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**Improvement in the Balance of
Payments: A Response to Monetary
Policy or to *AD HOC* Fiscal Policies**

by

Allan H. Meltzer

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Pittsburgh, Pennsylvania 15213

Graduate School of Industrial Administration

William Larimer Mellon, Founder

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(Continued on inside back cover)

IMPROVEMENT IN THE BALANCE OF PAYMENTS: A RESPONSE TO MONETARY POLICY OR TO *AD HOC* FISCAL POLICIES

ALLAN H. MELTZER*

THE events of the past few years have alerted economists and non-economists alike to the difficulty of choosing appropriate monetary policies while making the implicit assumption that the economy is closed. The problems posed for policy-makers by the existence of a deficit in the balance of payments and a continued gold outflow are familiar enough. Indeed, the balance-of-payments deficit and the gold outflow have received so much recent attention that it is perhaps time to recall that there are also dangers in ignoring or minimizing certain domestic effects of monetary policy. The dangers result from the tendency to equate monetary policy with its effect upon interest rates and its effects on gold outflows and balance-of-payments deficits through interest rates.

My conclusion that the domestic effects of changes in money are often ignored is based on several sources. Some of these are familiar; for example, the analysis that was widely used to support the 1964 tax cut in the United States, and recent governmental policy statements suggesting that monetary policy be used for balance-of-payments purposes, while fiscal policy be used to stimulate the domestic economy. More disturbing are the indications of a possible change in current monetary policy that

is reflected in a reduced growth rate of the money supply. Enticing as it is to speculate about the present direction of policy, it is probably more fruitful to discuss the rationale used to justify the policy actions of the last few years.

THE ECONOMIC BASIS OF RECENT MONETARY POLICY

Like other policy prescriptions, present policy reflects an explicit or implicit analysis of the causal mechanisms that are at work in the economy. Four assumptions seem to play a particular role in the analysis. These assumptions are (1) fixed exchange rates will be maintained or at least the United States will use its power to maintain the dollar price of gold; (2) wages are rigid downward; (3) gold flows are sensitive to interest-rate movements, and a rise in domestic rates, particularly short-term rates relative to foreign rates, reduces gold outflow; (4) household and business expenditures are relatively insensitive to interest-rate movements.

The first assumption concerns political realities and social goals. It is a statement about the influence of those who believe that continued gold outflows or changes in the exchange rate will have a deleterious effect upon people's confidence in our military might, our economic strength, and our determination to resist Mao Tse Tung—or some combination of the three. The last three assumptions are specifications about magnitudes of response within some model or theory. Some have been obtained by careful em-

* Professor of Economics, Graduate School of Industrial Administration, Carnegie Institute of Technology, currently Ford Foundation Visiting Professor, Department of Economics, University of Chicago. This paper is a slightly revised version of the one presented to the Conference of Business Economics, University of Chicago on April 29, 1965.

pirical research, others by the more familiar method of plausible assertion. In the case at hand, the underlying theory is of the income-expenditure, or Keynesian, type. Given the theory and the assumptions about response magnitudes, the conclusions follow. Monetary policy can be used to raise short-term interest rates and reduce the gold outflow; fiscal policy can be used to stimulate the domestic economy.

The problem is that our recent experience and implications of the analysis do not jibe. One would expect from the underlying theory that, in periods when the money supply was declining or growing very slowly and the government deficit was relatively large, the gold outflow would be reduced and economic activity would expand. At such times, according to the theory, interest rates are high and the outflow of short-term capital is small or is replaced by an inflow. When there is a surplus or small budget deficit, the theory predicts that interest rates are low and unemployment rates are high. At such times the gold outflow should increase. But in 1958, 1959, 1960, and 1962, years of slow monetary growth or declining money supply, the balance-of-payments deficits were among the largest in recent years and the gold outflows were substantially larger than in almost any other recent year. In 1964, the year in which the money supply grew at one of the fastest rates in contemporary or longer-term peacetime history, the balance-of-payments deficit declined for the first three quarters of the year, the gold outflow was the smallest in recent years, and there began to be talk of a permanent improvement in the balance of payments.

The last recession we have experienced started in 1960, a year in which the money supply declined. Since 1960, the growth rate of the money supply has gen-

erally been positive, and the growth rate of the money supply for 1963 and 1964 was approximately 4 per cent on the average. As in the past, income expanded during the years of substantial monetary expansion and declined following substantial decline in the rate of monetary expansion. A similar analysis could be used to show that there is little relation between current or lagged values of the government deficit and current growth rates in real income. These facts are difficult to subsume under a theory that says or implies that restrictive monetary policies are well suited for improving the balance of payments or reducing gold outflows, and that fiscal policy is the appropriate policy for increasing the pace of economic activity.

Let me make clear that I am not suggesting that the deficit resulting from the 1964 tax cut or earlier government deficits had no effect on the pace of economic activity. But observations cast up by our recent experience make it difficult to accept as correct a theory that tells us that the rate of monetary expansion has its principal effect on the gold outflow and not on the domestic economy, that it makes little or no difference for the rate of domestic economic expansion whether the government's deficit is financed by issuing interest-bearing debt or money, and that, by pursuing a policy of monetary restriction, we have prevented a gold outflow and encouraged an inflow of short-term foreign balances. An alternative explanation of the recent movements in real income, in the balance-of-payments deficit and in the gold stock, that is more in keeping with the record of our recent experience, seems to be required.

AN ALTERNATIVE EXPLANATION OF RECENT POLICY

Before presenting an alternative interpretation of the effects of recent mone-

tary and fiscal policies, a few additional facts must be cited. Since my subject is the effect of monetary policy on the balance of payments, my remarks are confined to the movements recorded by a few balance-of-payments indicators—to the money supply and not to the details of fiscal policy. The first total, liquid liabilities held by foreigners, is a measure of the amount of dollar deposits and dollar securities held by foreign commercial banks, central banks, and other foreigners. The trend of such claims against us has been steadily upward. Although there have been some large redistributions within the total, the over-all record is one of uninterrupted expansion. Only one year, 1962, merits any particular comment. In that year the increase in liquid liabilities held by foreigners was smaller than in any of the preceding or following years during which the balance of payments has been recognized as a problem. To come directly to the point, there is no apparent relation between the rate of increase of the money supply and the rate at which foreigners have been willing to acquire and hold liquid liabilities in the United States. To the extent that any relation can be gleaned from the scanty number of observations, the evidence suggests that, in years when the growth rate of the money supply accelerated, the growth rate of liquid liabilities held by foreigners accelerated also. There is no need to insist upon a positive correlation between the two growth rates. But it should be noted that there is no evidence of a negative relation and that the evidence is far from clear that monetary restriction has had an important influence on the growth of "liquid liabilities held by foreigners."

Turning to short- and long-term private capital flows, we find a much more erratic pattern of movement. No one who has looked at these data can fail to be im-

pressed, however, by the dramatic reversal that occurred in the summer of 1963. At that time, both short- and long-term capital movements changed markedly, falling from an annual rate of outflow of more than \$5 billion in the second quarter to an annual rate of outflow of only \$2 billion in the third quarter. The rapid fall in capital outflows was fully reflected in an improved balance-of-payments position for the United States. By the first quarter of 1964, the private capital outflows had returned to an annual rate in excess of \$5 billion. By the end of 1964 they greatly exceeded that rate.

The major reasons for the improved balance-of-payments position of the United States in late 1963 and for the first three quarters of 1964 are not difficult to find. First, a threatened tax on capital movements slowed the outflow of capital from the United States in the period prior to the enactment of the tax. Second, an improvement in the net export position of the United States that began in the summer of 1963 and continued throughout 1964 improved the balance-of-payments position in the United States during the early part of the year. By the fourth quarter the steady rate of increase in capital outflow had more than offset the improvement in the net export position.

There are, no doubt, many reasons for our improved position on current account, including, of course, the higher rates of inflation in other major trading countries. It is difficult to know precisely how much importance to assign to the effect of inflation, since precise measures of either price levels or average price elasticities for exports and imports are not available. But it is difficult to assign the full weight of the improvement in our trade position to relative price changes, since the magnitude and the timing of the improvement on trade ac-

count occurred exactly at the time of U.S. and Canadian grain exports to the Communist countries. The U.S. trade balance benefited directly from our own exports. It benefited also—by increased exports to Canada—from the improved foreign-exchange position of Canada that was a consequence of cash sales to hungry Communists.

Thus responsibility for the improved balance of payments in 1963 and in the first three quarters of 1964 can be assigned to three quite different causes. First, there was the dramatic reduction in private capital flows lasting one quarter and clearly influenced by the threatened tax on capital movements, euphemistically called the "interest-equalization tax." Second, there were direct and indirect effects on commodity exports of U.S. and Canadian grain sales to the Communist countries. Third, there were reductions in the relative price of U.S. exports. Only the third factor can be expected to remain as a source of permanent improvement.

The deterioration of the payments position in the fourth quarter of 1964 can be explained in much the same way. Methods of avoiding the interest-equalization tax developed. The export of grain sales declined, reducing the surplus on current account. But the export position remained above the level of the previous year. This produced increased short-term capital outflow for much the same reasons that increased domestic sales lead to higher levels of accounts receivable and bank loans on business balance sheets.

Again, in the first quarter of 1965, the improved balance-of-payments position of the United States followed the threat of new federal legislation. Since my subject is the effect of recent monetary policy on the balance of payments, it should be noted that, unlike the experience of

1963, the 1965 improvement occurred after the rate of growth of the money supply had slowed. But the decline in the rate of growth of the money supply came several months before the improvement of the balance-of-payments position and continued after the improvement was under way. It requires a relatively large interest elasticity—and a relatively small arm-twisting elasticity—to reconcile the balance-of-payments improvement and the decline in the rate of monetary expansion.

An alternative explanation seems far more consistent with the facts. This explanation assigns primary importance for the improved balance of payments in the summer of 1963 and winter of 1965 to *ad hoc* fiscal devices. The record that supports this interpretation also suggests that we should not be sanguine about the extent to which such *ad hoc* devices bring permanent improvement in the payments position. Extrapolating from the 1963 experience suggests that bankers and businessmen will find a way around present capital restrictions within, at most, one additional quarter—if they have not found the way already. Much of the balance-of-payments problem remains to be solved.

THE ROLE OF RECENT MONETARY POLICY

If monetary policy has not been the most important influence on the balance of payments, what has it achieved? The answer seems obvious. Restrictive monetary policy has not improved the balance-of-payments position because monetary policy has not been restrictive during most of the months of improvement. There seems little point in debating whether the combination of a policy of monetary restriction and a policy of fiscal expansion worked to achieve the goals of balance-of-payments improvement and

economic growth, since that combination has not been used. Instead, fiscal and monetary policies have promoted full employment at home, as I indicated previously. Threats of *ad hoc* fiscal measures have had a major part in the temporary improvements in the balance-of-payments position that have been experienced.

Some evidence was mentioned above which supports the interpretation that until recently monetary policy has been expansive. Let us consider the record more carefully. During most of 1962 there was much talk in the United States of lagging growth rates and lagging incomes—talk that suggested a revival of the stagnation thesis. Beginning in the late fall of 1962, the Federal Reserve announced that it was moving toward a policy of “slightly less ease.” As has so often occurred in the past, actual policy moved in a direction opposite to announced policy. The growth of the money supply changed from negative to positive, accelerated, and expanded at a rate not observed in any period of comparable length since 1946. These changes occurred before the tax cut was enacted, while there was much doubt about whether the tax cut would ever be passed. It is hard to explain the recent improvement in national income and the prolonged period of economic expansion without assigning some role, and an important one, to the rate of monetary expansion. It is even more difficult to do so if we view the record of the U.S. economy for the past half-century or longer.

In some recent work, an attempt was made to predict income velocity from a theory of the demand for money.¹ Predictions were made for the years 1910 to

1958. The prediction of velocity, when multiplied by the money supply, is, of course, a prediction of the level of money income. These predictions have three features that are of interest for this discussion: (1) the average absolute error obtained from the predictions is relatively small, approximately 2 per cent for the postwar years; (2) the predictions missed only three turning points, all of them prior to 1925; (3) since 1925 the predictions accurately indicated every turning point in the level of income.

The evidence from the long-term record of the U.S. economy supplements the evidence from the recent record to which I have referred several times. Further support comes from Friedman and Schwartz's monumental study of U.S. monetary history. They summarize part of their findings with the statement: “Of the relationships revealed by our evidence, the closest are between . . . secular and cyclical movements in the stock of money and . . . corresponding movements in money income and prices.”² Still more support is found when similar procedures were applied to the analysis of income movements in other countries, as Beryl Sprinkel's work suggested a few years ago.³ The record of evidence supports the conclusion that monetary expansion and economic expansion are closely and positively related.

If these interpretations of the evidence are correct, there is reason to expect that the balance-of-payments problem will remain with us for some time. Thus far, most of the effect of the high rate of recent monetary expansion has been on

² M. Friedman and A. J. Schwartz, *A Monetary History of the United States* (Princeton, N.J.: Princeton University Press [for the National Bureau of Economic Research], 1963), p. 678.

³ Beryl Sprinkel, “Relative Economic Growth Rates and Fiscal-Monetary Policies,” *Journal of Political Economy*, April, 1963.

¹ Karl Brunner and Allan H. Meltzer, “Predicting Velocity: Implications for Theory and Policy,” *Journal of Finance*, May, 1963.

real income. The effect on price levels is just beginning to become apparent. As the rise in the U.S. price level becomes larger, some of the reduction in the relative price of U.S. exports will be offset, the extent of the offset depending on the relative rates of inflation in various countries and the price elasticities of traded commodities.

Since a part of 1964's improvement on trade account was the transitory effect of grain sales to eastern Europe, the sacrifice of a part of our improved price position has a serious consequence. It threatens to reduce further the amount of improvement in our current position. Possibly in anticipation of this problem, the Federal Reserve may have acted to reduce the rate of monetary expansion. The growth rate of the money supply slowed after November, 1964. Since the growth rate of the money supply is almost always quite erratic, because of the Federal Reserve's undue concern for money market conditions, it is difficult to know from month to month precisely what growth rate is being achieved. But over the period from November through March, the growth rate of the money supply at annual rates has been 1.3 per cent, slower than the growth rate of population, and slower than the long-term monetary growth rate that is required to maintain expanding real income. If the slow rate of monetary expansion continues, a slowing of the pace of economic activity should be observed within the next few months. Should this occur, the economic situation will be analogous to the situation in 1961-62, with relatively high unemployment rates and a balance-of-payments deficit. What do we do if that happens?

SOME ALTERNATIVE SOLUTIONS

One policy proposal is to continue as we have in the past. This method can be

characterized as one of prayer, threats, and a strong dose of expansive monetary and fiscal policy. The prayer is that there will be more inflation in Europe than in the United States; the threats are that we will invoke more domestic controls, more restrictions on capital movements, perhaps stronger price and wage guidelines, or even some form of price and wage controls to prevent the fiscal and monetary policies from showing up in the balance-of-payments statistics.

The basis for this policy is very difficult to understand. It is often closely tied to the arguments for fixed exchange rates and is defended with the best of intentions and with statements of high principle about the importance of confidence in the dollar, about the maintenance of the U.S. position in the world economy, and about the provision of something called "discipline." Many of the arguments used to defend the position are so vague that they cannot be easily refuted. But they seem to carry the presumption that, without the restrictions imposed by the loss of gold and without the desire to maintain a fixed exchange rate, U.S. policy would be one of reckless monetary expansion at rates considerably larger than those of the past.

There is so little evidence for this presumption in the record of U.S. monetary history that it is difficult to believe that those who advance the argument have ever looked at our history. During peacetime the average rate of monetary growth has rarely been inflationary. There is little reason to believe that the rate of monetary expansion that has been observed in the past would increase suddenly if we were not "disciplined" by the balance of payments. Moreover, the data for recent years suggest that monetary expansion has been about twice as high during the past two years of balance-of-payments difficulties than it was on the

average of the postwar years as a whole. It is not clear at all that the restriction or so-called discipline has been important.

A major argument of those who wish discipline and fixed exchange rates, particularly the latter, is that fixed exchange rates are of advantage because they stimulate trade. The argument is that fixed exchange rates remove most of the uncertainty about future exchange rates and thereby encourage businessmen to engage in international commerce. It is difficult to know how important this argument is, but let us assume that increased certainty has an important effect on the volume of international trade. Further assume, contrary to what might be expected, that there would not be an active, forward foreign-exchange market in which businessmen could eliminate uncertainty about exchange rates if these prices were allowed to vary. Now let us inquire how fixed exchange rates have worked in recent years to stimulate trade and eliminate uncertainty. In place of speculation about the future movements of flexible exchange rates, there is speculation about the devaluation of particular currencies. A few years ago speculation centered on the dollar; in the recent past the pound has received attention. Although it may seem strange today, past speculation centered on the franc. It is not inconceivable that at some time in the future there will be speculation about the future of the mark or again about the dollar or the pound. Fixed exchange rates have not eliminated uncertainty—only the form has been changed. In place of the type of uncertainty that businessmen can eliminate by operating in an active, forward market, we have the type of uncertainty that is not easily eliminated in this manner because an active, profitable, forward market does not become established in a regime of fixed exchange rates.

Furthermore, the policies used to maintain fixed exchange rates involve an increasing number of restrictions on capital movements and property rights. To maintain the asserted benefits of fixed exchange rates, including the stimulus to trade that they are said to bring, restrictions that lower the efficiency of the international economic system have been introduced, and others are threatened. These restrictions are a high price to pay for the unknown volume of increased trade induced by the unknown amount of increased certainty.

There may be a combination of prayer and threat that will eventually bring the balance-of-payments problem of the United States to an end. But the record of the past is not overly promising, and it is useful to consider some alternatives.

A second proposal for managing the international economy is: Turn the management over to a world central bank of limited scope. A variety of proposals has been offered along these lines and some very hesitant steps have been taken to expand the International Monetary Fund. Each proposal merits some individual attention, but such discussion must be left to another occasion. Instead, I would like to express doubt about the general notion of having international monetary management through some type of world central bank.

The study of the monetary history of the United States by Friedman and Schwartz⁴ suggests that errors in policy at crucial times have been responsible for major depressions and inflations. In a recent study of the Federal Reserve System that paid primary attention to the record of the Federal Reserve in the postwar period, Karl Brunner and I concluded that the record of monetary man-

⁴ *Op. cit.*

agement continues to be quite poor.⁵ Major errors often seemed to be the result of a failure to properly analyze, or to attempt to analyze, the behavior of the monetary system. The performance of the Federal Reserve—and of other central banks that have been studied—suggests that the requisites for appropriate monetary policy are still unknown to central bankers. The baneful policies of Governor Coyne in Canada during the 1950's and numerous examples of other policies based on good intentions and poor analysis support this conclusion.

If we do not have a valid theory of the determination of the money supply or of interest rates in a single country, can we hope to manage money effectively and appropriately on a world-wide basis? There is no reason to believe that the problems of international monetary management will be more tractable; that a detailed theory will be more readily developed, tested, and confirmed; or that the results of international monetary management will be much better than those observed in our own and other countries. A valid theory of exchange-rate movements and of the quantitative effects of interest rates, relative prices, and other variables on short- and long-term capital movements and on trade flows between countries and third-country effects is a prerequisite for the management of an international money. In the absence of a detailed understanding of the international monetary mechanism, it is a great deal to expect that international monetary management or an international central-banking arrangement can solve short-run problems of international adjustment without causing more serious problems.

⁵ See esp. *The Federal Reserve's Attachment to Free Reserves*, House Banking and Currency Committee, 1964.

No doubt, detailed quantitative knowledge applicable to short-run international monetary problems will be developed. Work along these lines has barely started. When the theoretical and empirical problems have been partly overcome, the management of money by an international central bank may be more attractive than existing alternatives. But that does not seem to be a likely prospect for the near future.

There is, however, a third alternative that requires neither monetary management nor substantial increase in the validated portion of the theory underlying international monetary movements. This proposal does not require an increase in the number of restrictions imposed on the domestic economy or on international capital movements and, in fact, it is quite consistent with the removal of many of the restrictions that have already been imposed. Furthermore, the policy has been tested by the United States and other countries in the past. From 1862 to 1879, and again from 1933 to 1934, the price of the dollar was not fixed in terms of gold. The dollar price of gold was set by market forces, including governmental transactions in the 1933-34 experience.

These periods are of particular interest since both were times of substantial uncertainty. The first period includes the Civil War and Reconstruction era, which witnessed silver agitation, large capital movements, and substantial changes in the pattern of trade. During these years industry developed in the North, and output expanded rapidly. The second period is at the bottom of the Great Depression. If uncertainty and a market-determined price of the dollar are incompatible, it is likely that the system would not have worked during the two periods. But there is no sign of inflationary expansion

of the money supply during either period with the exception of the war-induced inflation of 1862-64. The period of 1862 to 1879 is of particular interest in this respect because of its length. There were large-scale capital inflows that financed industrial growth, a rapid upsurge in economic activity, and generally falling prices. There is very little evidence in either period that fluctuations in the exchange rate seriously inhibited the volume of exports and imports. These conclusions are somewhat less certain for the period 1933-34, since the dollar price of gold was not free for very long and there was substantial governmental intervention in the foreign-exchange market (aimed at raising the dollar price of gold). Nevertheless, there is little evidence to indicate that allowing the market to determine the dollar price of gold, to the extent that this has been the practice of the United States in the past, has been seriously disruptive of trade flows or capital movements.

A rather indirect form of evidence about what might be expected to happen if this policy were adopted comes from a more recent period. In 1951, the Treasury and the Federal Reserve agreed to stop maintaining a fixed minimum price of long-term bonds. Before this step was taken, fears were expressed that the bond market would be unstable, unsettled, or chaotic if the market were given an important role in the determination of bond prices. A number of seemingly persuasive arguments were advanced to that effect. The record shows, however, that the bond market was not unsettled after the peg was removed. In fact, the movement of interest rates in 1951, after the accord, was smaller than reasonably might have been expected. Interest rates did not rise precipitously, and bond prices did not vary in a manner that could be described

as chaotic. Instead, interest rates adjusted slowly from 1951 to a peak in 1953.

It will be recalled that the removal of the peg from interest rates in 1951 was done at a time that was less than propitious. The Korean war was under way, there was much talk of the danger of inflation, and the economy was in the early part of an upswing from the low level of economic activity that prevailed in 1949 and early 1950. The conditions were ripe for speculators to cause unsettled conditions in the bond market—if *that* is what speculators do. Unsettled conditions did not occur, a conclusion that is at least consistent with the view that we need not expect chaos if the market is allowed to establish the dollar price of gold.⁶

There are numerous additional examples of the removal of governmental restrictions followed by a great deal more price stability than had been anticipated. But let me conclude the argument for a market-determined price of gold in terms of dollars by stating that I do not know of any persuasive evidence suggesting that such an arrangement is destabilizing.

CONCLUSION

In the past few years a number of myths about the U.S. economy have been repeated with great frequency. There is the myth that monetary contraction or a slow rate of monetary growth has been the important source of improvement in the balance-of-payments position. In fact, the rate of monetary expansion has

⁶ There is a tendency to dismiss any unilateral effort to let the market determine the exchange rate because of the Canadian experience in the fifties. There is little reason to dispute the fact that the policy failed in Canada, but general conclusions should not be drawn hastily. Canadian and U.S. monetary policies played an important part in the failure of the experiment.

been faster than the average for most peacetime periods. There is the myth that fiscal policy has been the major expansive force bringing about the recovery of the economy to the high levels of production in 1964 and 1965. The fact is that the rate of economic expansion began shortly after the rate of monetary expansion increased, and the rate of economic expansion has continued at a pace to be expected from the combination of government deficits with monetary expansion. There is the myth that the goals of economic expansion and improvement of the balance of payments have been pursued simultaneously, when in fact much of the improvement in the balance of payments appears to be a temporary response to fiscal expedients or the result of grain sales to Communist countries.

If these interpretations are correct, the choice that faces us in 1965 is very similar to the one we had to make four or five

years ago. The choice is between monetary contraction, a change in the dollar price of gold, or a continuation of the balance-of-payments problem. These seem to be the alternatives that are open to us, and if we desire a permanent improvement in the balance of payments, choice is restricted to the first two. There is little reason to believe that the salutary effects of arm-twisting persist beyond a quarter, or at most, a half-year. The record for the fourth quarter of 1964 suggests that our balance-of-payments position in 1965, without arm-twisting, would be only slightly better than it was in 1961.

This article has attempted to answer the question asked in the title, so I feel free to ask another. Why is it so difficult to abandon the present policy of restrictions on capital movements and accept the alternative of allowing the price of gold to be determined by market forces? I have no answer for that question.

(Continued)

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