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Professor Lerner on "The Cross of Gold"

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Professor Lerner on "The Cross of Gold"

A plan which allegedly would solve most of the problems of the international monetary system has recently been put forward by Abba P. Lerner, professor of economics at Michigan State University. In the April issue of Challenge and in the April 19 issue of the Washington Post, Lerner has argued that demonetization of gold, combined with establishment of a purchasing-power guarantee of dollar holdings, would eliminate the balance-of-payments constraint on U.S. domestic policy, and would simultaneously solve the whole problem of international liquidity.

Lerner sees the situation in the following terms. The "natural cure" for the U.S. balance-of-payments deficit is to raise the dollar price of foreign currencies (i.e. to make the dollar worth less in foreign currencies), in order to stimulate exports and depress imports. Under existing arrangements, this could be done only by raising the dollar price of gold. But the U.S. does not want to do this, for three good reasons. It would be a breach of faith with our foreign friends who have been willing to hold dollars instead of demanding their conversion into gold; it would constitute "large and undeserved" gifts to the gold-producing countries (notably South Africa and the Soviet Union) and to those who have speculated against the dollar by hoarding gold; and it might not work, because other countries might decide to raise the price of gold in their own currencies (i.e. to devalue) to the same extent. In one of the articles Lerner adds a fourth consideration: that devaluation might stimulate (instead of reducing) the outflow of gold from the United States, because foreigners would no longer be willing to hold significant amounts of reserves in the form of dollars.

He also notes that restriction of imports of goods and services, and of capital exports, could hardly be a primary solution, for such action, in addition to its other undesirable consequences, would invite retaliation by other countries.

But the whole problem exists, Lerner argues, only because of "the tyranny of gold," and can be solved "quite easily" by ending this tyranny. All the United States has to do is to stop supporting gold at $35 per ounce or indeed at any price--i.e. stop buying gold, and dispose of its existing gold holdings to any willing buyers (presumably at whatever price they would bring), either all at once or gradually. At the same time the U.S. would enhance the acceptability of dollars to foreign holders (Lerner says to <u>all</u> foreign holders) by giving the latter a purchasing-power guarantee, stated in terms of some appropriate index of prices. If this index showed a rise of, say, 5 per cent, the U.S. would augment foreign dollar balances by an amount sufficient to offset the rise in prices, thus maintaining the dollar purchasing power of such holdings.

Thus far the proposal has been summarized as if it envisaged only the encouragement of foreign holdings of U.S. dollars; but in one of the articles Lerner suggests inclusion of sterling and the Canadian dollar. What such "inclusion" might mean is not made clear. In any event, to simplify the discussion it will be assumed in what follows that the plan contemplates stimulation of foreign holdings of U.S. dollars only.

The consequences of the steps suggested would be, Professor Lerner thinks, as follows. First, there would be a shock to confidence in gold, and a fall in its value. Thus instead of the rise in the dollar price of gold that a devaluation of the dollar would entail, its price would decline; in other words, the value of the dollar stated in terms of gold would rise. The consequent decline in the book value of our own gold stocks would be of negligible importance, Lerner feels, "compared with the real economic loss we are currently enduring from our own level of employment and slow economic growth."

Second, there would be something of a scramble for dollars by foreigners to make up for the decline in the value of reserves caused by the drop in the dollar value of gold holdings. To achieve an increase in their dollar holdings, some (or many) countries would exert efforts to sell more to, and buy less from, the United States. As a result, the U.S. balance-of-payments deficit would increase, but the deficit would be covered by our supplying the dollars thus implicitly demanded by foreigners.

Third, as a result of the steps suggested and the foreign reactions indicated, there would have come into existence "an automatic dollar (or dollar-sterling) standard, working just like an ideal gold standard." An "ideal" gold standard, which the actual gold (or gold-exchange) standard was never able to be, is one in which "the supply of gold is never too scarce or too plentiful, but increases sufficiently whenever a scarcity of gold tends to raise its value, and decreases sufficiently whenever an abundance of gold tends to lower its value, so as to keep its value stable." That is to say: unlike experience to date with gold, the supply of dollars could be made to increase in proportion to need; but in addition it could also be made to decrease when appropriate--something which could never be true of gold. Gold, once produced, can never be--so to speak--"unproduced," since pouring gold back into the mine from which it came would not regurgitate the labor lost in digging and refining it.

Analysis and Appraisal

Neither of the two chief elements of Professor Lerner's plan, taken separately, is new: the proposal to demonetize gold, and the proposal of a value guarantee on dollar holdings by foreigners. The latter has been suggested by many people, although what they have usually proposed is a gold value guarantee--obviously impracticable under the Lerner plan--rather than a guarantee of value in dollar goods and services. Gold demonetization has also been recommended explicitly or implicitly--notably in the half-facetious, half-serious article in the London Economist (issue of December 24, 1960) referred to by Lerner. What is new is Lerner's combination of these two proposals in one "plan." The guarantee feature is obviously his answer to the question of why foreigners would hold dollars whose value (in gold or in anything else) is uncertain, thus risking loss--through inflation in the United States--of whatever value they may have had at the outset. His answer is: the plan eliminates this risk by assuring maintenance, through guarantee, of the constant purchasing power of foreign dollar balances.

The following discussion of the Lerner plan leaves entirely aside the question of the extent to which the U.S. balance-of-payments deficit is still a problem, and the extent to which its solution may be in sight. To offer an optimistic view of the present U.S. balance-of-payments outlook as an answer to Lerner could leave a misleading impression--namely, the view that his plan might otherwise be worthy of adoption. In order to appraise the plan properly it is necessary to view it on its own terms--i.e. as one aimed at, among other things, eliminating the constraint of U.S. domestic policy by a balance-of-payments deficit assumed to be sizeable and to continue for some time to come. Accordingly, the plan is so viewed in the following discussion.

There are three main objections to the Lerner plan summarized above.

1. Whether, as Lerner expects, demonetization of gold by the United States would destroy or at any rate substantially reduce the value of gold is--for reasons to be indicated presently--extremely doubtful, at best highly debatable. But assume for the moment that it would. In that case the act he proposes could only be characterized as unworthy of a great nation. True, the United States has never guaranteed the value of gold; but we have certainly acted as if gold were a thing of value, not lightly to be tossed away. It is no answer to say that demonetization of gold would punish only speculation against the dollar; for not all holding of gold, especially by central banks, can properly be so characterized.

Many countries have a substantial interest in the value of gold; in an era in which the rational conduct of economic affairs is increasingly dependent upon international cooperation, how could any one country justify deciding unilaterally (if that were in fact possible), in its sovereign might, that the time had come to destroy the value of gold? While it may be true that the U.S. has carried the bulk of the burden (if it is a burden) of maintaining the value of gold, many countries have helped carry the burden of maintaining the gold-exchange standard. If and when the time comes to eliminate gold from the basis of the world's monetary system, such elimination should not be accomplished through a hit-and-run act by one country; rather, it should be done on as orderly a basis as possible, following international study, consultation, and negotiation.

2. In fact, however, it is questionable whether movements in the price of gold following its demonetization by the United States would be those expected by Lerner. The belief that gold prices would decline catastrophically following a U.S. decision to cease buying gold, and to sell off its present holdings, seems to be based on an assumption of no increase in demand by others, except perhaps the European central banks, which might, Lerner reasons, try to maintain the $35-per-ounce price by buying up all the gold we dumped on the market. This, he suggests, would cost them $15 or $16 billion, "plus additional funds which might be needed to buy up the gold thrown on the market by other countries and by frightened gold hoarders."

To begin with, his analysis of costs to the European central banks rests on shaky ground. On the assumption that all U.S. gold were put on offer, and that substantial additional amounts were "thrown" on the market by other countries and by some private holders, the price would presumably fall. Whatever gold price the European central banks might aim at establishing ultimately, they would have no necessary interest in <u>paying</u> $35 per ounce; it would be to their interest to buy up the gold as cheaply as possible.

Secondly--and more important--Lerner's assumption of a decline, rather than an increase, in demand by hoarders is certainly debatable. To an important extent the hoarding of gold is irrational; therefore it may be dangerous to assume a rational reaction to the Lerner plan (assuming that buying gold under such circumstances would in fact be irrational--which is by no means certain, in view of the uncertainty as to subsequent movements in gold prices). Hoarding demand has been strongest at times of currency uncertainty, because many people have a deep-seated belief that whatever may happen to currencies, gold retains its value. Millions of people may well believe that the value of gold is intrinsic. It is not at all certain that this belief would disappear overnight, whatever the United States might say about the significance of its demonetization of gold as proposed by Lerner. Thousands, perhaps hundreds of thousands, of people who had never previously bought gold might decide to do so--especially at what might appear to be bargain prices. Thus private demand, plus buying by European central banks, might well be more than enough to absorb the U.S. gold stock (assumed to have been dumped on the market) at not much less than $35 per ounce. Depending upon subsequent selling policies by foreign central banks, and upon the strength of subsequent hoarding demand, we might therefore have lost all our gold without permanently affecting its price; in the end the price might well be higher than the foreign-currency equivalent of $35 per ounce.

This question of the subsequent level of the price of gold is of crucial importance to the Lerner plan; for his expectation of an increased foreign demand for dollars rests on the idea that foreigners would wish to replenish their reserve holdings, assumed to have been depleted by a bookkeeping loss on gold. But no such bookkeeping loss need occur as long as the European central banks were prepared to accept gold from each other at the foreign-currency equivalent of at least $35 per ounce. The question then becomes: how would European countries needing dollars acquire them? Part of the answer would probably be: from each other, in exchange for gold. Presumably, however, they could also buy dollars from the U.S. with their own currencies, which we would certainly need from time to time.

This raises the question of exchange rates, about which Lerner has curiously little to say throughout most of the two articles. In the light of most of his analysis, what he does say about exchange rates, near the end of one of the articles, is remarkable. We shall revert to this point later.

3. The Lerner proposal takes on an air of unreality, of legerdemain, when one looks closely at the results it is supposed to yield, in the light of the problem from which it starts. Lerner starts from the balance-of-payments constraint on domestic policy. To the extent that such constraint exists, what constrains us, essentially, is the fact that foreigners are unprepared to accumulate dollars in indefinitely large amounts. All we have to do to change this attitude, says Lerner, is to undermine the value of gold, and guarantee foreign holdings of dollars. Foreigners will then be not merely willing but eager to hold more dollars (since at least some of them "would try to increase their holdings of dollars . . . by selling more to us and buying less from us"). The implication is that U.S. policy-makers

could at that point cease worrying about the balance of payments, and orient all policies exclusively to the needs of domestic expansion.

To suggest that a problem that most observers have assumed to be real--the problem of continued financing of a large U.S. balance-of-payments deficit--could be made to disappear simply by juggling international monetary arrangements (such action including a measure intended to wipe out some of the external assets of friendly countries and people throughout the world) sounds preposterous. But it is not enough merely to say it is preposterous. To be so, the proposal must have a fatal weakness. It does. That weakness is the assumption that foreigners (in the aggregate) would be prepared to hold practically any amount of dollars so long as such holdings carried a purchasing-power guarantee.

One way to test the validity of this assumption is to ask what relative weight foreigners have attached to guarantees on dollar holdings as in some sense an "answer" to the problem of the U.S. balance-of-payments deficit in recent years. The answer, of course, is that among policy recommendations to the United States by foreign countries during the period of our balance-of-payments deficit, measures to terminate the deficit have been stressed vastly more than guarantees on dollar holdings. Such countries (especially some of the European countries) have several reasons for urging termination of our deficit. One is their belief, right or wrong, that that deficit contributes importantly to inflationary pressures abroad. Another is some element of resistance to the continued capital inflow into Europe which, in a sense, our deficit makes possible. Capital inflow may consist of either short-term or long-term capital or of both. A prolonged net inflow of short-term capital makes a country particularly vulnerable to a sudden massive outflow of funds. A prolonged net inflow of long-term capital may have implications regarding the relative ownership of domestic assets, implications that would eventually become unacceptable to the country concerned.

Moreover, every country has some limit to its need for reserve-asset accumulation. It is simply not true that foreign countries would be willing to accumulate indefinitely large dollar holdings provided only that these carried a purchasing-power guarantee.* For obviously the dollar balances earned could themselves come to exceed the amounts ever likely to be needed, quite aside from any additional amounts the United States might have to deposit under the terms of any guarantee agreement. Unable to convert all unwanted dollar balances into gold (except perhaps at a discount--another point involving the exchange-rate question, to be considered later), and unwilling to incur extreme inflationary pressure if that were necessary to dispose of such balances, foreign countries might feel driven to adopt direct trade and payments restrictions in order to prevent further accumulations of dollars.

In short, there is reason to think Lerner has confused two quite different questions. One is the question of how foreign reserve-holding practices would be influenced by U.S. severance of the gold-dollar link as proposed by Lerner. The second is the question of how foreigners would react to a continued (and enlarged) U.S. balance-of-payments deficit. If the value of foreign external reserves were to

* The present analysis ignores all the questions and problems that would arise in attempting to choose a suitable form of guarantee. It also leaves aside the question whether any democratic government could prudently take on a guarantee commitment unlimited as to amounts.

decline substantially because of a decline in the value of gold, it is possible that foreigners would begin to hold more international media of exchange; but it does not follow that those holdings need be dollars. They could be in some other currency, or perhaps in units of an international currency which they themselves could create. Given the probable foreign reaction to the U.S. action Lerner proposes, the extent to which these increased holdings of international media of exchange would be something other than dollars can perhaps be imagined.

Three fundamental objections to the main body of the Lerner exposition have been indicated. We now come to a fascinating and rather crucial question: what Lerner really believes would happen to exchange rates if his scheme were adopted.

His exposition of that part of his proposal which we have discussed thus far seems to imply a belief that the values of currencies in relation to one another would remain unchanged. Certainly his assumption that aggregate foreign demand for dollars would rise implies that at least there would be no decline in the exchange value of the dollar. But suppose this assumption is wrong--that on the contrary, foreigners refused to hold more dollars? Continuation of the U.S. balance-of-payments deficit would then imply eventual if not immediate depreciation of the dollar in the exchange markets of the world. For the dollars foreigners would continue to gain presumably would be convertible into gold for a time, as long as our gold stocks held out, at $35 (or less) per ounce; but eventually they would be disposable--either for gold or for foreign currencies--only at a discount, i.e. at the equivalent of a price higher than $35 per ounce. This eventuality, which would constitute a de facto devaluation of the dollar, would be hastened if, contrary to Lerner's expectations, some part of our gold stock (to be thrown on the market under his plan) was bought up by hoarders, leaving less available for foreign central banks.

Would Lerner be depressed by this development? There is reason to think he would not: that in fact his concept of an "ideal gold standard" is merely a stalking horse for a very different and very familiar idea: a system of flexible exchange rates. The reason for thinking this is Lerner's real goal is that he says so in so many words, is the following remarkable passage near the end of his Washington Post article. The passage is remarkable not for what it says, but because what it says bears no clear relationship to what had gone before.

> With the dethronement of gold by the dollar standard, adjustments of the values of currencies in terms of one another would touch no gold tab[illegible] and the world could move toward a regime of free exchanges in which the natural cure for excess demands or excess supplies of currencies would be allowed to operate. The many tens of billions of dollars worth of international reserves, now so urgently sought and so passionately retained, would become unnecessary. They are needed only to allow countries to cover enormous deficits while their fixed exchange rates are out of alignment.

This is not the place to pursue the involved argument about fixed vs. flexible exchange rates. The only point of mentioning the flexible-rate question here is to bring out the fact that a flexible-rate system seems to be Lerner's real objective.

But whatever his objective, he has given us, in both articles, a clue to the nature of his approach to the subject at hand, and to the reason for his failure to grasp the nature of the issues actually at stake. "We possess the means to free ourselves from the tyranny of gold.

We need simply announce etc." "The solution to the [U.S. balance-of-payments problem] is . . . simple." (Underlining added in both cases.) This is the essential clue. For Lerner, the problem is one of some easily-solved inadequacy or inappropriateness in the machinery of the international payments system. His approach is reminiscent of much of the thinking about international liquidity a year or so ago, when the idea prevailing in many quarters was that there is no reason whatever for a shortage of international liquidity, since such liquidity can be created at will. Like Lerner's, that attitude (which fortunately seems to have died away to some extent as people have become better acquainted with the underlying substance of the subject) reflected lack of awareness that the issues actually at stake involve profound differences of view, both within countries and among them, as to the extent to which it is desirable or safe for the international community to trust the policy-makers of any country to deal, largely without outside interference, with domestic economic problems having international implications. These differences, which may seem to pertain only to deficit countries but which invariably lead to debate over surplus countries as well, cannot be exorcised or evaporated by monetary gymnastics.

The plain truth is that we now live a world that has to be managed; and it is being increasingly recognized that that would be just as true under a system of flexible exchange rates as under one of fixed rates. And in a democratic world the task of management is never going to be "simple."