Gold Would Serve Into the 21st Century
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Wall Street Journal (1923 - Current file); Sep 30, 1981;
ProQuest Historical Newspapers: The Wall Street Journal
pg. 28

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I want to begin with an enormous platitude: No country in a world community can establish a monetary policy that does not take account of the international economic system of which it is a part. No country can dissociate entirely its monetary system from that prevailing elsewhere. There is no such thing as a closed-economy monetary policy except the monetary policy of all the nations making up the world system.

It is unfortunate that two of the 20th Century's most influential monetary economists, Keynes and Friedman, wrote their major theoretical works for a closed economy with scant attention to the problem of international interdependence. Both economists generally assumed a national closed economy on an inconvertible paper standard, generally ignoring that in the 1930s as today gold represented the principal external monetary reserve. I am aware, of course, that both men wrote on international monetary arrangements, Keynes favoring a fixed, but adjustable exchange-rate peg, and Friedman a "clearly floating" exchange-rate system, but their theoretical masterpieces did not develop international interdependence into their systems of policy.

Keynes wrote the "General Theory" for a closed economy on an inconvertible paper-currency standard. This assumption was important for elucidating theoretical matters, but it misled his followers, and Keynes himself, on matters pertinent to economic or monetary policy.

Keynes had advocated adjustable exchange rates earlier in his "1923 Tract on Monetary Reform" to preserve price stability on lines not dissimilar from his older American contemporary Irving Fisher back in 1912. In the "General Theory," Keynes attacked fixed exchange rates:

". . . . . the City of London gradually devised the most dangerous techniques for the maintenance of equilibrium which can possibly be imagined, namely, the technique of bank rate coupled with a rigid parity of the foreign exchanges. For this meant that the objective of maintaining a domestic rate of interest consistent with full employment was wholly ruled out. Since, in practice, it is impossible to neglect the balance of payments, a means of controlling it was evolved which, instead of protecting the domestic rate of interest, sacrificed it to the operation of blind forces. Recently, practical bankers have learned much, and one can almost hope that in Great Britain the technique of bank rate will never be used again to protect the foreign balance in conditions in which it is likely to cause unemployment at home."

This astonishing passage is good poetry but bad economics—it is confused, illogical, inconsistent and irrelevant. It reveals how unfortunate, for Keynes and for ourselves, was his inability to incorporate the essentials of the efficient international adjustment mechanisms under fixed exchange rates between countries or between regions in the same currency area as it had been worked out by Ohlin, Viner, Pigou and Robertson in the 1920s and 1930s.

It Was His Aim to Elucidate

Keynes's assumption of a closed economy let him sidestep discussion of the foreign sector, the merits of fixed versus flexible exchange rates or of the degree to which international credit positions, trade imbalances, reserve losses or speculation would alter the real wage, employment and output positions which it was his aim to elucidate.

Nevertheless he recognized explicitly the need for flexible exchange rates in an open system if money was to be stabilized, as the following passage shows:

"In the light of these considerations I am now of the opinion that the maintenance of a stable general level of money-wages is, on a balance of considerations, the most advisable policy for a closed system; whilst the same conclusion will hold good for an open system, provided that equilibrium in the rest of the world can be secured by means of fluctuating exchanges."

Keynes explicitly rejected, however, the idea of fixing the quantity of money or its rate of growth:

"If, indeed, labor were always in a position to take action (and were able to do so), whenever there was less than full employment, to reduce its money demand by concerted action to whatever point was required to make money so abundant relatively to the wage-unit that the rate of interest would fall to a level compatible with full employment, we should, in effect, have monetary management by the Trade Unions, aimed at full employment, instead of by the banking system.

"Nevertheless while a flexible wage policy and a flexible money policy come, analytically, to the same thing, inasmuch as they are alternative means of changing the quantity of money in terms of wage-units, in other respects there is, of course, a world of difference between them. . . ."

Keynes's system thus takes into account the wage rate, the money supply, the price level and the exchange rate, and the need to anchor the system by choosing a "numeraire" or a "standard"; he chooses wage rates. This accounts for the support of "wage policy" by his influential disciples.

By contrast, Friedman's system, while endorsing flexible exchange rates rejects the idea of wage policy and (after an earlier flirtation with 100% reserve money expanding or contracting with budget deficits and surpluses) now focuses attention on fixing the rate of growth of the supply of money.

There are several arguments against the Friedman policy system. One is that money is too elusive a concept to define, measure and predict, and is therefore of little use as a guide for rational expectations of future prices and incomes, whether reserve money alone, M-1A, M-1B, M2 or other definitions are used. None of these measures takes explicit account of the liquidity of dollars created in the offshore markets despite the confirmed role these markets play in contributing to inflation.

More important, the facts have clearly demonstrated the breakdown of monetary discipline after the collapse of the gold exchange standard. Eurodollars increased from $150 billion in 1970 to more than 10 times that amount in 1981. A comparison of the weak gold discipline of the Bretton Woods period with the floating rate period is even more revealing in connection with international reserves:

> *The U.S. is still the dominant economy and the hegemonic super-power in the free world. The dollar is still the major currency reserve and gold is the only other major component of international reserves.*

Billions of U.S. Dollars

	1950	*1960*	*1970*	*1980 (est.)*
Foreign Exchange	13.3	18.5	15.4	300.0
Gold	33.8	37.9	37.0	600.0
Total	47.1	56.4	82.4	900.0
Eurocurrencies (est.)	10.0	25.0	163.0	1,600.0

Since the breakdown of the U.S. gold standard the U.S. monetary system has produced more dollars than in the entire previous history of the republic. The prices of gold, oil, silver and other commodities have risen more than tenfold and, barring a drastic change in the monetary system, prospects are for more of the same in the future.

Never before in U.S. history has the Treasury had to pay 15% for 30-year bonds, implying an incredibly pessimistic outlook with respect to inflation. It is these considerations that prompt a consideration of the policies needed to restore convertibility of the U.S. dollar to gold.

If there is a stable international money, there is no conflict between fixed exchange rates and the goal of internal price stability for a single nation state. Under fixed exchange rates the price level of the individual nation state has to converge to the price level of the world as a whole provided that commodity markets are sufficiently integrated internationally.

The monetary authorities of small countries have usually observed this fact and accepted its implications. Purchasing power parity areas, where the Law of One Price holds, imply a geography of inflation rates based on currency areas. Currency areas determine common inflation rates and interest rates. On a map of the world common inflation rate zones correspond to zones of fixed exchange rates.

If there is a stable external currency area a country has the convenient option of fixing its own currency to it, or scheduling its exchange rate at a pre-arranged rate of devaluation or appreciation. In the world of the 1980s countries that have historical inflation rates above that of the U.S. would benefit by fixing their currencies to the U.S. dollar and adapting their monetary policy to make that exchange rate an equilibrium one.

This assignment implies a monetary approach to the balance of payments, with the central bank allowing its purchase and sales of foreign exchange reserves to reduce automatically the high-powered money base of the banking system. The monetary approach to the balance of payments does not leave much room for neutralization or sterilization operations; the idea instead is to take full account of international impulses in the formulation of domestic monetary policies.

Our experience with this kind of system is instructive, since it was precisely this kind of monetary arrangement that constituted the Bretton Woods system from 1918 to 1971. Except for the great devaluations of 1949, the quarter century of this regime was exemplary in its stability, growth and world economic development, perhaps unmatched at any time outside an imperium, such as the Roman Empire. There was never any doubt that the *central tendency* of the Bretton Woods era was the U.S. economy, and the dollar was the dominant currency.

The Bretton Woods system broke down for two reasons. First, the gold base of the system, at a price of $35 an ounce, had become too narrow to sustain the mounting liquidities in the U.S. and outside in the Euro-, Asian- and Caribbean-dollar markets. Gold had been artificially in surplus after 1934 because Americans had been deprived of the right to own or hold gold, but the "surplus" vanished as a result of World War II inflation.

After the Korean War inflation, gold became undervalued, and after the opening of the London gold market in 1954, dollar interest rates had to rise steadily to tempt central bankers and foreigners from holding gold and reaping the capital gains expected when the anticipated upvaluation of gold occurred. Thus interest rates, which in 1946 had been less than 4% rose above 10% by 1969.

The second reason Bretton Woods broke down was the revolt against U.S. leadership that occurred in Europe, partly because of the Vietnam war. The DeGaulle-led movement toward the gold standard in the 1960s had wider support than within France; the German objections to holding the overhang of excessive dollars, however, were suppressed by the U.S. counter-threat of troop withdrawals.

What Britain's Prime Minister Wilson described as a "monetary war" broke into the open when in the spring and summer of 1971 the Europeans stuffed excess dollars into the Eurodollar market while the U.S. gunned the U.S. money supply to inflate its economy out of the 1970-71 recession in preparation for the 1972 presidential election. President Nixon killed the limping gold standard on Aug. 15, 1971, and the price of gold shot up to $200 an ounce by 1974; after the lifting of the prohibition on gold holding by U.S. citizens in 1975, gold's price marched irregularly upward, reaching at one point in 1980 nearly $850 an ounce, 25 times its 1970 value, before dropping to the $400-$600 range.

The underlying economic conditions in 1981 and prospects for the next two decades are not as different from the 1950s and 1960s as they may appear. The U.S. is still the dominant economy, and the hegemonic superpower of the free world. The dollar is still the major currency reserve and gold is the only other major component of international reserves. A rerun of the monetary structure of the 1950s and 1960s, without the deadweight difficulties of undervalued gold would probably serve us well into the 21st Century.

An 11-Point Proposal

The basic ingredients of a restored *Equilibrium Atlanticum-Pacificum* would involve the following elements:

1. Stabilization of the dollar price of gold, probably in the $300-$650 range, to be determined by the U.S. in consultation with its allies.

2. Issuance of a gold coinage (various fractions of an ounce) with a face value equal to the stabilized gold parity.

3. Stabilization of other currencies—particularly the DM to the dollar in the DM1.80 to DM2.20 range.

4. Attention to the gold "discipline" by the U.S. such that the U.S. money base is allowed to increase or decrease with gold purchases and sales.

5. Attention to the balance-of-payments discipline by the non gold-pegging countries such that the national money base rises or falls with increases and decreases in holdings of gold and foreign exchange.

6. Co-ordination of interest rates to prevent excessive disparities from developing between money market centers and gales of hot money disrupting confidence and purchasing power parity relationships of exchange rates and price levels.

7. Multilateral surveillance of the balances of payments problems and exchange rate policies of the major countries within an OECD-OPEC institutional framework, along with multilateral discussion of anti-inflation policies and unemployment-stagnation problems.

8. Programmed adjustment of dollar-gold portfolios of major reserve holders to encourage more expansive or restrictive monetary policies in the center reserve country or countries (initially the U.S.).

9. *General* budgetary policies and if necessary, incomes policies, should be employed to mitigate the business fluctuation, with tax cuts and extra government expenditures to stimulate aggregate demand, and reduce unemployment during recessions, and budgetary surpluses to restrain aggregate spending in periods of inflationary boom.

10. Reform of tax rates and structure in the U.S. and other countries to enhance incentives for more employment saving, productivity and growth of potential output, to offset distortions arbitrarily produced by past and anticipated inflation; replacement of the income tax by a 20% value added tax should be considered.

11. Balance of government budgets over the cycle at levels of deficits necessary to keep debt ratios at realistic proportion to GNP, thus making central bank finance of the government-sector deficits unnecessary.

These 11 policy guidelines would represent bold first steps toward a workable managed gold Standard. They are not incompatible with the policy aims of the Reagan administration and they would induce, if adopted by Britain, Germany, France, Italy and Japan improvement in their economic management on a scale not experienced since the heyday of the Bretton Woods era. I see no political barriers to their adoption if economists can overcome their present love affair with flexible exchange rates, indefinable monetary aggregates and the unemployment approach to stopping inflation.

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