

**INVESTMENT  
RESEARCH**

**MORGAN STANLEY**

*Protectionism, Inflation, or Monetary Reform:  
The Case for Fixed Exchange Rates  
and a Modernized Gold Standard*

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## INTRODUCTION

This is the seventh in a series of strategic-issue essays by "good thinkers" that we have published over the past five years on subjects ranging from gold, supply-side economics (before it was fashionable), to three papers on the world debt problem. I like authors like Lew Lehrman and George Soros, who are exceptional investors and businessmen, because their perspective is fresh and unequivocal, but most of all because their judgment has already been tested in commercial battle. Getting rich on one's own seems to clear the mind.

Lew Lehrman needs no introduction. His magnificent burst from obscurity in 1982 to battling within a fraction of beating the formidable Mario Cuomo for the governorship of New York dazzled the political world. His earlier great success building Rite Aid is a typical American story. At present, as the President's handpicked choice for chairman of Citizens for America, he has an important voice in the policy formulations of the Reagan Administration.

In this paper, Lehrman argues that the record of the last decade makes clear that floating exchange rates create monetary anarchy. His view is neopopulist. Working people in particular need a stable monetary standard. Businessmen are diverted from commerce to currency speculation. Foreign-exchange trading creates very few jobs. The predicament we are in today came about not because politicians are more irresponsible than they have ever been but because effective monetary restraints on their behavior have been removed. Lehrman does not claim that fixed exchange rates and some form of gold convertibility will solve all our problems, but he does build the case that multilateral currency convertibility into gold is the least imperfect system to create trustworthy money, low interest rates, a reasonably stable price level, and steady economic growth.

I do not agree with everything Lew writes, but I do believe we will not have a major secular bull market in stocks and bonds until we stabilize money. Lehrman proposes a definite plan, and his analysis is so crisp and incisive that the reader's understanding of the issues and complexities is measurably deepened. This essay is not short, but it is well worth taking the time to read.

Barton M. Biggs

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Lewis E. Lehrman  
November, 1985

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## THE PROBLEM: THE GLOBAL TRADE AND FINANCIAL CRISIS

### PROTECTIONISM: A SYMPTOM, NOT THE CAUSE

One year ago, Congress began to assemble the most comprehensive protectionist bill since the Smoot-Hawley tariff legislation of 1929-1930. Hundreds of new bills have been introduced, some calling for "fair trade" (by which is meant high tariffs), others calling for quotas, "voluntary" and "orderly" marketing agreements, export subsidies, selective import fees, countervailing duties, and manipulation of foreign exchange rates. A number of our major trading partners stand ready to retaliate, although all of them know that quotas and high tariffs, however well-intentioned, are not a true solution. Such measures would spell the end of the integrated world-trading order, so laboriously constructed after World War II upon the foundations of Bretton Woods and the General Agreement on Tariffs and Trade (GATT).

There is wide agreement among historians that the Smoot-Hawley Tariff Act, proposed in 1929 in response to the overvalued dollar of the 'Twenties, was a prime cause of world economic collapse, and it also deepened and prolonged The Great Depression. Even among those who lead the protectionist brigade in the United States House and Senate, there are many who privately concede that their prescriptions make no sense. And in the light of the history of the 'Thirties, serious politicians cannot believe such zero-sum politics hold hope for the future. But disinflation and the overvalued dollar have led to protectionism. And we are told that the consensus for some form of protection is now overwhelming; that the cries for relief from unions and wounded industries -- while momentarily muted by the Group-of-Five currency agreement -- will not be stilled.

And who can fail to understand the pleas for relief from labor and business in the nation's export- and import-competing industries? The U.S. balance of payments on current account -- mostly goods and services -- has swung from a surplus of \$6.3-billion in 1981 to a deficit of \$101.5-billion in 1984. The largest component in that shift was a surge in the merchandise trade deficit from \$28.0-billion to \$108.3-billion. The figure for 1985 will come close to \$150-billion, and a net 300,000 jobs in the manufacturing sector will have been lost this year alone.

The U.S. trade deficit with Japan climbed from \$1.7-billion in 1974 to \$34-billion in 1984 and will approach \$50-billion in 1985. The Common Market countries posted a \$10.5-billion trade surplus with America in 1984, compared with a \$4.6-billion deficit in 1982. Even Latin America had a surplus of \$18.2-billion in 1984, compared with a surplus of \$3.7-billion in 1983. In 1985, trade in advanced technology, the symbol of American entrepreneurship, has turned from surplus to probable deficit. Inflation-adjusted exports in the first half of 1985 were 12% below those in the first six months of 1980, a threatening 30% below the long-run trend. Compare this to the 7% annual growth of

exports during the 'Sixties and 'Seventies. One need not subscribe to mercantilist fallacies to be alarmed at these figures.

We can readily sympathize with industries being menaced by a rapidly growing competitive disadvantage, and we concede that advocates of a new protectionism may be well-intentioned. But protectionism is the wrong solution. We must patiently ask the tariff proponents the fundamental question: do we not all agree that the trade deficit is closely associated with the unprecedented rise of the dollar that began in 1980? And is the rise of the dollar not a monetary or financial problem? Consider that the trade-weighted dollar in February of 1985, at almost double its 1980 low, had risen by 30% to 50% above some estimates of its true purchasing-power parity against other key currencies. At this point, we can hardly be surprised that the protectionist bomb exploded in Congress. But, if the problem is essentially monetary, it follows that the solution must be a monetary one. A protectionist trade law cannot help; in fact, it will further fracture what is left of the international monetary and trading system.

And yet, we must credit the protectionist politicians for coming to grips with the problem. When effective solutions are not proposed, however, one must expect that constituents instinctively will demand relief. Witness the proliferation of so-called "jobs bills" when the Government ignores high unemployment. Or the calls for wage-and-price controls that accompany government-induced inflation. Given this rapid growth into what could emerge as a malignancy, the protectionist impulse can be seen as not only comprehensible, but also, in some respects, as a fulcrum that has given rise to a serious and healthy debate over what represents the best solution to the trade problem: protectionism or monetary reform.

To his great credit, President Reagan has carefully resisted most of the protectionist forces now at work. Yet, in the past, the Reagan Administration has decreed "voluntary" import quotas for cars, steel, sugar, and textiles -- among other items. That the results were often self-defeating was evidenced in the auto industry from 1981 to 1982, when the trade deficit increased by half despite the quotas. Few of our leaders realize that, despite our professed policy of free trade, nearly 30% of the market for manufactured goods in America is already governed by various quantitative restraints. Expanding these restraints could wreak worse havoc than did the Smoot-Hawley tariffs -- since quotas effectively eliminate further trade, while taxes on imports may merely raise their prices.

The fact is, the defenders of "free trade" are now on the defensive because they do not demand its essential precondition: fixed exchange rates based on a fair and stable value for the dollar. The Administration has proposed no coherent, comprehensive financial reform to remove permanently the true monetary cause of protectionism -- the ever worsening exchange rate disorders.

This omission is curious, particularly since President Reagan has initiated bold reforms in our nation's tax, regulatory, and spending policies. The Reagan recovery has helped the country move forward from the economic failures of the past 15 years, confounding the President's critics. Nevertheless, in absolute terms, American economic performance has remained anemic. Civilian unemployment stands at 7%, once (and still) a symbol of failure. GNP growth has slowed to 2% over the past 12 months. The Federal budget deficit remains at unacceptable levels. Despite congratulations about the defeat of inflation, the inflation rate hovers at the same 4% level that caused Richard Nixon, a Republican President, to impose the first peacetime wage-and-price controls in American history. And now the movement toward protectionism threatens what remnants still exist of the liberal international economic order. Progress has stalled for Reagan Administration policy because the fourth and indispensable element of the economic program is missing: monetary reform -- the only species of reform that can permanently end the threat of a trade war and significantly help our textile, auto, steel, and farm producers.

This is true because mercantilism in its most advanced form -- albeit a form that conventional economists of all persuasions have ignored during the past 15 years -- is nothing less than trade war practiced in an environment of unrestrained monetary policies of all nations. This monetary struggle takes the form of competitive depreciation of currency values similar to that which led us from the depression of the 'Thirties into the nightmare of World War II. Managed floating exchange rates have become hidden proxies for explicit tariffs, quotas, and export subsidies -- and, ironically, they provoke these same measures in response. The high rates of unemployment and perverse trade effects associated with floating exchange rates require an efficient and lasting international monetary reform, not economic autarky that would wipe out the gains of decades of global economic integration. What seemed unthinkable after Bretton Woods, "beggar-thy-neighbor" trade policies, has nearly come to pass.

Faced with this threat, on Sunday, September 22, 1985, the President and his senior financial advisers, in concert with our major allies, "The Group of Five," took a cautious first step to stem the protectionist tide: a realignment of the value of the dollar. The agreement shows a dawning awareness of the true problem. The Group of Five has clearly recognized the political choice between protectionism and monetary reform. What is not clear, however, is whether the President and the Group of Five realize that exchange-rate intervention is merely a tactical maneuver of no lasting value unless it is immediately followed by a plan to move forward to a period of general currency stabilization and thence to fixed exchange rates based on convertibility of the key currencies into gold. As an isolated maneuver, sustained dollar devaluation can yield only higher inflation or a destructive form of U.S. monetary protectionism without lasting benefit to our trading partners or to us.

## THE TRUE CAUSE: MONETARY DISORDER

### Floating Exchange Rates

Consider the financial history of the past 15 years.

From 1971, when President Nixon formally suspended the international convertibility of the dollar, until 1974, America endured four phases of wage-and-price controls. Then came the "energy crisis"; an "era of limits" resource crisis; a sustained double-digit inflation rate, unprecedented in the entire peacetime history of the Republic; back-to-back recessions in 1980 and 1981-1982 that set records for suddenness and severity; Treasury interest rates topping 15 percent -- twice the level that prevailed during the Civil War, when the Union had collapsed; economic disarray in the farm belt and in the heavy industry sector; a domestic banking crisis that has accelerated since 1982, with failure rates of all banks now running higher than in any year since the depression; a budgetary crisis pushing Federal deficits to record levels in a conservative administration; and currency fluctuations that, overnight, create jobs or abolish them, bring new prosperity to farms and businesses built up over generations or devastate them, defying even seasoned money managers, who successively warn that the dollar "must come down," "may never come down," and, most recently, "may come crashing down."

These economic and monetary disorders are not random events. The price mutations of the 'Seventies stemmed from a single source: total collapse of international monetary stability in the Free World. The great inflation of the 'Seventies was a product of domestic and international monetary policy -- unbridled central-bank credit expansion in an era of floating exchange rates and declining gains in output. During such a period, the predictable effect must be a dramatic shift to excess monetary demand for all commodities and a concomitant explosion in their prices.

The persistence of both high inflation and high unemployment related directly to the fiscal and monetary disorders of the post-Bretton Woods period. Before the 'Seventies, such "stagflation" was inconceivable to neo-Keynesian advocates of the Phillips Curve -- just as, in 1980, the conventional wisdom pronounced the impossibility of bringing unemployment and inflation down in tandem within a short period -- the Reagan achievement of 1981-1985. But the stagflation of the 'Seventies was first predicted by the great French classical economist, Jacques Rueff. He saw that the loose-money policies of the Federal Reserve would create excess demand at full employment conditions; and that without fixed exchange rates based on a true international gold standard, this excess demand would destroy the Bretton Woods reserve-currency system and lead to higher gold prices, rising prices in general, world monetary disorder, and declining world trade. But few saw that this worldwide inflation of the 'Seventies, for the first time in history, would come at a time when most nations had in place progressive-tax systems featuring extraordinarily high marginal

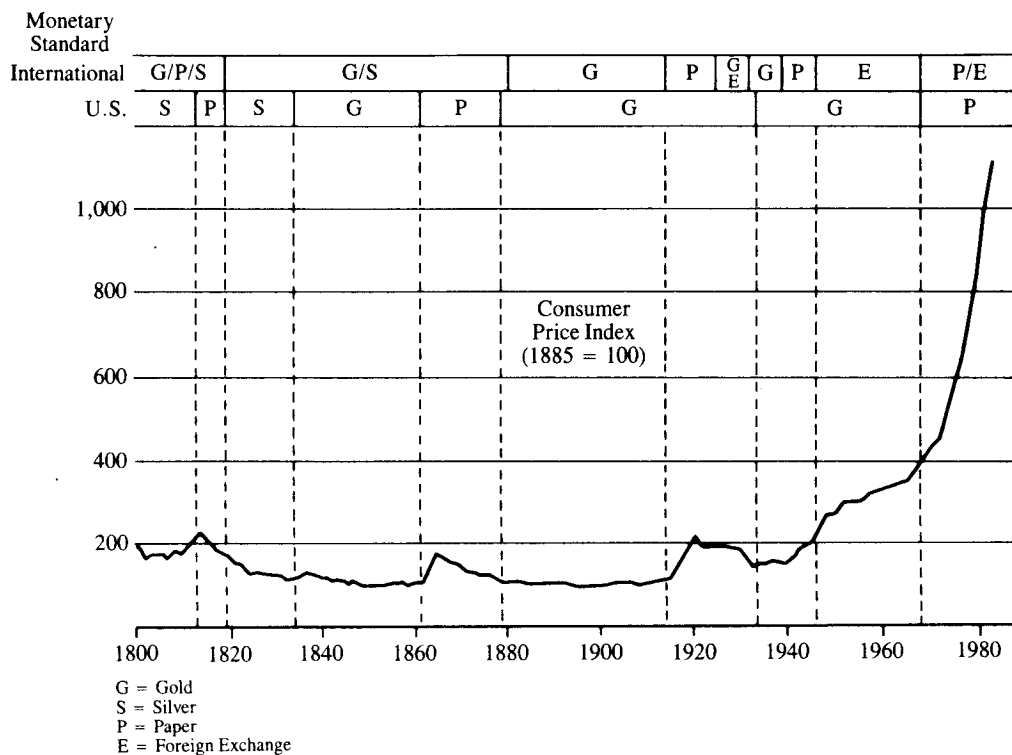


tax rates. All over the world, inflation would push even average earners into ever-higher marginal tax rates on a constant real income base: a phenomenon known as bracket creep. The resulting tax disincentives to work, save, and invest would cause output to falter, while rapid monetary expansion caused the prices of a slow-growing supply of goods and services to rise ever more rapidly.

As one reviews the immediate past, it is worth remembering that, with only brief interruptions, some degree of convertibility of the dollar anchored the American monetary system from 1792 to 1971, and each interruption was characterized by the kind of economic turbulence we have witnessed since 1971. The current period is unique, however, since for the first time in centuries, none of the major countries has a real currency, i.e., one that is convertible into gold or silver (see Figure 1). This circumstance was first highlighted for all to see in the March 1968 closing of the London Gold Pool, following which private parties everywhere no longer could withdraw gold previously deposited with central banks. The formal switch to today's floating "system" occurred in 1973, when the last vestiges of international currency stability were swept away. The conscious decision of 1973 to abolish any system of stable exchange rates, ratified by the IMF in 1976, is the original source of the over- and under-valued currencies of today.

Figure 1

U.S. Consumer Prices  
Under Various Monetary Standards



At the most fundamental level, floating exchange rates signal an indifference to economic disintegration. A stable international monetary standard is both the means and the symbol of worldwide free exchange. The absence of such a common money, which alone can act as the effective global coordinating mechanism linking national currency areas, implies, of necessity, a gradual Balkanization of world economic markets, with a corresponding loss of the immense gains accruing from international trade. To grasp the essence of the current problem, one need only imagine what would happen if each of the 12 Federal Reserve districts were to manipulate the value of an indigenous paper currency against the currencies of the other districts. Who can deny that, under such conditions, the "commerce clause" of the Constitution would be meaningless and the U.S. "common market" would slowly disintegrate?

Under a system of floating exchange rates, we gradually revert to a system of barter. The true and necessary functions of money are progressively undermined, as currency becomes a vehicle of speculation rather than a fixed accounting standard, a reliable store of value, and a stable medium of exchange against goods and services. Trying to make economic decisions with a wildly fluctuating monetary standard resembles the effort to build a house with the aid of a measuring standard, say a yardstick whose length is 36 inches one day, 40 inches the next, and 32 inches the day after that. Similarly, the monetary standard is the measuring rod of economic value, the usefulness of which cannot be separated from its stability. Who would give a Board of Governors the power to augment or diminish the value (the length) of the yardstick from week to week? But that is precisely the arbitrary power we give the Board to change the value of the economic measuring standard called the dollar.

With all monetary standards disintegrating, with currencies rising and falling against one another and against goods and services the world over, we have what amounts to a monetary state of war. It is the world of the political philosopher Thomas Hobbes -- a war of all against all. Creditors, debtors, unions, industries, and investors all lobby for the changes in the value of money that will be most suitable to them. Debtors want a cheap dollar so that the monies they repay will not be so dear as they are today. Some creditors, by contrast, want tight money, even deflation, hoping for a windfall. And there are those who look to gain a mercantilist advantage from manipulating the exchange rate.

As in any war, the innocent, the weak, and the least sophisticated are the most seriously hurt. Thus, a stable world of producers and consumers has been turned into a global casino of part-time gamblers. Farmers, squeezed today by high interest rates and falling prices, were encouraged by the Government to borrow money in the 'Seventies to acquire land to produce for export. They learned in the 'Seventies that land was a hedge against Government-created inflation. Today, the farmer, trapped by a major change in Government policy, has per-

force become a commodity futures speculator, with the difference that his savings, home, and way of life are now at risk.

The same monetary anarchy has caused businesses and banks to employ a battalion of consultants simply to track Federal Reserve Board moves, exchange rate fluctuations, and the costs of buying protection against both in the form of currency futures contracts. These experts speculate over what used to be taken for granted by producers and consumers: a stable dollar defined as a fixed weight of gold. The average worker knows intuitively that a dollar backed by something requiring real labor to produce, e.g., gold, roughly translates into other things requiring real labor to produce -- a certain amount of bread, butter, automobiles and houses -- today and in the future. The same worker cannot employ an economist, an investment banker, and a foreign-exchange adviser to insulate him from dramatic changes in currency values and thus preserve the value of his savings for the education of a child, the acquisition of a home, or for a comfortable retirement. Only the elite can afford to hedge against major currency fluctuations. A stable monetary standard, alone, provides the hedge for working people.

It seems difficult to believe today, but floating exchange rates were actively desired by a majority of a whole generation of economists, both monetarist and Keynesian. In the late 'Sixties, both schools believed that stable exchange rates stood in the way of their economic policy objectives: for the Keynesians, full employment through budget deficits and Federal Reserve credit expansion; for the monetarists, price stability through targeting the domestic money supply. The irony, of course, is that the U.S. achieved neither full employment nor price stability under floating exchange rates. Instead, we suffered "stagflation."

The Keynesians of the 'Sixties blamed fixed exchange rates for -- guess what? -- an overvalued dollar. John Maynard Keynes had built his economic theory on the assumption that prices and wages are rigid. He proposed "demand management" -- central bank manipulation of deficit spending -- to stimulate employment, essentially by reducing real wages through inflation. Keynes's theory (like Milton Friedman's) assumed a closed economy. But Keynes's followers, grafting onto his model net exports as another source of demand, argued by analogy that devaluation of the exchange rate could stimulate employment -- once again, by reducing real wages to gain a competitive advantage abroad and to increase profit margins at home. For the Keynesians, international currency stability, no less than domestic currency stability, was viewed as an obstacle to exploitation of the neo-Keynesian doctrine of the Phillips Curve -- the theory that, even in the long run, unemployment varies inversely with the rate of inflation.

The real world falls somewhere between the assumption of Keynesian wage rigidity and the pure neoclassical model of a frictionless economy. There are delays in adjustment to new market conditions, because, for example, the capital represented by a steel mill cannot be trans-

formed instantly into an office building, nor can steelworkers turn into computer programmers from one day to the next. People are reluctant to move from their neighborhood, let alone their country, when opportunity declines at home and beckons from abroad. These, at bottom, are the reasons monetary policy and exchange rates can affect the real economy in the short and medium term. In the long run, though, the domestic market does respond to world market prices. Factors of production will be allocated by the price mechanism more or less efficiently in a world where international trade has not been abolished.

The monetarists -- more "classical" in their views of wage-and-price flexibility -- pointed out the inflationary bias in Keynesian domestic economic policy. But, curiously enough, they were prepared to accept the Keynesian argument for purposes of international exchange. The monetarists argued that floating rates would constitute a "free-market" alternative to the protectionist tariffs and exchange controls that characterized the decade after World War II. This sincere monetarist hope has not materialized, since floating rates have only intensified the demand for protectionism in the 'Seventies and 'Eighties.

The goal of a "free float" of national currencies was not the central monetarist objective, however; it was a by-product. In the monetarist view, stable exchange rates stood in the way of their prescription for targeting the domestic "money supply" on the theory that such a policy could stabilize both the domestic price level and output fluctuations. For, as the monetarists recognized, it is impossible to target both the price of a currency (the exchange rate) and its quantity (the "money supply") at the same time. (I place the words "money supply" in quotation marks because in practice the monetarists do not observe the distinction between money and bank credits. Thus, ineffective as they have proved to be for the Fed, monetarist quantitative targets on a heterogeneous "money supply" are tantamount to quantitative restrictions on credit -- analogous in principle to auto-import quotas, which undermine market pricing by trying to fix the quantity sold.) The wisdom of monetarist policy depends almost entirely on the assumption that the demand to hold cash balances is stable, an assumption for which the monetarists had gathered compelling empirical evidence -- except that the historical and statistical evidence was drawn from periods of fixed exchange rates based on gold convertibility. But we now know that, under the present system, the demand for money is manifestly not stable, nor has it ever been stable in the past under floating exchange rates and inconvertible paper money systems. Only under a monetary system of currency convertibility was there, and is there, a stable demand for cash balances -- because only convertibility produces stable expectations by insuring a stable future value for the currency. Hence, in the present real world, a monetarist policy, lacking the mechanism of convertibility upon which its theory is based, has been and will be destabilizing.

The conventional Keynesian and monetarist models of the past generation have done so poorly in their predictions as to lead many to dis-

parage the study of economics in general. Melville Ulmer observed recently in Commentary that these models have failed to predict virtually "every single turning point" in the United States and world economy since 1971. For example, the distinguished Nobel Prize winner, Milton Friedman, publicly predicted an inflation rate of 12% for 1984 -- and perhaps wage-and-price controls for 1985 -- because of previous rapid M1 growth. The prediction was confounded by a large shift in the demand to hold dollars, related in part to the rise of the dollar on the foreign exchanges.

There is another well-known explanation for today's financial turmoil: the "twin-deficit theory," which argues that the U.S. trade deficit is caused by the Federal budget deficit and that the budget deficit has nothing to do with floating exchange rates. The theory argues that a budget deficit, if not monetized by the Federal Reserve, all other conditions being equal, will cause interest rates to rise. Rising interest rates attract foreign capital, which -- again assuming tight money at the Federal Reserve -- bids up the dollar, making U.S. goods internationally uncompetitive. Hence, it is argued, if nations simply follow sound fiscal and monetary policies, a system of fixed rates based on gold convertibility is an unnecessary harness; and, on the other hand, if nations do not follow such policies, the system of convertibility is useless anyway.

The irony is that the elements of this argument, now received as conventional wisdom, were first elaborated by the architect of the astonishing French economic recovery of the 'Sixties, Professor Jacques Rueff, and in this country by the international monetary economist, Robert A. Mundel, to explain why, in the real world, fixed exchange rates are, as a practical matter, a more stable basis for international exchange than floating rates. They argued that convertible currencies, or fixed rates, were the necessary institutional disciplines, the effective monetary mechanisms needed to bring about the desired domestic fiscal and monetary policies -- and global financial balance as well.

A theoretical difficulty shared by both monetarists and Keynesians in the 'Sixties was the implicit assumption that goods and money cross international borders -- but that financial capital does not move so readily. Yet, because of the postwar success of the Bretton Woods accord, international lending and investment occurs quite freely. Financial capital moves effortlessly across borders. Thus, if today's markets for goods are more sluggish, this means, roughly speaking, that liquid financial markets will have a more immediate effect upon exchange rates. Under a floating system, exchange rates will then tend to drive trade -- not vice versa. Macroeconomic policies will not work as either Keynesian or monetarist theory predicts, because these financial policies designed to stabilize the markets for goods and services (full employment or stable prices) will tend to act first upon exchange rates. The exchange rate will "overshoot" in real terms, causing new disruptions in the market for goods -- as we have recently observed. Thus, the same macroeconomic monetary and budget-

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ary policies can have different effects, depending upon whether exchange rates are fixed or floating.

As an empirical matter, the twin-deficit theorists must deal with the fact that other major nations have had budget deficits as large or larger relative to GNP than that of the United States -- yet they have not been "sucking in" foreign capital. For example, Canada, Italy, Japan, Belgium, Sweden, The Netherlands, and Spain are among the major nations that have experienced budget deficits as large as or larger than that of the United States over the past few years. At the very least, this fact should force the twin-deficit theorists to search for additional causal factors driving up the dollar: higher aftertax rates of return following the Reagan tax cuts, safe-haven motives, the stage of the business cycle, the level of outstanding debt, incentives for personal saving, different degrees of market flexibility, and, above all, the unique and official reserve-currency status of the dollar. It goes without saying that such qualifications reduce the plausibility of the twin-deficit theory as a sufficient explanation.

Yet there is a very real sense in which the twin deficits are at the heart of the world's fundamental economic problem. As a practical matter, however, the causation is substantially the reverse of the "twin-deficit" theorists. The twin deficits -- in the federal budget and U.S. trade -- are ultimately the symptoms rather than the causes of monetary disorder, both in the United States and in the international economy. And this argument takes us beyond the problem of floating exchange rates and their consequences to the fundamental structure of the world financial system.

### The Reserve Currency System

The problems we face are not new. Two-and-a-half millennia ago, in The Republic, Plato discussed the foundations of political society in classical civilization. The first requirement he established was "some means" to facilitate "the free exchange" of the market. The essential means is an honest money. To many, it is but a quaint fact of history that an honest weight of commodity money is also upheld as the only just standard of exchange in Leviticus, an essential part of the first rule-book of Western Civilization -- the Bible.

But, for purely practical people, the resounding truth of honest and stable money echoes through all the pages of modern history. Britain maintained free trade and economic primacy for more than a century, as the leading nations of the West submitted to the liberating discipline of convertible national currencies and the common underlying currency of the international gold standard. In France, Napoleon ended the inflation of the revolution with a franc convertible into gold, ushering in a period of economic prosperity. The United States began its surge to world power due in part to the economic genius of two of our first Secretaries of the Treasury, Federalist Alexander Hamilton and Jeffersonian Democrat Albert Gallatin, who based their hopes for free

national markets and growing world trade on the fixed monetary standard of the Constitution, the silver dollar and the gold dollar (later embodied in the Coinage Act of 1792).

A century-and-a-half later, our fathers and grandfathers faced up to the insidious effects of floating exchange rates during the 'Thirties. Subsequently, during and after World War II, they tried systematically to solve the problems with which we are faced again today. To this end, they inaugurated in 1944 the Bretton Woods system. This relatively successful effort to stabilize exchange rates grew out of first-hand experience in the 'Thirties. Our fathers had learned the hard way that stable currency values were the necessary bases for international free trade. They knew that free trade without stable exchange rates is a fantasy. They had concluded, from trade and exchange-rate wars, that to dismantle protectionist devices, they had to remove the fundamental cause: managed floating exchange rates. This they did. Only after they had completed the Bretton Woods exchange-rate accord in 1944 did they agree upon international trade liberalization, the General Agreements on Tariff and Trade (GATT) in 1948. Then came trade and exchange liberalization, rapid world-trade growth, and the successful Kennedy Trade Round of the 'Sixties.

Whatever its defects, Bretton Woods was an immense practical improvement over the managed floating rates and trade wars of the 'Thirties. Through the Bretton Woods monetary system, leaders of the Free World tried to rule out the worst forms of exchange-rate manipulation and the associated effects of overvalued and undervalued currencies. The Bretton Woods statesmen tried to encourage international business competition based on comparative advantage, innovation, and better management, rather than on currency manipulation.

The result: growth and productivity in the developing world soared in the 'Fifties and 'Sixties, while, in the industrial countries, unprecedented economic development held sway for a generation. The relatively stable period of low interest rates, reasonably stable price levels, expanding world trade, and rapid economic growth experienced after general convertibility was restored in 1958 compares very favorably with the disordered and anemic period of 1971-1985, an era of price-and-wage controls, exchange-rate instability, inflation, slow growth, and creeping protectionism.

It must be recognized by its defenders that there were defects in the Bretton Woods agreement. And in any new fixed-rate monetary system, these defects can and must be remedied. Just as floating-rate theorists turned the monetary chaos of the 'Thirties into a nationalist "system" of economic isolationism, the Bretton Woods agreements endorsed what had previously been considered a makeshift expedient: the gold-exchange standard, or gold-based reserve-currency system.

Under the classical gold standard, central bank reserves consisted largely of gold. That is to say, gold was the common coin among different national currencies that were directly convertible to gold at

fixed rates. The monetary base in each country was backed by both gold and liquid financial assets denominated in the domestic currency, e.g., secured commercial paper. In this case, the term "fixed exchange rates" was merely another way of saying that all national currencies linked to the gold standard at fixed parities shared indirectly a common monetary standard -- rather like the fact that the bank deposits for the 12 regional Federal Reserve Banks are linked by a common currency, the dollar.

Under the gold-exchange standard, or reserve-currency system, central bank reserves came to consist not only of gold but also of the short-term debts issued by dominant foreign nations like the United States or Great Britain. That is, the monetary base in the other countries was not only backed by gold and domestic financial assets but also by dollar or sterling financial assets. In effect, when the dollar is the reserve currency, other central banks stand in somewhat the same relation to the Federal Reserve as do American commercial banks.

The reserve-currency system was first devised in 1898 as an imperial expedient in colonial India and subsequently was copied in other colonial possessions, like the American Philippines. But general use of a national currency as an official reserve currency came into vogue among industrial countries after the First World War when a conference in Genoa in 1922 agreed on the practice as a temporary method of dealing with a so-called gold shortage. The "shortage" was caused by the fact that credit-inflated prices were 50% higher than before World War I, while the convertibility price of gold in the two major currencies -- the pound sterling and the dollar -- was eventually reinstated at prewar parity. Without a rise in the value of monetary gold to its proportional place in the hierarchy of prices (a step that was urged at the time by the economist Charles Rist, among others), the inevitable result would be an overvalued dollar and pound, and deflation of wages and prices to prewar levels, something one could expect during the first major financial crisis. And, indeed, this occurred in the United States between 1929 and 1934. The gold-exchange standard was liquidated, first by world deflation, then by Great Britain's default and devaluation of sterling in 1931, as well as by the rising economic nationalism of the 'Thirties, which effectively closed financial markets. Meanwhile, the world economy literally disintegrated in a free-for-all of beggar-thy-neighbor policies of managed floating-exchange rates, combined with all forms of capital controls and protectionism. Such systematic and global protectionism almost always leads to a depression. Finally, in a desperate but deliberate move, President Roosevelt devalued the dollar in 1933-1934 ("raised the price of gold"), which, together with the previous deflation, reliquified the financial system, brought down interest rates, stimulated gold production and investment, discouraged hoarding, and led to a gradual upward drift in prices, profit margins, and output.

The architects of Bretton Woods -- apparently believing that the Depression had been partly caused by the rigidity of the gold standard rather than by the collapse of the sustained credit expansion based on



the post-Genoa reserve-currency system -- crowned the postwar dollar as the Free World's official reserve currency. Under the Bretton Woods rules, other currencies were convertible into dollars, but only dollars were officially convertible into gold. The American banking system, under the Federal Reserve, became in effect the world's central bank. The credit of other nations was leveraged upon U.S. credit, which, in turn, was leveraged upon U.S. gold reserves. Our banking system and money markets accepted dollar deposits from foreign central banks and re-lent them to private or public borrowers. Once again, the relationship of foreign central banks to the Fed was similar to that of American commercial banks. (The year -- 1922 -- of the Genoa Conference, which conferred de facto reserve-currency status upon the dollar, also happens to be the year the Federal Reserve "discovered" open-market operations -- the direct purchase of securities in the money market. The Fed previously had relied upon a market-related discount rate policy, which responds more to the demand for credit in the market, believing that open-market operations could only change the composition, not the volume, of its portfolio. As we shall see, expansionist Fed open-market operations depend largely on the dollar's reserve-currency status.)

The reserve-currency system made a certain sense during the 'Fifties, when the United States was all-powerful and the other industrial nations virtually prostrate. But once reconstruction was substantially advanced and the European currencies became externally convertible into one another in 1958-1959, the Bretton Woods system lasted only nine years. The much-discussed "dollar shortage" of the 'Fifties turned suddenly into the dollar glut of the 'Sixties, and Fed credit expansion and the reserve-currency status of the dollar led the U.S. into a permanent balance-of-payments deficit. Thus, the other industrial nations began increasingly to demand gold for their excess dollars. During the 'Sixties, the rest of the world built its reserves only as the United States lost gold and increased its short-term dollar indebtedness. New gold production was inhibited by the fact that, while the price and cost level had roughly doubled since the 'Thirties -- a general rise financed by dollar credit -- the price of gold had remained fixed at its 1934 level. Meanwhile, speculative hoarding was encouraged by expectations, fanned by the Keynesian credit expansion of the 'Sixties, that the dollar would have to be devalued against gold sooner or later.

One clearly sees that the dollar's official reserve-currency status conferred an obvious benefit upon the United States. Charles de Gaulle called it an "exorbitant privilege." Jacques Rueff spoke of "deficits without tears." Fed credit expansion and American balance-of-payments deficits were automatically financed under the reserve-currency system by the voluntary or coerced buildup of undesired dollar balances abroad; and these official foreign dollar reserves were immediately invested directly or indirectly in the market for U.S. securities, thus giving back to the U.S. the purchasing power lost abroad as a result of the persistent U.S. balance-of-payments deficit. This process may be likened to a household or a business running up

huge, accumulating accounts payable that can never be paid from current income or liquid savings -- leading to bankruptcy.

As in the case of Great Britain in the 'Twenties, however, the reserve-currency role also placed increasing burdens on the United States economy, because the dollar gradually became overvalued, leading to calls for protection. American industry's international competitiveness was sapped by the same process that perpetuated the U.S. balance-of-payments deficit and caused the real, or price-adjusted, dollar exchange rate to appreciate.

Under fixed exchange rates based on a true international gold standard, even during periods of very rapid growth, global financial balance is maintained by virtue of the fact that, as one country loses reserves, another country gains them. When, in one country, a rising price level or a too-easy domestic money market leads to a private capital outflow or an excess of domestic purchasing power directed to imports, the balance of payments deficit to be settled abroad must lead to increased exports or to an export (loss) of gold reserves, both signaling and initiating a rise in interest rates and a fall in the price level ("a tightening"). The rise in interest rates halts the outflow of capital: and the net export of domestic purchasing power (i.e., the balance-of payments deficit) also releases unpurchased domestic goods for export to settle the deficit -- just as the decline in domestic prices tends to check imports. Thus, through improvement of either the trade or the capital account or by the transfer of gold reserves, or all three, equilibrium is re-established in the overall balance of payments.

There is not sufficient space to dwell on all the details of the superior efficiency of the balance-of-payments adjustment mechanism under fixed exchange rates based on domestic and international convertibility to gold. But it can be shown that, in all cases, this monetary mechanism works best both in theory and in practice to maintain global trade and financial balance. Consider only one additional aspect: the indissoluble global links, under multilateral convertibility, of price and interest rate movements, spot and forward transactions, and the global flow of goods, services, capital, and monetary reserves -- all of which tend toward a dynamic general equilibrium.

At the beginning of a given period, if the level of cash balances equals the desired cash balances, any new demand for money or credit will tend to raise the rate of interest in the market. But then a profitable arbitrage opportunity against goods will open up. Since the rate of interest has risen, the value of securities will have fallen compared to the price of goods. Arbitrageurs will have an incentive to sell goods for cash, thus tending to lower goods prices, and to buy, say, 90-day securities with the proceeds, thus tending to raise securities prices and reduce rates. But desired portfolio balance among money, goods, and securities will tend to prevail because the sale by portfolio holders of spot goods for cash, to purchase 90-day securities, will be joined by an immediate arbitrage purchase

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of the same goods in the 90-day forward market; and the required cash settlement for this future purchase will be made with the proceeds received from the newly owned 90-day securities when they mature. This delicate spot and forward market mechanism of arbitrage unites global markets and tends to stabilize, over the long run, the supply and demand and the prices for all marketable goods, services, and securities under a regime of convertibility.

Thus the general price level tends to be maintained as it oscillates around unity. Under the previous example, if the demand for money (or credit) and the rate of interest continues to rise, the price level itself, because of the profitable arbitrage described above, will be drawn down in the same movement. But under domestic and international convertibility, all rates and prices move, except the gold parities of the currencies. As interest rates rise and prices fall, exportable goods tend to be more competitive and get sold abroad, thus importing the desired cash balances; or securities become attractive and draw cash and credit from abroad. Or, because the gold price remains the only price that does not fall, gold importing and new gold production becomes more profitable, thus supplying at home and abroad the unsatisfied demand for money and credit, thus tending to reverse the interest-rate rise and price-level fall.

In all cases, the market mechanism of fixed exchange rates based on multilateral convertibility tends to ensure that domestic and international price level stability endures; that the supply of money and credit will expand to meet the demand for it to produce new goods and services in the global market; and that the stability of the international monetary standard will prevail and act as the spontaneous regulator of balance-of-payments equilibrium among all countries whose currencies are directly convertible at fixed rates into gold.

But when one country's currency -- the reserve currency -- is used to settle international payments, as with the dollar, the adjustment mechanism is jammed for that country -- and for the world. In the reserve-currency country, an inflationary outflow of capital or a growing expenditure on imports, when it accumulates in foreign central banks, is promptly redeposited in the reserve currency (dollar) market. Everything proceeds as if there were no deficit, and the process only reinforces easy money-market conditions. Moreover, the money is used in the reserve-currency country to purchase more imports, while it also tends to absorb domestic goods which would otherwise be available for export to reestablish equilibrium in the overall balance of payments. In the absence of deliberately tight Fed policy, the reserve-currency system thus accommodates excess demand in the U.S. for foreign goods or financial assets, leading to an overvalued currency and permitting real wage rates and production costs for tradable goods to rise higher than they would under a multilateral gold standard; and, of course, the trade balance of the reserve-currency country declines as a result, along with its international competitiveness.

Ultimately, this process is not sustainable, because when the expanding short-term dollar liabilities abroad are finally presented for redemption, the reserve-currency nation is faced with the choice between suddenly deflating the domestic economy to repay them, or else repudiating all or part of its debts, thereby destroying the whole system. Moreover, it was precisely these dynamics of the dollar's reserve-currency role, not fixed exchange rates, that contributed to a steadily rising real exchange rate for the dollar during the 'Sixties. This gave rise to pressures at home for protectionism (for example, in the steel industry) and for currency devaluation. These pressures ultimately destroyed the Bretton Woods system, leading to President Nixon's declaration of bankruptcy, the official suspension of gold convertibility in 1971.

It is essential to understand the nature of this process, because the dollar's reserve-currency role did not end with the breakdown of Bretton Woods. In fact, with gold immobilized, its role expanded. Advocates of floating exchange rates did not reckon with at least two important facts: the protectionist effects of managed floating rates and the continuity in demand for the dollar as a reserve currency. According to floating-rate theorists -- burdened by some misconceptions, as we have already seen -- appreciation or depreciation of national currencies are supposed to remove the need for international reserves. But, as long as there is international exchange among national currency areas, common markets with linked prices will tend to seek a common underlying money. Prevented after 1971 from using gold by the unilateral action of the United States, the world turned to the dollar, the currency of the world's largest trading area, for its official reserves. Indeed, most smaller countries still either peg or target their currencies to the dollar, or to the currencies or basket of currencies of other important trading partners. These economic facts of life ensured a continued and, sometimes expanded, role for the dollar -- and a perpetuation of the benefits and burdens of the dollar's status as an official reserve currency.

The net effect of the dollar's reserve role on the American and world economies under managed floating rates is similar to the situation under fixed exchange rates -- including the adverse effect on American trade. To oversimplify, the extra demand for the dollar as the world's official reserve currency tends to keep the real value of the dollar higher than it would otherwise be. The mechanism is complicated, but not fundamentally altered, by the added instability of floating exchange rates. Since 1968, the "twin deficits" of the United States have mushroomed. The exponential growth of the budget deficit is too familiar. But the degree to which the "external deficit," during a given market period, appears in the trade or the capital account of the balance of payments is more elusive and depends on the state of the American economy, on Federal Reserve policy, and on the response of foreign central banks.

Generally speaking, when real interest rates are low, either because Federal Reserve policy is easy or the U.S. economy is weak, a private

capital outflow results, lowering the dollar on the foreign exchanges. In 1970-1973 and again in 1976-1978, the central banks of industrial countries responded by purchasing these surplus dollars. Their reasons for doing so presumably were to curtail the adverse effects of a cheap dollar on their export industries -- this period was one of mushrooming European protectionism -- as well as to accumulate reserves, or to make up a reserve loss caused by dollar depreciation. But, in choosing to buy dollars against the issue of their domestic currencies, they in effect imported U.S. inflation. Expectations of inflation led to speculative dollar borrowing and increased spending by domestic and foreign debtors, the value of whose debts declined as the dollar depreciated. Two worldwide inflationary episodes (1972-1974 and 1978-1980) arose in the aftermath.

Conversely, whenever the Federal Reserve has tightened credit, foreign central banks also have tended to tighten. A rising dollar, in less developed debtor nations, means an increased real burden of debt and lower primary product prices with which to service the debt. To avoid a worsening of the balance of payments, their central banks, often with IMF pressure, are required to reinforce existing austerity by reducing the real money supply -- in order to cut imports and service the existing dollar debt out of declining export values. On the other hand, a rising dollar means a capital outflow for other industrial countries, a relative fall in the domestic costs of production of their exports, and a relative rise in the price of imports. Growing trade surpluses and central bank dollar reserves make bankers in the trade surplus countries of Europe or Japan reluctant to change policy. Thus, even if the world as a whole suffers deflation from the Federal Reserve's tightening, other central banks generally lack the ability or the incentive to offset it, because of the asymmetrical nature of the dollar-based system.

These patterns can be seen in balance-of-payments statistics (Table 1). The largest increases in foreign official dollar reserves occurred in 1970-1973 and 1976-1978 -- \$27-billion in 1971 alone, and \$89-billion in 1976-1978 -- periods that combined the beginning of recovery from recession, the onset of easy Fed credit, with a falling dollar. (In 1979, foreign central banks gave up supporting the dollar and sold \$14-billion net, and, in response to the accelerating decline of the dollar, Europe formed a regional monetary system, a development that helped precipitate Paul Volcker's October 1979 change in Federal Reserve policy.) The nominal growth of official dollar reserves has slowed in the intervening periods when the dollar or the American economy has been strong and when dollars have been repatriated by U.S. residents or acquired and held by private foreigners. There has been no significant change in the U.S. net reserve position since the Federal Reserve tightening of 1979, just as there was only a \$6-billion net change during the recession year 1975.

Theory and evidence show that the U.S. trade balance moves in an opposite direction to the capital account -- tending toward deficit as the dollar rises or as the economy grows and toward surplus when the dol-

Table 1  
U.S. International Transactions, 1970-1984  
(\$ Billions)

Year	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Current Account	2	-1	-6	7	2	18	4	-15	-15	-1	2	6	-8	-41	-102
Merchandise Trade Balance	3	-2	-6	1	-6	9	-9	-31	-34	-28	-25	-28	-36	-62	-108
Exports	42	43	49	71	98	107	115	121	142	184	224	237	211	201	220
Imports	-40	-46	-56	-70	-104	-98	-125	-152	-176	-212	-250	-265	-248	-263	-329
Investment Income (Net)	6	7	8	12	16	13	16	18	21	31	30	34	29	25	19
Other Services (incl. mil.)	-3	-3	-4	-2	-1	1	3	3	3	1	4	7	7	5	-1
Unilateral Transfers	-3	-4	-4	-4	-7	-5	-5	-5	-5	-6	-7	-7	-8	-9	-11
Capital Flows:															
U.S. Assets Abroad (- Increase)	-9	-12	-14	-23	-35	-40	-51	-35	-61	-64	-86	-111	-119	-55	-20
U.S. Official Reserves	2	2	0	0	-1	-1	-3	0	1	-1	-8	-5	-5	-1	-3
Other U.S. Govt. Assets	-2	-2	-2	-3	0	-3	-4	-4	-5	-4	-5	-5	-6	-5	-6
U.S. Private Assets	-10	-13	-13	-20	-34	-35	-44	-31	-57	-59	-73	-101	-108	-49	-12
Foreign Assets in U.S. (+ Increase)	6	23	21	18	34	16	37	51	64	39	58	83	94	84	97
Foreign Official Assets	7	27	10	6	11	7	18	37	34	-14	15	5	4	6	3
Other Foreign Assets	-1	-4	11	12	24	9	19	15	30	52	43	78	91	79	94
Statistical Discrepancy	0	-10	-2	-3	-1	6	11	-2	13	25	25	20	33	12	25
SDR Allocations	1	1	1	0	0	0	0	0	0	1	1	1	0	0	0

Source: Department of Commerce, Survey of Current Business

lar falls or the economy weakens. However, the secular deterioration in the trade balance can be seen in the fact that, in contrast to the American economy of the 'Sixties, the United States, since the advent of floating rates, has achieved a merchandise trade surplus only during the 1975 recession, during which imports fell drastically. It is interesting that, despite a substantial depreciation of the dollar after 1976, most of the improvement in the current-account balance can be attributed to net income from previous investments (made during the inflationary capital outflow) and not to the merchandise trade balance. The dollar's reserve-currency role increases the trade deficit compared with the overall current account balance. This is not to argue that, under a properly functioning international monetary system, a trade surplus is good and a trade deficit bad; that argument is an all-time fallacy. The point is that the increased foreign official dollar reserves -- redeposited, say in New York -- permit the United States, temporarily at least, either to increase current consumption in excess of income, for example by financing the budget deficit, or to acquire foreign assets. In addition, the dollar's reserve-currency status alters, and at times jams, the natural adjustment mechanism tending to ensure equilibrium in the balance of payments -- under both fixed and floating exchange rates.

Over time we also observe a "ratchet effect" in the magnitudes of both the U.S. budget deficit and the U.S. current account deficit. The deterioration in the current-account balance parallels the growth of the combined Federal, state, and local budget deficit during periods of recovery, compared with earlier norms. The relationship is not surprising, for two reasons. First, the current account is a measure of domestic spending relative to income: a current account surplus represents domestic saving invested abroad, while a current account deficit represents domestic spending in excess of current income, financed by a capital inflow. Obviously, insofar as the Government deficit affects total national saving, it can affect the current account. Second, the increase in the twin deficits can be traced to the increased ease of financing a budget deficit by importing capital from abroad when official foreign dollar reserves must be invested primarily in U.S. Treasury securities. In principle, increased foreign official dollar balances, invested in U.S. securities, can be used, temporarily at least, either to finance U.S. current consumption in excess of income (e.g., the budget deficit); or else to acquire foreign assets. For 1970 to 1982, in fact, the recorded U.S. net investment position (net claims on foreigners) increased from \$58-billion to \$147-billion (see Table 2). Since there was actually a \$5-billion cumulative current-account deficit during this period, these claims -- largely private bank loans -- must have been financed out of the \$150-billion or so increase in foreign official dollar balances. From 1982 to 1984, however, some \$120-billion of these assets were liquidated to finance the current-account deficit. The liquidation continued through 1985. The net effect over the period was to use the increased official dollar balances to finance the current-account deficit, which, as we have seen, is also indirectly linked to the financing of the Federal budget deficit.

Table 2  
International Investment Position of the U.S. at Year-End, 1970-1984  
(\$ Billions)

Year	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
U.S. Net Investment Position	58	46	37	48	59	74	84	73	76	94	106	141	147	106	28
U.S. Assets Abroad	165	179	199	222	256	295	347	379	448	511	607	720	839	894	915
U.S. Official Reserve Assets	14	12	13	14	16	16	19	19	19	19	27	30	34	34	35
Other U.S. Govt. Assets	32	34	36	39	38	42	46	50	54	58	64	68	74	79	85
U.S. Private Assets	119	133	149	169	202	237	282	310	375	433	517	621	731	781	795
Commercial Banks	14	17	21	27	46	60	81	93	131	157	204	294	405	435	443
Other	105	116	129	143	155	177	201	218	244	276	313	328	326	346	352
Foreign Assets in the U.S.	107	133	162	175	197	221	264	306	375	416	501	579	692	788	886
Foreign Official Assets	26	52	63	69	80	87	104	141	173	160	176	180	189	195	199
Other Foreign Assets	81	81	99	105	117	134	159	165	199	256	325	399	503	593	687
Commercial Banks	23	16	21	26	42	42	53	60	78	110	121	165	231	281	312
Other	58	65	77	79	75	91	106	105	121	146	204	233	272	312	375

Source: Department of Commerce, Survey of Current Business



However, this analysis suggests that the "twin deficits" are more a result than a cause of the current monetary disorder. There is today no efficient monetary mechanism to forestall the secular growth of the deficits. In the absence of certain institutional arrangements in our domestic banking system (which I describe below) and without the official reserve role of the dollar, twin budget and trade deficits of this magnitude could not exist. We seem to be dealing with what insurance companies call "moral hazard." Indeed, the late Wilson E. Schmidt once wrote a paper called "The Moral Hazard of IMF Lending," in which he argued that the offer of large loans for troubled borrowers tends to increase the number of troubled borrowers. The same principle is involved in the argument, popularized by Charles Murray, that the greater the number of social and economic payments given for not working, the greater will be the number of Government dependents -- welfare recipients getting Government benefits.

The reality behind the "twin deficits" is simply this: the greater and more permanent the facilities for financing the budget and trade deficits, as is the case under an official reserve-currency system, the greater will be the deficits. This principle helps to explain the total collapse of the congressional budget process, and the increasingly wild, coercive, and ineffectual attempts to correct it. Such administrative and statutory attempts to end the deficits will be futile until the crucial underlying flaw -- namely the absence of the efficient market mechanism of currency convertibility -- is remedied by some farsighted political leader.

Politicians are not more irresponsible today than they have been in the past; the difference is that effective monetary constraints on their behavior have been removed. Both the internal budget deficit and the external current-account deficit can be financed in the U.S. by virtue of the unique reserve-currency status of the dollar. To finance each deficit, the U.S. Treasury issues new debt which -- because of its domestic and international monetary status -- is absorbed abroad as well as at home. An effective monetary reform is necessary, not only to restore institutional financial disciplines; but also to provide the economic preconditions necessary to balance the budget through spending restraint, and to bring about low interest rates and strong, noninflationary economic growth.

It is sometimes argued that the dollar standard, or gold-dollar standard, is a valuable source of unearned income, or "seigniorage," for the United States -- analogous to the coin-clipping of medieval potentates -- a privilege the United States should not surrender. This argument is tantamount to saying that it's more efficient to risk a jump from a 10-story building than to take the stairs, because the first nine floors can be skipped. But everyone knows that, at street level, the "adjustment process" ultimately will take place, with unhappy consequences that might have been avoided.

As the world's banker, the United States -- like any banker -- can reap no "seigniorage" in the long run unless it defaults. And if the

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United States does not honor its debts, the reserve-currency system collapses -- as the sterling reserve-currency system did in the 'Thirties and the dollar system almost did in the 'Seventies. Like any banker, the United States can earn interest by re-lending money placed on deposit; though as we see in the current debt crisis, this process is at the very least subject to the banker's risk of a borrower's default. More fundamentally, the dollar's reserve-currency benefit must be offset against the costs of adjustment borne by America's trading industries and workers; first, a steady decline of manufacturing and export industries as capital inflows predominate; and then the gearing-up again of these same industries when our creditors finally seek repayment in real goods, as sooner or later they must. It is instructive to hold up the example of the United Kingdom, the reserve-currency country of the first half of the twentieth century, its industry now in shambles, its people the poor cousins of Europe, whose standard of living is lower than that of Italy. This is hardly an enticing example of the long-run benefits of a half-century of "seigniorage" derived from the pound sterling's former reserve-currency status. Seigniorage, or unearned income, leads to the same unhappy outcome as does welfare dependency.

The U.S. financial system will continue to enjoy a competitive edge, drawing as it does on the largest financial market in the world. But this is a dynamic that does not require the burden or the privilege of the dollar as an official reserve-currency system -- whatever may have been the usefulness of that system in the postwar years -- when Japan, Germany, France, and England were in ruins.

We need not accept second-best solutions now -- especially if, as I am convinced, we have a great opportunity, perhaps once in our lifetimes, to fundamentally reform the international monetary system.

#### A Domestic Equivalent of the Reserve Currency System

As a parallel to the economic and moral arguments about the ultimate consequences of the reserve-currency system, consider the results of an analogous and dramatic shift in the relation of the Federal Reserve and the U.S. banking system to the U.S. Treasury. As originally envisioned in 1913, the credit and currency of the Federal Reserve System was to be based essentially upon the most liquid monetary asset, gold, and on self-liquidating commercial bills -- short-term notes issued to finance goods in the process of production. An issue of Federal Reserve Notes required both a 40% gold reserve and 100% collateral of secured, self-liquidating commercial paper. The use of secured commercial paper was then in its infancy in the U.S. market and thus did not turn out to be workable. Consequently, Federal Reserve Notes made up only a small part of our currency before 1932.

During the 1932 banking crisis, Section 412 of the Federal Reserve Act was amended to allow U.S. Government debt to serve for the first time as collateral for the issue of Federal Reserve Notes. Shortly thereafter, President Roosevelt confiscated privately held gold and deval-

ued the dollar. Federal Reserve Notes ceased to be redeemable in gold on January 30, 1934. Since then, American legal-tender currency came to consist almost exclusively of Federal Reserve Notes, plus coinage.

Since 1932, the Comptroller of Currency has issued new Federal Reserve Notes to the regional reserve banks at their request, provided the Federal Reserve Board guarantees that an equivalent amount of collateral has been posted with the Federal Reserve Agent, i.e., segregated from the general portfolio of the regional reserve bank. (The Monetary Control Act of 1980 removed the collateral requirement for notes not yet in circulation.) Such collateral is now almost exclusively U.S. Government debt securities. The Board of Governors has the power to deny a request for notes but has never done so.

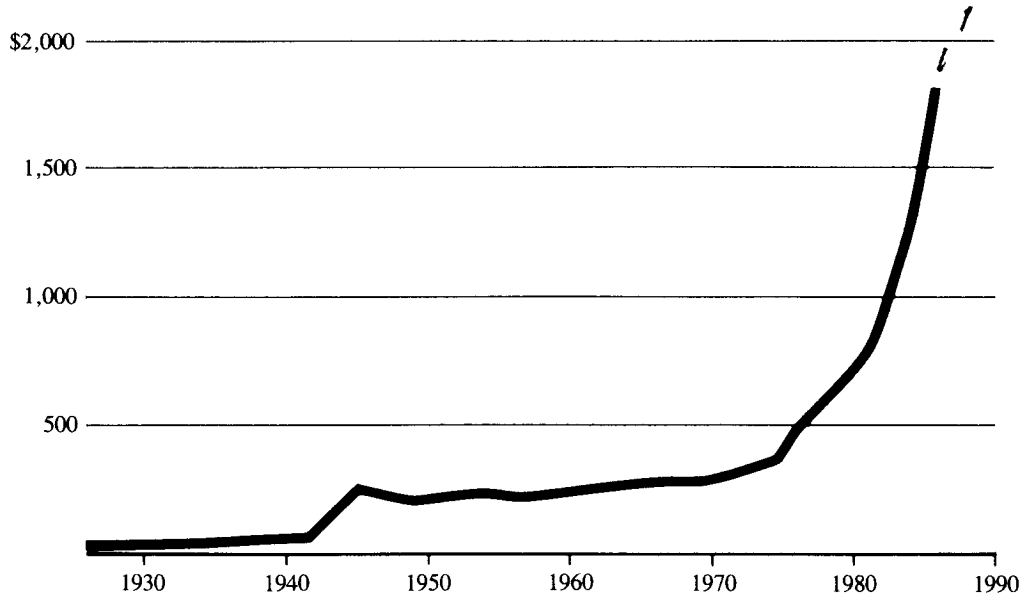
Through Federal Reserve open-market operations, a portion of new issues of Federal debt securities are monetized as backing for newly issued currency, namely Federal Reserve Notes; and, since Government securities also serve as collateral for commercial bank borrowing at the Fed, they are the backup reserves of the more broadly defined money supply as well. These cumulative new issues of Government securities tend to keep the rate of interest rising toward the level at which the Federal Reserve is prepared to intervene and monetize a portion of the deficit; or, alternatively, permit the market rate of interest to rise dramatically. It could be argued that, whatever the deficit, monetization of Federal debt happens purely at the discretion of the Federal Reserve. After all, the outstanding Government debt is large enough that a current deficit is not required for monetization. But if there is no budget deficit, there must be a balance or a surplus, and thus the monetary expansion is checked by the gradual repayment of the debt securities that back the new issue of currency. Moreover, under a regime of convertibility, a desire by the Fed to monetize existing Government securities -- in the absence of a budget deficit -- is not sufficient to increase the money supply at rates of gain approaching those of the last 15 years.

Consider the effects of such a Fed policy under a convertible currency system, as the Fed purchases existing Government securities in the open market, with no new supply being added. First, the rate of interest in the money market would tend to fall and continue falling as the monetization proceeded. But when the rate of interest on money market instruments (e.g., commercial paper, bankers' acceptances, and Treasury bills) fell below the lending rates at the banks, then all loans coming to maturity in the banking system would tend to be refinanced at lower rates in the money market; and, with the proceeds, the higher cost loans at the banks would be repaid, thereby reducing both the assets (the loans) and the liabilities (the deposits) of the commercial banking system. Thus, under convertibility, normal market mechanisms tend to reduce the money supply (more precisely, the deposits component of M1), when the participants in the market do not desire to hold the new money created by Fed monetization of existing Treasury securities (or even new issues to finance the deficit).

That is not all. If the banks lower their lending rates to the new market rates and follow the rates down, then, from a given equilibrium position, under a regime of convertibility, the fall in domestic interest rates relative to foreign rates would create a sustained capital outflow tending to create an overall balance-of-payments deficit. Settlement of the deficit abroad would lower the reserves of the domestic banking system and, through the same market mechanisms of interest rate and price changes, bring about the necessary and proportionate fall in the level of the domestic money supply. One sees that, under international convertibility, with no reserve currencies, domestic and international market mechanisms work to discipline the budget deficit and to bring the supply of money into balance with the true desire to hold money, no matter what the intent of the central bank may be. In these market mechanisms lie the chief institutional virtues of an international monetary system based on multilateral currency convertibility into gold.

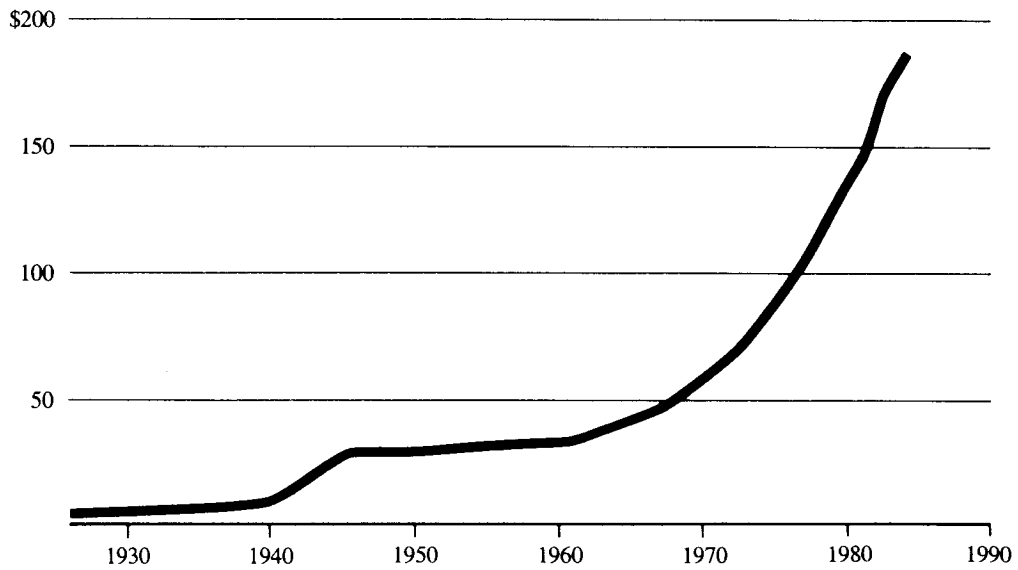
A comparison of the growth of Federal debt, currency, and the M1 money supply since 1932 (see Figures 2, 3, and 4) shows the close association of the secular budget deficit with both the broadly and narrowly defined money supplies over the long run. In general, when the Federal debt grows, the money supply grows; when the growth of Government debt slows, so does growth of money. This case illuminates the principle that the excess demand for Treasury bills -- as backing for Federal Reserve Notes and U.S. banking system reserves, and as official monetary reserves in foreign central banks -- weakens the natural disciplines that tend to curtail budget deficits. Thus, it comes as no surprise that, in the 53 years since 1932, when Section 412 of the Federal Reserve Act was changed, there have been only eight years without budget deficits. During the period under consideration, the close relationship between the growth of Treasury debt and M1 is also partly due to the fact that U.S. domestic gold convertibility -- or even private ownership of gold -- was forbidden from 1934 to 1975. This prohibition removed another important check on the issue of currency and credit, especially given the reserve-currency status of the dollar. Indeed, as the actual balance sheet changes of the Federal Reserve shows, new issues of U.S. currency after 1932 came to depend almost exclusively on the backing of U.S. Government debt. Despite this flaw, the relatively limited discipline of mere international convertibility under Bretton Woods enabled western nations to make adjustments in economic policy in the 'Fifties and 'Sixties that have not proved possible from that time when all external disciplines were abandoned between 1968 and 1973. This point is even clearer when we observe that Federal debt, currency, and the money supply all have risen exponentially for 17 years -- from the moment when the final constraint of gold convertibility on foreign account was suspended in March 1968.

Figure 2  
Total Federal Debt  
(\$ Billions)



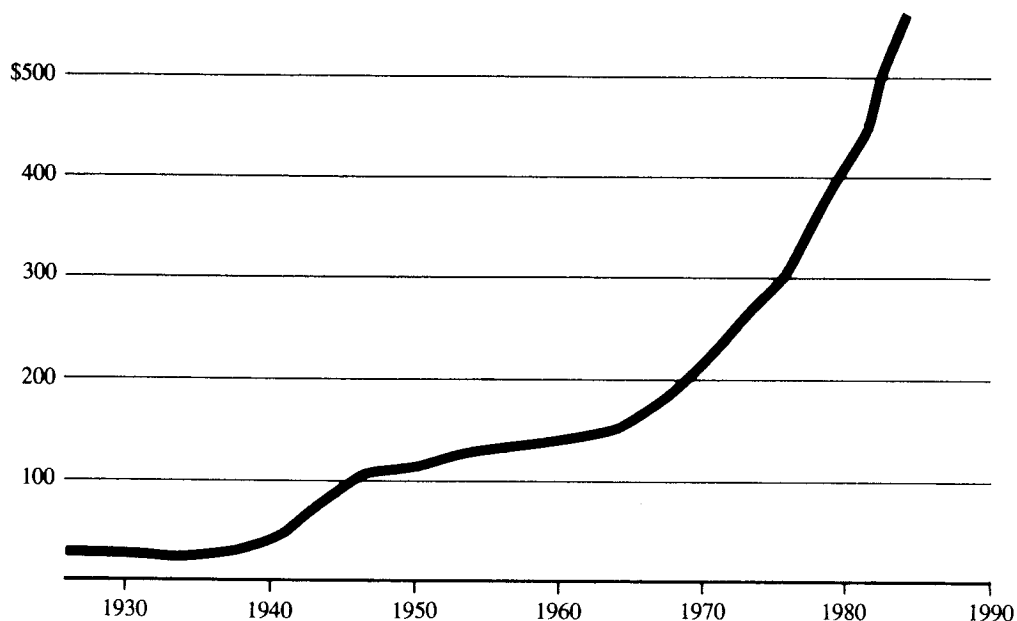
Source: Council of Economic Advisers, Walter Westcott

Figure 3  
U.S. Currency in Circulation  
(\$ Billions)



Source: Federal Reserve Board

Figure 4

U.S. M-1 Money Supply  
(\$ Billions)

Source: Department of Commerce, Council of Economic Advisers

THE SOLUTION: MONETARY REFORM

A new international monetary system should not only adopt the strength but also remedy the defects of Bretton Woods. It should solve the institutional problems of managed floating exchange rates. A simple domestic monetary reform, moreover, must eliminate fundamental domestic flaws. The way to do this is to make the dollar convertible to gold domestically, as it was not under Bretton Woods; and, by law, to substitute gold, self-liquidating Treasury bills, and secured commercial paper -- in the place of permanent Treasury debt -- as the backing for U.S. currency. In addition, as part of a new Group-of-Five understanding, all parties would agree to rule out any national currency as an official reserve currency. The gradual refunding of both domestic and international dollar reserves would be brought about by the revaluation of gold reserves -- without long-term inflation or deflation.

We now know that the privilege and the burden borne by the reserve currencies of the past -- the dollar and sterling -- were too great. Only gold, an objective non-national monetary standard, an independent reference point, and not subject to creation by sovereign governments, can be the stable underlying reserve currency -- the common currency linking all the nations.

True, a number of other schemes have been put forward for international monetary reform. But the eminent Harvard economist, Professor Gottfried Haberler -- who is old enough to have lived through each monetary system we have considered -- makes a trenchant observation in discussing them:

*It is interesting, however, and should give satisfaction to the advocates of the gold standard, that the basic rule of balance of payments adjustment under the gold standard inevitably emerges again and again in present-day discussions -- in modern terminology, of course, and transposed to the inflationary conditions of our times. This rule can be stated as follows: A deficit country that loses gold should let its money supply decline by the full amount of the gold loss or by more. A country in surplus should let its money supply expand by the full amount of the gold gain or more. This will bring downward pressure on the money incomes and prices in the deficit country, and upward pressure in the surplus countries, and thus restore equilibrium in the balance of payments.*

*To translate the rule into modern terminology, substitute the broader concept of "international reserves" for the gold stock and reflect that the policy of central banks under the gold standard to buy and sell gold at the gold export and import points, respectively, to keep exchange rates stable can be described as "nonsterilized interventions"...*

*To transpose the gold standard rule to the inflationary conditions of our times, substitute "changes in monetary growth targets" for "absolute changes in the money supply." Countries in deficit should lower their monetary growth targets; countries in surplus should raise their money growth targets. (Gottfried Haberler, "The International Monetary System in World Recession," in Essays in Contemporary Economic Problems: Disinflation, AEI, Washington, D.C., 1984, p. 103.)*

Haberler concludes that various proposals for partial reform of the international monetary system represent "the recent reappearance, in modern dress, of the basic role of the gold standard."

In fact, if we must make monetary reforms designed to discipline the budget deficit and to solve the problems of the international monetary system -- the destabilizing effects of floating exchange rates, an overvalued dollar, and the equally destabilizing effects of official reserve currencies -- we will eliminate all but two choices. And if we desire long-run price stability, there is only one: fixed exchange rates based on unrestricted domestic and international convertibility of the key currencies into gold.

In an integrated world economy, the enduring solution to the reserve-currency problem requires that all nations share a common monetary standard separate and apart from any national currency. The solution to the problem of floating rates requires that all currencies be convertible into this monetary standard at fixed parities. Practically speaking, this leaves us the following choice: either a return to multilateral currency convertibility into gold (we could keep saying,

"or some other commodity," but monetary authorities for millennia have accumulated and still hold over a billion ounces of gold, not pork-bellies or platinum or baskets of commodities). Or, instead, we could create another supranational institution, a world central bank, whose credit would serve as reserves for all central banks, including the Federal Reserve. The latter choice is not only impractical; in the light of 30 years' experience with the U.N., the IMF, and the World Bank, it is undesirable and unworkable.

No other proposal offers a serious, lasting solution to both problems. The only significant criticism of the gold standard used to be that the supply of gold is "too inelastic;" but the facts of history show this to be untrue. In those days, economists overlooked the profound flaw in the reserve-currency system and erroneously believed that inflation was necessary for full employment. The Phillips Curve reigned -- until it disappeared in our day. The major criticism of the world central bank, however, is still unequivocally true: the supply of paper money is too elastic! If we add the criterion that the world monetary system should be neither inflationary nor deflationary over time, history shows that there is, in the real world, no genuine alternative to domestic currency convertibility and fixed exchange rates based on the international gold standard. This is not to say that gold convertibility is a perfect solution -- there is no such thing in an imperfect world. But fixed exchange rates, based on multilateral currency convertibility, is the least imperfect monetary system known to history -- if our goals are a trustworthy money, low interest rates, a reasonably stable price level, and steady economic growth.

Critics argue that "you can't put Humpty Dumpty back together again." But an international monetary system is not an eggshell. Like the Constitution, it is a human creation, a product of civilization -- not some blind, irreversible evolutionary process. And it has been "put together again" many times throughout history. At least a dozen times in the last two centuries, Britain, France, Germany, the United States, and other countries have done what some skeptics now regard as impossible: restored a system of convertible currencies, and based these currencies on gold or silver -- the two most stable monetary commodities. In their magisterial histories, Professors Milton Friedman and Roy Jastram, among others, have produced the empirical data of 400 years to establish the long-run stability of convertibility beyond a reasonable doubt.

Broadly speaking, we must now take three essential steps toward convertibility.

- (1) President Reagan should direct the Treasury to cooperate with the Group of Five to stabilize the value of the dollar at a fair level consistent with balanced international trade among national currency areas. That is, exchange rates should be stabilized at approximately their longer term purchasing power parities. Indexes of



purchasing power can be agreed upon within the Group of Five and an optimum price determined for convertibility of the dollar into gold. The optimum gold parity would reflect a gold price correctly related within the hierarchy of all prices; that is, a price proportional to its cost of production. Such a price would put all present operating North American gold mines into full production -- a good leading indicator, as history shows, for future "full employment" of resources throughout the whole economy. This dollar price of gold, or the gold value (weight) of the monetary standard, must therefore be set roughly equal to the average of the marginal costs of production of operating North American gold mines. This price would provide for steady output of the gold monetary base (about a 2% increase per year, over the long run, as centuries of statistics show), and would also prevent any decline in the average level of nominal wages -- avoiding, for example, the British problem of underemployment in the 'Twenties caused by an overvalued pound. Under existing conditions, during the present market period, the optimum convertibility price of gold is about \$500.

On September 22, the President took a first step in this direction with our four major trading partners. The President and Secretary Baker have not suggested, however, the necessary second phase: a period of systematic currency stabilization, promptly followed by domestic and international convertibility. If the President does not move from the Group-of-Five dollar devaluation to a general currency stabilization and, finally, to convertibility, there is a danger that the monetary authorities will not know where to stop their interventions. Or, even if they do, they will succumb to protectionist pressures to continue. The result could be an outcome worse than the situation before September 22 -- intensified pressure toward trade war, or lower output, or higher inflation, or higher interest rates than would prevail if the dollar adjustment were executed as part of a coherent move toward a new international monetary order. We must not now forget that the United States tried to balance international trade through the "correct" amount of inflation at least once in the 'Sixties and twice in the 'Seventies. But, in each case, we wound up with the failures of high inflation and, later, deep recession.

- (2) The President should promptly send <sup>gold</sup> legislation to Congress specifying the dollar price of (the gold value of the dollar) to take effect at a fixed date in the future, after the period of currency stabilization (say one year from now). The gold dollar once again must become the monetary standard of the United States, just as the gold

standard must become the common money of world trade. Then, if the Federal Reserve creates too many or too few dollars, under conditions of convertibility it will know in a relatively short period, because it will be forced by those at home and abroad who exchange paper for gold, or gold for paper, to bring its supply of dollar credit into line with the demand for dollars. Moreover, domestic monetary reform means that only gold and domestic short-term self-liquidating securities, convertible at maturity to gold, could serve as collateral or backing for new currency issues such as Federal Reserve Notes. Gold or silver coins, minted according to the statutory standard, should be circulated to provide all working Americans further insurance that neither the monetary standard nor their wages or savings will be violated.

- (3) President Reagan should convene an international monetary conference of the principal trading nations, the purpose of which would be to stabilize the reciprocal values of all major currencies, and proceed to general convertibility and thus to fixed exchange rates. The new system should rule out official reserve currencies, which so plagued Bretton Woods. Existing official dollar-reserve balances abroad should be consolidated and refunded and could be gradually retired through amortization and in large measure by the necessary rise in the value of gold reserves above the last official valuation (\$42.22 per ounce). Once a fair value of the dollar and stable exchange rates are negotiated, the conference agenda should be expanded to include trade discussions to dismantle protectionism. Only with stable exchange rates will nations feel confident enough to forgo protectionism, the conference having finally established the level playing field of fixed exchange rate rules for fair international competition that all desire.

Ironically, such a solution is today regarded as a conservative issue. Not long ago, before Bretton Woods, it was seen as liberal internationalism. Yet, if we and our formidable adversary, the Soviet Union, can share capsules in space or agree to limit nuclear arsenals, why can the United States and its allies not agree to restore the indispensable conditions for world economic growth and free trade -- monetary stability? Settling on a monetary system not easily tampered with is actually the most ancient of political compromises, in which debtors and creditors, weak and strong, poor and rich, and rival political philosophies agree to compete across national borders without using the most treacherous of monetary weapons -- manipulated floating exchange rates.

The results would be dramatic. The pre-World War I international gold standard lasted a century and was directly linked to the success in the West of the Industrial Revolution. The more recent, Bretton Woods experience also shows that we can have, in effect, national currencies and international money -- while retaining sophisticated domestic and international banking arrangements. And the economic benefits of lasting free trade will be much greater than the returns most nations realize from an arbitrary sovereign power to manipulate money. It is by giving up the autonomy to drive on the left side of the road that we gain the freedom to drive safely. By the same token, the new commitment -- to a free international monetary order, substantially free, that is, of government intervention -- will deprive individual nations and their leaders of the license to change currency values by caprice, or conduct protectionist warfare using the secret proxy of exchange-rate manipulation. A just monetary order will, however, usher in a new era of global prosperity.

By pinning down the future price level, the immediate effect of international monetary reform will be gradually to end wild currency speculation and inflation hedging, thus channeling immense new savings into the long-term financial markets. Lower interest rates, increased long-term investment, and new prospects for improvements in world productivity will follow, as real investment (not speculative) capital moves out of these unproductive hedges and more confidently crosses national borders. Naturally, the quantity of investment capital demanded will rise as the price of credit, the interest rate, falls. Along with increased capital investment will come sustained demand for unemployed labor to work the new plant and equipment. With the demand for new money to produce a proportional quantity of new goods and services rapidly on the rise, it will be possible for the supply of money to rise rapidly without inflation. Precisely this condition -- rapid money growth and rapid real growth without inflation -- has occurred many times, but only under stable money conditions. This is the road to full employment and a long-term economic boom in America and in a Free World economy. This is also the road to a balanced budget.

It is safe to predict, on the basis of many historical examples, that long-term interest rates would gradually fall to their historic average under fixed exchange rates based on convertible currency systems -- 3% to 5%. As interest rates fall, the present wards of the international financial system -- less developed debtor countries in Africa, Asia, and Latin America, now effectively bankrupt in all but the balance sheets of western bankers -- will be able to service their debts more rapidly and, through a growing world economy, increase their standards of living and, it is hoped, win their freedom.

This is the world we can create for our children and our grandchildren. If the recent steps announced by the Group of Five are not just another attempt to patch up the failed experiment of floating rates, we may already be on the road to a new international monetary order. The entire program could be put in place during President Reagan's second term.

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