From 'static' gold to the floating dollar*

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I. Introduction

In this paper we discuss some essential features of the balance of payments position of the country that issues the key currency under different international monetary standards. The analysis takes a Sraffian ‘standpoint’, where the monetary rate of interest of the central country is seen as an independent policy variable, institutionally determined (Pivetti (1991, 2001), Serrano (1993, 2002)). We start in section II by making a preliminary discussion of the balance of payments position of the central country in the abstract, within a simplified scheme of an international monetary standard referred to gold. In the subsequent sections we apply the results of our scheme to the historical evolution of the international monetary system, criticising along the way some curiously “monetarist” hypotheses (of either "national" or "global" type) which are implicit or explicit in many well known analyses of the subject. We shall criticise the orthodox idea that the gold-sterling standard operated through international movements of gold and also Triffin’s alternative view according to which the pace of growth of the world economy was ultimately dependent on the physical availability of gold (section III). In what regards the gold-dollar standard, we shall also take issue with the well known “Triffin’s Dilemma” (section IV). This brief and schematic analysis of the theories and experiences of the earlier

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international monetary standards shall allow us to reach, towards the end of the paper\textsuperscript{2} (section V), the prime aim of this work, which is that of providing a simple but sufficiently precise characterisation of the current international monetary standard, that we shall call the “floating dollar standard” (see Medeiros & Serrano (1999, 2003)).

\section*{II. The Adjustment Without Movements of Gold}

The country that issues the key currency in a gold-referred standard can in fact settle its balance of payments in its own national currency. This means that this country can have chronic global deficits in the balance of payments of any magnitude.

Nevertheless, this does not mean that this country should not worry about its external position. There are two things that this country should not allow to occur: a) chronic deficits in the current account; and b) changes in the official price of gold in terms of the local currency (the parity), which must remain fixed in nominal terms for the longest possible length of time (in other words, the central country should not take the initiative of devaluing its own currency relative to gold and the other currencies).

In a closed economy, the State does not really need to worry about the risk of default regarding its internal debt because the latter can always be settled with currency it issues. Moreover, it is the fact that the State is the zero risk internal debtor gives it the power of exogenously determining the basic interest rate for loans denominated in the currency it issues.\footnote{Instituto de Economia, Universidade Federal do Rio de Janeiro, Brazil (franklin.s@openlink.com.br). This view of the rate of interest determined exogenously by the monetary authorities follows the Sraffian approach (see Pivetti(1991, 2001)). Note that this exogeneity of the rate of interest does not require any restrictive hypothesis either on the “supply” or on the “demand” for money, and neither on the type of policy.}
By analogy, in a gold-referred international monetary system, the economy of the central country which issues the internationally accepted currency and observes the two above mentioned conditions (namely: a) avoids current account deficits; and b) keeps the nominal parity fixed) has zero “sovereign” risk of default on its external debt, for this country can always settle it in its own currency. This zero risk condition by its turn also makes the interest rate fixed exogenously by the monetary authorities of the central country become the international economy's basic interest rate.

Let us see how such a system would operate, beginning with the question of the global deficit of the balance of payments. We may write the balance of payments of the central country as follows. The global result of the balance of payments of this country will be defined as being equal to the net change in the stock of gold of this country (G), plus the net change of external short term assets (STC) (following Kindleberger(1987))

\[ G + STC = X - M + R - LTC \]

followed by the central banks. In this approach bank credit (and as a consequence the aggregate M1) is seen as endogenous (for private banks cannot be forced to lend) but at the same time the high powered monetary base may be partially exogenous due to fiscal or balance of payments reasons (the money “multiplier” is, from this standpoint, a mere ex-post ratio between the above two aggregates, Serrano(2002)). Fortunately, in recent years more and more Post-Keynesian authors have abandoned the theory of the interest rate based on supply and demand for money and got closer to the above view, either via “horizontalist” (endogenist) arguments or more directly via the recent rediscovery (see Randall Wray (1999)) of the “Chartalist” approach of Knapp and Abba Lerner who emphasised that money was "a creature of the State".

\(^2\)Note that in this equation a negative STC indicates an inflow of short term capital while a positive STC indicates an outflow of short term capital. By the same token a negative LTC indicates inflow of long term capital while positive LTC indicates an outflow of long term capital.
where $X-M$ is the overall trade balance (note that we are including the non-factor services or "invisible trade" in the trade balance), $R$ is the factor services balance, and $LTC$ is the balance of the flows of long term capital (including both lending and foreign direct investment).

Let us assume that our hypothetical central country has a chronic deficit in the commodities trade account, which is nevertheless fully compensated by the surplus both of the non-factors service and of the factors service accounts. In this case the current account balance $(X-M+R)$ will be either zero or positive. The important condition here is that no chronic current account deficit happens, to prevent the central country from loosing gold – accumulating gold claims through current account surpluses is not a problem.

Let us suppose also that this country builds many railways abroad and lends money to the other nation States, that is, that $LTC$ is positive and reasonably large.

This means that the central country has a global deficit in the balance of payments, but since it is this country’s currency that is accepted for international payments, this deficit does not generate any problem. The reason is simple. The other countries that collectively will have a surplus in their balance of payments will not accumulate barren gold that pays no interest but, instead, they will invest their surpluses in high liquidity assets in the central country itself. This means that, for the central country, every deficit on BP caused by the large positive LTC will be fully compensated by a flow of short term borrowing (a negative STC). That makes the change in reserves of gold be exactly equal to zero (in fact if we defined the result of the balance of payments merely as movements of gold, the balance of payments would be, in this case, always in equilibrium).

It is possible to object here that nothing guarantees that all the potential outflow of gold is going to be automatically counterbalanced by an inflow of short term capital
(negative STC) of an identical value. This is true but, as it has been said in the age of the gold-sterling standard, “six percent will bring gold from the moon”. That is, we must remember that it is the central country that autonomously fixes the short term rate of interest and can manage it as necessary in order to make the change in its gold reserves be around zero (or positive).

Note that in the abstract case we are analysing, successive deficits in the balance of payments of the central country will be accompanied by equilibrium in the current account. Therefore, "below the line", the change of the net external liabilities of the central country is zero, that is, the absolute value of STC is equal to that of LTC. Note that these are the ideal conditions for the operation of a gold standard, from the point of view of the central country. The central country stimulates effective demand in the rest of the world with its trade deficit, and at the same time, by investing long and borrowing short term, provides liquidity for the other economies in the system (Minsky (1994)).

Within the scheme we are using both the central economy and the others can grow continuously and, in the limit, even without any increase in the production of gold or any movement in the stock of gold whatsoever. In other words the gold “monetary base” may well be constant.

If one wants to reason in these traditional terms we may also note that the “monetary multiplier” of gold is equal to one (in the extent that banks do not produce gold), but then because of the continuous increase of the values of both the LTC and STC (i.e., of the gross capital flows) the “velocity of circulation” of high powered money (gold) increases continuously.³

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³ For the sake of the argument we could apply the same reasoning in terms of the "supply" of fiat money of the central country (instead of gold). In this case, if we assume that the monetary base of this country is
However, as long as the central bank of the central country maintains the full\textsuperscript{6} liquidity of its national public debt bonds, there will be no shortage of liquidity in the system (Kindleberger (1987)).

Thus, regarding movements of gold, it is possible to argue exactly the opposite of the conventional view. The system actually only works well (for the interests of the central country) while gold does not start to flow out of the central country. This is why it is not recommended that the central country runs deficits in its current account persistently, for that would entail a situation in which its net external liabilities in fact increase period after period. That would result in actual gold (or rights to gold) changing hands.

It is easier to see this if we rewrite the result of the balance of payments with the current account on one side ("above the line", i.e., revenues and expenditures) and its financing on the other side ("below the line").

In this case we have:

\[ X-M+R=(G+STC)+LTC \]

If the central country runs deficits in the current account, the right hand side (the change of the external net liabilities) will necessarily be negative, for in this case, even if the physical movement of gold is avoided, making \( G \) equal to zero, this can only happen at the cost of the absolute value of \( STC \) being larger than that of \( LTC \), i.e., at the cost of the central country being borrowing short more than it is investing long. Thus its net external liabilities, in terms of gold, will be increasing.

\footnote{constant and that their banks create money in the orthodox textbook way from a “monetary multiplier” which is also constant, the stock of M1 of this country will not increase. Even in this hypothetical case, if the deficit in the balance of payments caused by a positive LTC is compensated by a negative STC there will be no shortage of international liquidity, because the international "velocity of circulation" of this fiat currency is going to increase continuously.}
As we mentioned above, the other limit to the freedom of the central country is the fact that the latter may not take the initiative of devaluing its currency. This is because what allows the smooth financing of deficits in the balance of payments of the central country is the full convertibility between its currency and gold. If the value of this currency measured in gold starts to float, then it is not true anymore that this currency is “as good as gold” and it is quite probable that the other countries will start asking for external payments directly in gold instead of in financial assets denominated in the key currency.

III The Gold-Sterling Standard

III.1 The Gold-Sterling Standard and its Decline

Let us adopt the following chronology of international monetary systems:

1. The Gold-Sterling Standard, from 1819 to 1914;
2. The attempt to return to this standard from the end of the First World War until the 30’s;
3. The Gold-Dollar Standard, from just after the Second World War until 1971;
5. The floating dollar standard from 1980 until now.4

The first period corresponds to the gold-sterling standard. Over this period Britain:
1) kept the parity of its currency in relation to gold; 2) tended to have a merchandise trade deficit, but no deficits in the current account (during this period England experienced surpluses in this account – with deficits only starting to appear after 1914) and 3) financed its balance of payments deficits caused by the outflow of long term capital, by receiving short term inflows from the rest of the world.

Over this period, because of the protectionist policies and of the productivity gains of the other countries that industrialised later and also of the fixed nominal sterling
exchange rate, Great Britain had increasing deficits in merchandise trade. Those were (more than) compensated by the non-factors services balance (insurances, freight, etc.), by the large surpluses in merchandise trade *vis a vis* the colonies (specially in regard to India) and by the net income received from its investments abroad (DeCecco (1984)).

In the second period, which begins at the end of the First World War, we see that the system does not work adequately anymore. On one hand, the former central country, England, incurs in current account deficits (it even looses the bilateral merchandise trade surplus with India). The post war attempt to return to convertibility is done using the old parity, despite of the different rates of inflation that occurred in various countries during the First War and of the change of parity of many other countries. This return to the old parity was heavily criticised by Keynes but, from the point of view of the British financial interests (as Hicks (1989) reminded us) it made sense, in order to keep the idea that sterling was in fact still “as good as gold”.

As it is well known, this return to gold failed, given the loss of competitiveness of Britain and the changes in the international situation thanks to the accumulated external current account deficits during wartime. Gold, during the 20's and 30's, kept flowing inexorably towards the USA.

However, American economic policy during that period was operated in a way that prevented the U.S. from performing the role played by Britain in the preceding period. In the interwar period, the United States obtains surpluses on the current account (and in its trade balance) and also on the capital account, draining gold from the rest of the world. To make things worse in the 30’s the USA increased import tariffs, raised interest rates and

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4 For an analysis of the center-periphery relations using this chronology of international monetary systems see Medeiros e Serrano (1999).
later even devalued the exchange rate, helping to push the world into the Great Depression.

III. 2 The National Monetarism from Hume to Eichengreen

In the orthodox neoclassical view the gold-sterling standard worked automatically and brought the external equilibrium of all the countries through international movements of gold, which by leaving the deficit countries caused deflation and competitive gains, and by entering the surplus countries caused inflation and loss of external competitiveness *a la* Hume(1752) (for a New Classical version see Barro(1979)). From this perspective its end was the result of political and protectionist interferences that led to the inobservance of the supposed “rules of the game” (flexibility of prices and wages, absence of interventions sterilising the impact of the result of the balance of payments on the domestic monetary base, absence of custom barriers, etc.) after the First World War.

Note in particular the recent analysis of Eichengreen (1996), who in a rather monetarist perspective attributes the collapse of the gold-sterling standard to the lack of downward flexibility of nominal wages in the central countries. Curiously enough Eichengreen(1996) tries to disguise a bit the limitations of his analysis by appealing to the well known and interesting political analysis of the period made by Karl Polanyi(1944) which he turns into a “sociological” explanation of the “nominal rigidity of wages”. In reality, contrary to Eichengreen (1996) the downward flexibility of nominal wages and prices seems to have been *excessive* and, since nominal interest rates did not fall nearly as much, led to increases in real rates of interest and the burden of debts, leading to waves of bankruptcies, debt deflation etc., as noted by so many analysts at the time, including, of course, Keynes.
According to a different and well know interpretation by Robert Triffin (1972) the system in reality never operated following the “rules of the game” imagined by the modern followers of David Hume. Triffin shows the fundamental relevance of capital flows of capital which made the maintenance of persistent trade balance disequilibria viable for decades (like that of Britain, for instance) and argues that the various countries instead of correcting deficits and surpluses with deflations, inflations and large movements of gold, had balance of payments disequilibria which were relatively small and tended to follow together the path of the international trade cycle (in terms of interest rates, prices and levels of activity) dictated by the expansion of international liquidity. In his point of view, Triffin argues that the fixed exchange rate regime imposed the constraint to the countries in the core of the system that they should avoid growing either much faster or much slower than what was allowed by their balance of payments situation, averting thus the necessity of adjustments which involved drastic changes in the levels of prices and wages (and/or exchange rates). Triffin shows also that in all core countries, the development of commercial banks increased substantially over time the domestic use of fiat money. He attributes the freeing of gold reserves which progressively left the domestic circulation and reinforced the reserves of the respective central banks to this increased domestic use of fiat money.

Still according to Triffin (1972), the expansion of the international liquidity before the First World War was satisfactory (for the countries of the core) because the quantity of gold possessed by the central banks increased enough to meet the needs derived from the
growth of the international trade, through the combination of larger discoveries of gold and the withdrawal of the latter from domestic circulation (either silver or fiat money were substituted for gold, according to the time and country under consideration) and also, in a quite smaller scale, by the acceptance of national currencies (in particular pounds sterling) as a component part of the core countries’ international reserves.

Following this analysis, Triffin considers that the failure of the attempt to return to the gold standard after the First World War had a structural reason, which was the inadequacy of the growth and distribution of the international reserves of gold, reserves that, with the by then almost complete extinction of the domestic circulation of gold, could only grow additionally from fresh increases in the world production of gold.

This interpretation, though evidently vastly superior to the orthodox neoclassical one, suffers however from two basic and inter-related deficiencies. The first one is the assumption that all countries of the core submitted themselves equally to the discipline imposed by the gold standard and adjusted their domestic expansions to the balance of payments constraint. Following Triffin’s argument, Britain seemed to be in the same footing as the other core countries regarding its (lack of) autonomy in terms of economic policy.

The second problem regards the idea that the global rhythm of expansion depended on the collective creation of international reserves, i.e., on the increase of the quantity of gold collectively available to the central banks.

In respect of the first point it seems to us that, in fact, the economic policies and the evolution of the core economies which took part during in the gold-sterling standard have

\[\text{\footnotesize{\textsuperscript{11}}}\]

\[\text{\footnotesize{However, in the countries of periphery countries these quantity adjustments were not enough and more drastic adjustments of prices and exchange rates were unavoidable and aggravated the instability of these}}\]
indeed been forced to follow to a certain extent a common cyclical rhythm, but this rhythm was given **asymmetrically** by the movement of the **British** economy, which led the world by means of the determination of the basic international interest rate, by the impact on effective demand of its external trade, and by the fundamental role of British capital flows for the financing of world trade.

The reason behind this asymmetry is the fact that the gold standard was, in reality, a gold-sterling standard where the international currency in practice was the pound sterling. The rhythm of expansion of trade and international liquidity therefore was not determined by the increase in the availability of gold, but instead by the expansion of the British economy and of the international financial system based on sterling (see Medeiros e Serrano (1999)). Apparently Triffin does not notice all this for two main reasons. First, because he seems to think that the global result of the balance of payments of any country is given only by the change of the stock of gold (G), forgetting the central role (both to Britain and to the other countries) of the financial assets denominated in sterling (STC), which he sees as having had a minor contribution to the formation of international reserves in that period. Triffin probably thinks along this lines because indeed the **net** effect of capital flows (LTC-STC) was small even though the **gross** flows of STC were becoming larger and larger. It seems that Triffin reads the equation of the balance of payments (both for Britain and the other core countries) as:

\[ G = X-M+R - LTC - STC \]

Moreover, Triffin considers that the expansion of international trade requires a proportionate increase in the volume of gold reserves.
Thus in his analysis Triffin (1972) does not only consider gold as the “monetary base” of the system, and that for the world economy the “monetary multiplier” of gold is always equal to unity (for the banks do not create gold), but considers also that the velocity of circulation is always constant or at least highly stable. Only reasoning in this way it becomes logically possible to say that it is the exogenous increase of the international reserves that determines the growth of the level of activity of the international economy.

These implicit hypotheses are all very close to what has come to be known as "global monetarism" in its version with non-flexible prices (see Johnson et alii (1976)) and are obviously very problematic in both empirical and theoretical terms.

As we saw on section II above, there is no reason for those hypotheses to be confirmed. For a given British rate of interest, a given rhythm of expansion of credit, of effective demand and of world trade, the ratio between short term assets in sterling and gold would be increasing all the time. If we wish we may say then that the “velocity of circulation” of gold increases continuously.

This being so, it seems clear then that the end of the gold-sterling standard and the failure of the attempts towards its return were linked to the First World War and its geopolitical consequences mentioned in the beginning of the section (see Medeiros and Serrano (1999)) and not to the physical limits to the adequate expansion of the supply of gold, as argued by Triffin.
IV The Gold-Dollar Standard

IV.1 The Gold-Dollar Standard and the “Triffin’s Dilemma”

After the Second World War we have the period of the Bretton Woods Gold-Dollar standard. Within this period, which lasts until 1971, the official price of gold in dollars is kept constant.

In the beginning of that period the USA has positive trade and current account balances, but the Cold War commitments made the country, via foreign aid, loans and foreign direct investment, have increasing deficits in the balance of payments. Over time, with the reconstruction of the other core capitalist countries (stimulated and financed by the US), the trade and current account surpluses of USA were continuously reduced until they both become negative in 1971.

It is within the context of this gold-dollar standard that comes to light the debate on the so-called “Triffin’s Dilemma”. The argument from Triffin (1969, 1972) is that the international monetary system with convertibility between dollar and gold suffered from a basic inconsistency. As we saw above, according to Triffin, under any international monetary system the growth of world trade requires the increase of the international reserves. In his point of view, the increase of the supply of gold showed itself to be completely inadequate for these purposes since the interwar period. Thus the only way out was that the other countries accumulated international reserves not in gold but in the key currency itself (the dollar and in a much smaller and decreasing scale sterling). This on its turn could only happen through global deficits on the balance of payments of the United States. However, and now the contradiction appears, the more the central country accumulates successive deficits on the balance of payments financed through its own
currency, the larger will tend to be the ratio between the quantity of the key currency in circulation in the world economy and the gold reserves of the central country.

If the process goes on for a long time, inescapably the lack of backing in gold of the key currency will become clearer and clearer and the maintenance of convertibility will become more and more problematic. Thus the “dilemma” would come from the contradiction between two facts. On one hand, if the central country has persistent deficits the convertibility and survival of the system will be threatened. But if, on the other hand, the central country avoids deficits in the balance of payments in order to maintain a reasonable gold backing for its currency, world trade will not be able to grow adequately for a chronic shortage of international liquidity will arise.

From the analysis of this “dilemma” Triffin (1960) has foreseen that the gold-dollar Standard was bound to go into crisis and wished that it could be replaced by a reserve currency that was truly international and which could not be the national currency of any particular country.

Because the system in fact ceased to exist in 1971, perhaps the most accepted interpretation for its end is the combination of Triffin’s Dilemma, creating the fragility of the gold-dollar parity, with the uncontrolled increase in credit within the offshore Eurodollar circuit from the end of the 60’s, which is said to have increased even more the quantity of dollars circulating in world, reducing additionally the backing in gold of the key currency and thereby aggravating the situation (Parboni (1984)). The speculative movements of de-regulated international financial capital, according to this view, have forced the USA to abandon the convertibility.

Note however that within our analytical scheme presented in section II above, the “Triffin Dilemma” does not occur, despite the successive global deficits in the balance of
payments of the central country and the continuous growth of trade and international finance. Besides, the convertibility of the key currency into gold is not threatened since, despite the deficits in the balance of payments, gold does not move (and does change hands either).

The problem with the argument of Triffin is that, as pointed out by Kindleberger in the 60’s (see Kindleberger (1987)), even though the international settlements are not made directly in gold, implicitly Triffin makes the arbitrary and monetarist hypothesis that the “velocity of circulation of gold” has to be constant. Thus for the convertibility to be sustained there must be some proportionality between the quantity of gold and of short term assets denominated in the key currency. Triffin simply ignores completely that the gross flows of international capitals can make the “velocity of circulation” of gold increase without limit.

This hypothesis of “constant velocity” of gold, is easily refuted by the observation of more than a century of national and international financial deepening all over the world. Without that hypothesis, however, the “Triffin Dilemma” simply disappears.

IV.2 The “Exorbitant Privilege”

The analysis in the terms of “Triffin’s Dilemma” has been on the centre of the discussion, during the 60’s, about what the French President Charles de Gaulle named the “Exorbitant Privilege” of the USA that could finance their deficits of the balance of payments by issuing their own currency without gold backing and therefore were benefiting themselves from international seigniorage gains. Following Triffin’s analysis this gain
would be measured exactly by the size of the deficit in the American balance of payments, which would be identical to the issue of international money by the USA.

Other authors questioned partially this measure because (at least from the end of the 60’s) with the growth of the offshore circuit of Eurodollar, the international banks also were seen as a source of dollars issued to the international economy. Then the deficit on the American balance of payments was just an increase of the international “monetary base”, which was “multiplied” by the international banks (in fact without any control from the American authorities), creating the international “money supply”. In this case the gain from international seignoriage would be divided between the USA and the international banks (see, for instance, Parboni (1984)).

The official position of the American government in face of this controversy with its allies has been entirely based upon the analysis of Kindleberger (see Solomon (1982)). The American argument was that the question of the seignoriage itself was not very important for in practice the central banks did not have as reserves dollars in cash as a counterpart to the American deficits in balance of payments. These central banks held their reserves in high liquidity American federal bonds.

As these bonds paid “market rates of interest”, according to Kindleberger(1987) the American government did not get any seignoriage gain. As the USA provided international liquidity lending long and borrowing short the single possibility of gain that Kindleberger could see was derived from an eventual difference between the short term and long term, which were also seen as “market determined ” and not very high.

Despite of these serious deficiencies “Triffin’s Dilemma” and the interpretation with a global monetarist flavor of the crisis of the gold-dollar standard became quite popular even amongst ‘critical’ economists such as Parboni (1981) and Arrighi (1996).
Thus, according to Kindleberger the USA simply supplied a service (international liquidity) to the international economy and received a “market” remuneration for this. In this way the USA behaved as the "commercial bank" to the world.

There was then, no “Exorbitant Privilege”, but only a division of labour between the USA and the other countries.

As a matter of fact, Solomon(1982) and Kindleberger(1987), were quite right on the question of seigniorage being not crucial because the other central banks evidently do not retain large amounts of dollar in cash. The analysis of the critics of the U.S. had exactly the same “global monetarist” deficiencies of the discussion of the so-called “Triffin’s Dilemma”.

However, in contradistinction to what Kindleberger, Solomon and the American government argued, in fact issuing the international currency gives the USA a privilege much bigger than, or more “exorbitant”, than the seigniorage gains calculated a lá Triffin. The USA has not in fact been the commercial bank of the world paying “market” interest rates on its external short run liabilities. The correct analogy is that the USA, when controlling the issuing of international money, plays the role of the central bank of the world.

The actual privilege of the USA within the gold-dollar standard was identical to that of Britain within the gold-sterling standard, i.e., the country has no global constraint on the balance of payments and besides its monetary authority determines unilaterally the basic world interest rate. It was quite clear that the USA did not intend to loose this privilege.

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7 His original paper, published at that time on the magazine The Economist, is reprinted in Kindleberger (2000).
IV.3 The Nixon Dilemma

Along the 60’s it becomes clear for the American government that a realignment of exchange rate will be necessary to slow down the comparative decline of the competitiveness of the U.S. economy.

Nevertheless, a devaluation of dollar via increases in the official price of dollar in gold would bring the risk of a rush to gold. With it, would come the threat of a reintroduction of the balance of payments constraint for the American economy, to the extent that international settlements would start to be made directly in gold instead of in dollars.

It is important to stress, as Solomon (1982) points out, that countries like the Soviet Union, being the biggest producer (together with South Africa, whose regime was “supported” by the USA), would gain a lot from an increase of the importance of gold in the world economy. And that France had been pressuring so much towards reforms in the system that could amplify the direct role of gold because historically it had retained a relatively large proportion of its external reserves in gold. Surely it was not seen as being in the national interest of the american State in the heat of Cold War to reinforce the relative power of any of these countries.

During this period, there were also several proposals of reform made by American allies aiming at the creation of a truly international currency by means of the introduction of the so-called special drawing rights (SDR) which was supposed to be the basis for a new truly international currency. The USA also vetoed all proposals of reform towards a truly international currency because although they did not carry the additional disadvantages of

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8 Of course the U.S. did get a lot of traditional seigniorage gains because a good part of the informal and illegal international economy (drugs and arms trade for instance) as well as many poorer countries actually
giving power to the countries who produced gold, if implemented they would also reintroduce the balance of payments constraint to the American economy, something that was considered as unacceptable by the American government.

We may call this situation “the Nixon Dilemma”: the American government wished, at the same time, to devalue the dollar and not to jeopardise the role of dollar as international currency.

The American partners refused the proposal from the USA of a co-ordinated movement of appreciation of the currencies of the other countries (that should simultaneously reduce the official price of gold in their respective currencies by the same proportion). Besides, these countries have kept insisting on proposals of reform that would diminish the importance of the dollar in the international economy (improving the role of gold and/or of the Special Drawing Rights).

Within this context, the solution found by the USA to this dilemma was to unilaterally decree the inconvertibility of dollar on gold in 1971, as a preparation to the initiative of devaluing of the dollar, which begins in 1973 (Parboni (1984)).

V. The Floating Dollar Standard

The American decision of dismantling the Bretton Woods system sent the capitalist world economy into a period of great turbulence. The intensification of rivalries between capitalist States and the complex geopolitical situation of the 1970's in the context of the Cold War naturally contributed to this systemic instability.

Moreover, U.S. nominal interest rates were kept relatively low to operate the desired devaluation of dollar, and helped to fuel a wave of commodity speculation that,
combined with the worsening of the distributive conflicts and the growing international challenge to American leadership, culminated with the two the oil shocks, leading to an inflationary explosion never seen before during peacetime in the developed countries (Biasco (1979)).

In the late seventies both the increasing international criticism of American geopolitical hegemony and the acceleration of inflation in the U.S. and in the dollar prices of international commodities markets where prices are set in dollars were seriously threatening the status of the U.S. dollar as the world’s currency.

This trend was completely reversed as a result of two major events. The first happened in the end of 1979 when there is decisive change in American monetary policy with the interest rate shock engineered by Mr. Paul Volcker, chairman of the U.S. Federal Reserve Board. This consisted of a drastic change in U.S. policy with the shift of emphasis from growth and employment to fight against inflation. Interest rates reached unprecedented levels and were accompanied by a wave of financial innovations and deregulation measures that, since then, have been spreading all over the world. This restrictive policy led to a world-wide recession in which the dollar prices of non-oil commodities fell drastically and inflation in the U.S. gradually slowed down. The second event was the election of President Ronald Reagan who recovered the Nixon-Kissinger project of reasserting American political and economic supremacy by all means (a project that had been partially put aside since Nixon’s resignation after the Watergate episode).

With U.S. and dollar inflation under control and the progressive elimination of any doubts about the U.S. government’s commitment to keep its geopolitical leadership the U.S. gradually regained control of the international monetary and financial system (Tavares
This has led since the early eighties to the current international monetary system in which in spite of the floating of exchange rates and the total lack of convertibility in gold or any real commodity the dollar is the world’s international currency, and that we can call the ‘floating dollar standard’.

Within this new standard the dollar is still the world currency. But now the inconvertible dollar is free from the two restrictions that both the gold-sterling, and the gold-dollar, imposed upon the countries that issued the key currency in the past. As we saw above, in a gold-referred system the country that issues the key currency can finance their overall balance of payments deficits in its own currency but it cannot have substantial current account deficits nor take the initiative of devaluing its exchange rate. In the floating dollar standard none of these constraints apply: the U.S. can have (and has had) chronic and growing current account deficits and it has in a number of times taken the initiative to move its exchange rate (up and down) relative to different other currencies in many occasions.

The biggest advantage for the USA that comes from the absence of convertibility to gold is the actual elimination of their external constraint. Now, the USA can incur in permanent deficits on the current account without any concern about the fact that their net external liabilities may be increasing, for these “external” liabilities are denominated in the American currency and not convertible on anything else.

In terms of our equation, the term G does not exist anymore and all the excess of absolute value of STC by LTC when a current account deficit exists means an increase of reserves of the other countries - that, by necessity, if they want to take part into the international monetary economy where the U.S. dollar is the accepted means of payment,
have to accept accumulating bonds in dollar (in general the American federal debt itself) or cash.

This means that the USA does not have to vary its interest rate to attract capital and protect its foreign reserves. In fact, the financing of the current account deficit of the U.S. is completely automatic at any given interest rate. There is no need to change American interest rates to attract gold or to protect the foreign reserves. The U.S. is completely free to set its interest rates according to their national objectives and gold can "stay in the moon". In the floating dollar standard the international economy works *de facto* as 'closed' economy which uses the U.S. dollar as currency. Thus the U.S. is the central bank of the world and accordingly sets the world’s basic interest rate.

Furthermore, the absence of gold convertibility gives the dollar the freedom to vary its parity in relation to the currencies of other countries following their convenience, through movements of the American interest rate (and other means). American interest rate policy is not constrained by the need to attract capital nor to defend the gold reserve and thus is in principle free (when other internal policy and economic conditions allow) to be used for appreciating and for devaluing the dollar if and when needed.

Fluctuations on the parity of dollar *vis a vis* other currencies may have large negative effects in the countries that issue the other currencies and then either loose

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9 This is why Mr. O'Neill the outspoken former Treasury Secretary of Pres. George W. Bush has often declared to the press that for him the current account deficit is a "meaningless concept" and that he "only talks about it because others do".

10 Recently Mckinnon(2001, 2002), also starting from the analysis of Kindleberger, realized with clarity the nature of the flexible dollar Standard, in an analysis that comes quite close to ours. The single more serious objection to his empirical works on this field is that this author considers the predominance of the dollar as the result initially of a “historical accident” in the immediate postwar period which was reinforced over time by the fact that the use of a single currency as a standard by the international economy facilitates trade very much (see in particular Mckinnon(2002)). However, it is a fact that the elimination of the possibility of balance of payments constraint for the USA has been the explicit aim of the policy of the American State over the whole post war period.
competitiveness when their currencies appreciate, something that worsens their external constraint, or suffer inflationary pressures when they devalue in relation to the U.S. dollar.

It is true that the U.S. looses real competitiveness when the dollar appreciates but since it has no external constraint and can let its current account deficit increase at will, this does not create any major problem. On the other hand, when the dollar is devalued the direct inflationary effect in the U.S. is minimal because the majority of international markets for homogeneous commodities and oil has prices that are set in dollars.\(^{11}\)

Another little noticed but extremely important advantage that the U.S. has in relation to other countries under the floating dollar system is that even full short term international capital mobility does not reduce the ability of the American government to pursue its desired macroeconomic policies. In the U.S. in spite of the so called financial globalization “the markets” do not have the power to prevent the government from following say a counter cyclical macroeconomic policy because the American economy has nothing to fear from “speculative attacks” on the currency not only because exchange rate devaluation generates little if any domestic inflation but also because the American “foreign” liabilities are denominated in dollars and thus the American foreign creditors are the ones that actually lose if and when the external value of the dollar falls. This perhaps could be one of the factors that explains why the U.S. has supported so strongly policies of international financial liberalisation all over the world.

\(^{11}\)In a recent paper Schulmeister(2000), one of the few authors that following Kindleberger grasps very well various aspects of the nature of the current flexible dollar standard, seems to overestimate very much the direct inflationary effect of a dollar devaluation and ends up appealing to a somewhat *ad-hoc* explanation (the
In his last book Hicks (1989) realised that the USA, from the beginning of the 80’s had taken “the duty” of making the dollar the international currency and therefore correctly (according to him) started to have a “passive” behaviour regarding their balance of payments.

Nevertheless, Hicks asks himself if this role can be played adequately by a “weak” currency like the dollar. By “weak” Hicks means only that it is the currency of a country that shows a tendency to have chronic deficits in the current account.

There are three different aspects to this important question. The first is: is it reasonable to assume that other countries will stop accepting dollars as payments for exports to the U.S. in the foreseeable future? First of all, the U.S. is still the biggest market for most products and services so not accepting dollars means being excluded from it. Moreover, some recent official estimates show that about a third of the American current account deficits are due to American multinational corporations that export back to the U.S. from other countries. Those firms of course will not refuse dollar payments for obvious reasons and to this we can surely add most of their local suppliers. It is also not likely, specially given the present military superiority of the U.S that this country will not find developing countries more than willing to supply it with oil or other commodities, accepting payments in dollars.

Therefore it is most likely that the U.S. shall continue to pay for its imports with the dollar making the financing of its current account automatic.

The second aspect is: what if the current account grows too much? Usually countries that accumulate current account deficits have growing factor service payments bills that grow at compound interest. This has not happened yet in the U.S. (mainly because the rate of return loss of bargaining power of OPEP) to explain why the devaluation of the dollar during the period 1985-95 came together with a fall instead of a rise of American and world inflation.
of American foreign assets has been much higher than the rate of return of American
foreign liabilities) but it is quite possible. In any case, contrary to other countries where most if not all foreign liabilities are denominated in other currencies, the U.S. has the prerogative of reducing the interest service on its “external” debt merely by reducing domestic interest rates. At the same time the trade balance may be improved by a devaluation of the dollar relative to the currencies of particular countries where the deficit is considered to be particularly large.

This brings us to the third aspect: what if the other countries for some reason start selling their dollar denominated assets? If a single country (whether driven by the market or by government policy) decides to dump its accumulated dollar assets, the dollar will certainly can fall drastically in terms of the currency of that country. But that would probably mean that this country would lose export market share in the U.S. and other dollarised markets and moreover it could easily cause a major domestic financial crisis as the domestic value of the dollar assets fall. It is not clear that it would be in the interest of the business community or of State of a particular country to do that.

Note also that the devaluation of the dollar against a particular currency tends not to have large effect in international dollar prices or in American inflation precisely because other countries will want to use the opportunity to steal their export market. Thus it seems that only a (very unlikely in present conditions) concerted movement of dollar asset dumping happening simultaneously in many countries, could generate higher dollar prices and some inflation pressure in the U.S. Even then should we really expect that if a lot of dollar asset holders suddenly shifted their portfolio to, say, Euros the U.S. suddenly would not find people willing to export to the U.S. accepting dollars as payments?
Therefore, we must conclude that given the current economic, political and specially military power of the U.S. the flexible dollar standard is likely to stay around for a while. Hicks seems to have got it wrong. It seems that in reality the dollar can be “weak” because it is the international currency.

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