSS. Isn't that figure something like $700 million, since May of 1968, since the two-tier day?

Mr. VOLCKER. In the past year it is 400-some.

Chairman REUSS. Well, that is sufficient for the purposes of my question which is this:

The United States would be able to pay in the probable $400-odd million worth of gold which the IMF quota increase would require from us without bringing its gold position below, or markedly below, where it was——

Mr. VOLCKER. Oh, yes.

Chairman REUSS (continuing). In March of 1968; is that not so?

Mr. VOLCKER. That is true. We are perfectly prepared, willing, and expect the gold to go into the Fund as part of the quota increase.

Chairman REUSS. In your statement, Mr. Volcker, you referred to the inclusion of South African rand in packages of currencies loaned by the IMF and said, in effect, that you do not consider this alarming because it was in accordance with IMF practices and did not amount to enough in quantity to really destabilize the March 1968 agreement.

Mr. VOLCKER. Precisely.

Chairman REUSS. What if there were a South African attempt to draw from the Fund in excess of the 25-percent automatic gold tranche borrowing privilege? Would this be the subject of approval or disapproval by our Executive Director?

Mr. VOLCKER. I think this would depend entirely upon the circumstances that surrounded such a request. South Africa is a member of the IMF. They are entitled to draw from the IMF monetary fund in circumstances of need.

Now, if they draw beyond the gold tranche, it is discretionary on the part of IMF whether the credit is provided, and they would presumably have to make a decision as to whether the South African economic situation, balance-of-payments situation, was such as to make this kind of a drawing appropriate. And that could not be judged except in the particular circumstances of the time.

Chairman REUSS. Let me now turn to the——

Mr. VOLCKER. If I may interject here, Mr. Chairman.

Chairman REUSS. Yes.

Mr. VOLCKER. I think this kind of question and suspicion, which I understand is inevitable. is an indication of why I think a more general understanding with South Africa would be desirable so that these little suspicions do not have to arise in your mind and other minds, and my mind, and everyone's mind from time to time.

Chairman REUSS. Let me turn now to the effect of the general gold purchasing commitment of the United States.

How do we phrase our gold purchasing practices?

On the other side, we have agreed to sell gold at $35 an ounce to any central bank or finance ministry or international institution.

Mr. VOLCKER. We are prepared to buy at $35 an ounce for legitimate monetary purposes.

Chairman REUSS. Prepared to buy. I am not clear exactly as to what that means. Does that mean that we stand ready, endlessly and without limit, to purchase all the gold that is offered? Or does the phrase "for monetary purposes" mean that we purchase only that which we consider we need for monetary purposes?

Mr. VOLCKER. I think we are passive in the process. If a country comes in to us and it is a legitimate monetary transaction, we will buy the gold. But we place no dollar or other limits on our willingness to do this.

Chairman REUSS. That commitment is at least a generation old; isn't it? It goes back to the thirties.

Mr. VOLCKER. It goes back to the thirties.

Chairman REUSS. Yes. That—check me if I am wrong.

Mr. VOLCKER. It goes back to the thirties at the present price. We bought and sold gold before the thirties.

Chairman REUSS. Yes. That generation-old commitment has, I reflect, been modified by the March 1968 two-tier agreement; has it not? That is to say, before March 1968, gold could enter the monetary system without limit and wouldn't this change modify our commitment?

Mr. VOLCKER. I do not know whether I would express it as a modification of the commitment to buy and sell gold for legitimate monetary purposes. The operational procedures are somewhat changed. For instance, we used to buy gold from our own domestic mines—or at least be willing to buy gold from our own domestic mines—which we no longer do. The communique in a sense, helped to define what a legitimate monetary purpose is by indicating we would not sell gold, for instance, to another monetary authority that was turning around and selling it in the market.

Chairman REUSS. Perhaps, this is what is in my mind. Prior to March of 1968, though, the problem never arose, because central banks were not trying to get rid of gold during that time.

Mr. VOLCKER. That is right.

Chairman REUSS. Prior to March 1968, if a given country, say France, has presented to us $3 billion worth of gold which they had acquired from the Soviet Union or South Africa, in the preceding period we would have had to purchase that, would we not, under our committment?

Mr. VOLCKER. We would have purchased it, yes.

Chairman REUSS. Yes, for dollars.

Mr. VOLCKER. Right.

Chairman REUSS. After March 1968, that would not be true, because it is only—the only gold in the system for legitimate monetary purposes that existed in March 1968, so it would be correct, would it not, to say that, "With perfect good faith on the part of the United States, as the result of the March 1968 agreement, our commitment to purchase gold has been markedly curtailed, in that the only gold around is the $39 billion worth in the system"?

Mr. VOLCKER. I think that is, with some minor exceptions, a fair characterization.

What the communique did, I suppose, in this respect, was to define a little more closely a collective judgment as to what a legitimate monetary transaction was, because I resist saying our basic policy in this respect has changed. Our basic stance is buying or selling gold for legitimate monetary purposes.

Chairman REUSS. And we in March of 1968 defined "legitimate monetary purposes" as being the closed system.

Mr. VOLCKER. As a matter of policy, the March communique defined certain behavioral patterns of central banks with respect to their relationships with the private market.

Chairman REUSS. My guess—and it is certainly just a guess—would be that probably the United States is not going to be asked to buy very large amounts of gold in the years to come. The $39 billion is pretty well spread around. Countries owning it have their own gold ratio habits and practices, and there is not likely to be any vast offering to the United States in monetary gold.

Would that be your hunch?

Mr. VOLCKER. I think that is fair for the foreseeable future. As you point out, we acquired a substantial amount in the past year, but if you are talking about all the gold in the world or a very large fraction of it, coming back into the United States, I do not see that at the present time.

Chairman REUSS. Thank you very much, Mr. Volcker and gentlemen.

We may have some additional questions to put to you before the hearing record is concluded. If so, we will submit them to you.

You have been your usual frank and helpful self, and we appreciate again, your being with us.

Mr. VOLCKER. Thank you very much, Mr. Chairman.

Chairman REUSS. Thank you, gentlemen.

We will now stand in adjournment.

(Whereupon, at 11 a.m., the subcommittee adjourned, sine die.)

(The following response was subsequently received from Under Secretary of the Treasury Paul A. Volcker to questions submitted by Senator Charles H. Percy:)

Question 1: When the Eurodollar market was first developed, central banks were the most important source of funds, and even to this day they remain a significant source. One estimate put it that one third of Eurodollar deposits in 1967 were owned by central banks. Do you believe that the central banks' desire to adjust their dollar holdings pursuant to the quota increase—whether to buy gold from the U.S. or to reconstitute an optimum reserve composition after making their gold contribution—will in any way affect the Eurodollar market?

Answer: Gold payments into the Fund resulting from the quota increase should initially reduce the gold reserves of the major gold holding countries and enlarge the gold holdings of the International Monetary Fund. However, it is not anticipated that these countries will be withdrawing dollars from the Eurodollar market, if they hold reserves in this form, or converting dollars into gold, on a significant scale, because of these gold payments. Over time, the Fund can be expected to reduce its gold holdings by purchasing needed currencies, and this will tend to restore the pre-quota levels of gold reserves of member countries. In the meantime, the countries concerned will have acquired gold tranche drawing rights on the Fund equivalent to their gold payments, which are readily usable as reserves, in the same way as gold.

Countries which hold only small amounts of gold in their reserves may have to acquire gold from other countries in return for dollars, in order to make gold payments to the Fund. Procedures to mitigate the effects of such transactions on the gross reserves of the United States or other countries may be needed. The effects of such mitigation procedures would be to increase the Fund's holdings of usable currencies rather than gold, and to shift dollars from one member country to another. Unless the country receiving dollars is less likely to place them in the Eurodollar market than the monetary authority previously holding the dollars, there would be no effect on the Eurodollar market.

Question 2: What do you think the effect that public discussions of mitigation procedures at this time is having or might have on the discussions which I understand are taking place within the Fund on this subject?

Answer: There are cases where public discussions of issues being considered within the Executive Board of the Fund may be helpful, or may add to difficulties, or may have little effect. On the whole, public discussions of mitigation may be mildly helpful. It was generally known that the subject would be taken up in the Executive Board.

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