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1988

MEMORANDUM

NATIONAL SECURITY COUNCIL

April 6, 1983

SUSPENSE

INFORMATION

MEMORANDUM FOR WILLIAM P. CLARK

FROM: NORMAN A. BAILEY

SUBJECT: Robert Mundell Summit Paper

This memo is in response to your question "Why are Wallis and Sprinkel not interested?" (Tab I). The answer is that there are two kinds of conservative economists on monetary matters -- hard money economists and those who believe that money is a commodity like all others and thus its "price" should be permitted to fluctuate freely. This is a fallacy easy to refute theoretically and amply demonstrated in practice since the world went off any monetary standard in 1971 (a result that was our fault). The so-called floating-rate "system," which is no system at all, has been an unmitigated disaster.

Both Wallis and Sprinkel are soft-money economists. These people dominate economic policy-making in this Administration and have from the beginning, when the hard money people were excluded or quickly forced out.

The attached memo to Henry Nau may elucidate matters further.

Attachments
Tab I My Memo of of March 25
Tab II Memo to Nau

NSC #8301988

Chron

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MEMORANDUM

NATIONAL SECURITY COUNCIL

~~CONFIDENTIAL~~ April 5, 1983

INFORMATION

MEMORANDUM FOR HENRY NAU

FROM: NORMAN A. BAILEY NB

SUBJECT: April 5 Summit Planning Meeting

Since I will have to attend a USJEWG meeting at 4:00 p.m. I will not be able to come to the 3:30 summit meeting. I would make the following comments on the papers you circulated:

-- The domestic policy/monetary stability question is a false dichotomy. The Bretton Woods monetary system fell apart because the United States, issuer of the exchange part of what was a gold-exchange standard made the conscious political decision under Johnson to finance the Vietnam War and the Great Society by debasing the currency. It need not have been done that way, as evidenced by the fact that the U.S. maintained gold convertibility throughout the second world war which was the only major war in recent history financed (by us) in a non-inflationary fashion. Now that the resulting inflationary spiral is being wound down <u>here</u>, we can move back to something like Bretton Woods. It does not require that all major countries do the same, only the country issuing the linchpin currency. Even the EMS, which doesn't have a linchpin currency, is doing (imperfectly) what it is supposed to do -- namely force appropriate domestic adjustment, as the French are trying to do.

What I conclude from the above is that the most important contribution the U.S. can make at Williamsburg is to take advantage of the present window of opportunity to propose a recreation of the Bretton Woods system through the convening of an international conference.

-- I disagree with the State position that OHT is a bottom-line item on East-West. On the contrary it is a giveaway item. I mean this literally. To continue to insist on it jeopardizes much more important agreements.

cc: R. Robinson
C. Tyson
D. Blair
D. Fortier
W. Martin

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1988

MEMORANDUM

NATIONAL SECURITY COUNCIL

March 25, 1983

INFORMATION

MEMORANDUM FOR WILLIAM P. CLARK

WPC HAS SEEN

FROM: NORMAN A. BAILEY NB

SUBJECT: Mundell Williamsburg Memo

The attached memo (Tab I) on the Williamsburg Summit was written by Professor Robert Mundell of Columbia University and discussed at a Lehrman Institute roundtable on March 23. Mundell's main point is that monetary instability since 1971 is the principal cause of the economic ills of the Western world. Thus, an initiative towards exchange rate stability is the most forward-looking thing the President could propose at Williamsburg. I agree, but Wallis and Sprinkel do not. Nevertheless, we will try to get a cautious, phased initiative adopted by our side. I have given copies to Don Regan and Henry Nau.

Attachment
Tab I Mundell Memo

The Lehrman Institute
Critical Economic Issues Round Table
Session #1: March 23, 1983

ECONOMIC AGENDA FOR WILLIAMSBURG *

by

Robert Mundell
Columbia University

Preliminary draft.

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*The views expressed in this paper are the authors' own and should not be taken to represent the views of the Institute.

I. Introduction: Five Economic Problems

The economic problems with which the major industrial countries are currently confronted include (1) the economic recession with its high unemployment, (2) the instability of the prices of internationally-traded commodities which hover on a razor's edge between inflation and deflation, (3) stagnation in six of the seven major countries, (4) high real interest rates, and (5) a world debt crisis. These problems should be on the agenda for the Williamsburg Summit Meeting. The purpose of this paper is to outline steps that could practically be taken to initiate solutions.

The problems are related to one another. Policies designed to cope with them must take into account the general equilibrium nature of the problem of matching policies to problems, instuments to targets. It is not very useful to say that budget deficits should be reduced outside the framework of the specific measures expected to achieve that result because direct attacks on the budget may deepen the world recession (e.g., if accomplished through higher tax rates or lower government spending) or accelerated inflation (if accomplished through acceleration of the money supply). The same holds for lower interest rates, which, except for the rediscount rate, are not directly under the control of monetary authorities; there exists considerable controversy over whether interest rates are lowered by increasing or decreasing the rate of monetary expansion.

The five economic problems have both domestic and international political repercussions. The world debt crisis would probably recede for awhile if the world economy were operating closer to full capacity. In the

U.S. the goals of better defense or increased social services would appear less out of reach if the U.S. economy could count on the utilization of the extra $500 billion of output that a successful prosperity would bring. Similarly an improvement in the global propects for a secure military peace would reduce the trauma of an accelerating international arms race and help all countries to devote a larger share of resources toward the solution of economic and social problems. By focusing attention on the economic nature of the agenda we should not lose sight of the important political problems raised by wars in Afghanistan, Central America, and the Middle East or by the urgency of defense in Europe, economic development of the Caribbean (and Africa, South America, and South Asia). We assume that the Western Summit will devote time to the possibility of a global summit meeting that includes the Soviet Union, China, and India as well as Japan, Western Europe, and the U.S. The economic agenda is therefore a complement to, not a substitute for, the complete agenda in this up-coming summit.

There are different levels at which economic debate on the five subjects can be conducted. There is no time for esoteric arcanities of economic models, the idealogueries of emotional fanaticism, or blueprints of unreachable utopias to which there is no transition. We have to start from the present and show how steps taken now will build a sequence of transitions to new plateaux of performance, where the goals suit a broad consensus.

In our present preliminary discussions of the agenda, it is not feasible to cover all subjects or deal with all points of view. There are some who still believe that flexible-exchange-rate monetarism gives us the best possible of worlds. For them the only job of cooperative policy-making at the international level is to share information about better methods of defining national money supplies, or changing the amount of reserves supplied to the banking system by the monetary authorities. If this were the case there would be no reason for deep discussion of the international monetary system; their minds would not budge. It is probable that the minds of those who are dogmatically committed to a set of ideas learned in their intellectual childhood would not be much altered by new information about the state of the world or improvements in economic theory. There are equally those who only want an isolationist monetary standard and would reject the implications of international interdependence. A national gold standard, however, would crash, just as world trade would collapse with a steepening of protection at the national level. If we wish the free world to maintain a high standard of economic welfare we may have to accept more rather than less interdependence in trade, capital and money flows, and less isolationism in economic policy-making. Exchange rates are by definition international and there are as many gold prices as there are currencies. The exchange rate(s) is (are) a policy matter that is by definition international and an appropriate subject for policy coordination whether achieved by intervention in the foreign exchange markets, in the bond markets, or the gold markets.

It cannot be our purpose to develop a detailed policy program of recommendations for each of the seven countries, or their smaller neighbors, to pursue in seeking their own internal balance. But the policies of the biggest countries are an international affair because of their great weight and influence in the world economy. The policy mix of monetary, fiscal, exchange rate, and gold policies cannot be ignored insofar as they impinge on the composition of the balance of payments and therefore on each of the other individual countries. This is especially true for the United States. When the Federal Reserve system tightens its monetary policy, the price of gold--and therefore the market value of world gold reserves--goes down. When monetary policy was eased in the third and fourth quarters of 1982 the market price of gold shot up from under $300 an ounce to over $500, adding $200 billion to international reserves, which represent high-powered money in the global monetary system. But when the Fed was expected to tighten monetary policy in early 1983 the price of gold dropped quickly by $100. This price instability because it affects the global money supply demoralizes capital markets, investment planning, and prospects for future GNP. U.S. monetary, fiscal, exchange rate, and gold policies have international ramifications that are not reduced by flexible exchange rates.

The same holds, to some extent, for the other countries. The seven country summit is a meeting of the big; over half world production is represented. Their business cycles are global. Their economic policies determine the exports of the rest of the countries. Their policies are crucial to equilibrium in the oil, gold, and primary products markets of the world economy, not to mention manufacturing output itself.

II. The Overriding Short-Run Issue of the Recession

The most important short-run issue by far is the cyclical problem of the great world recession, which is the greatest in world history judged by the loss of potential output, although it is still not as large proportionately as the Great Depression of fifty years ago. A rough idea of the gap can be got by starting with underutilization figures in the U.S. At the beginning of 1983, U.S. unemployment was over 10 percent of the labor force and manufacturing capacity utilization was less that 70 percent. There are various means of relating this shortfall in utilization to the output gap, ranging from "Okun's Law" (which equates the output gap to the unemployment rate according to the formula $g - 3.2(u - .04)$ to more sophisticated measures that take into account production functions, leisure-work choices, inflation pressures, etc. Very few measures of the gap would place it at less that 10 percent or more than 20 percent. This means that the loss of potential output would be between $300 and $600 billion.

Similar approximations can be made for the other countries, where, except for Japan, the unemployment and underutilization situation is equally bad. The published Japanese unemployment figure is put at less than 3 percent, but a method of calculating the figure comparable to the other countries would probably raise it by a factor of two or even three. In the OECD countries, total unemployment is over 35 million. U.S. unemployment therefore accounts for about a third of OECD unemployment, which suggests a gap in the OECD output of perhaps $1 trillion bearing in mind the lower per capita productivity of some of the poorer OECD countries.

The purpose of the above calculation is not to derive an exact estimate, but only to stress the overwhelming importance of putting the unemployment and recession problem in perspective. <u>It is by far the most important short-run problem of the major countries outside of defense.</u> If this gap were closed there would be ample resources for a much greater defense effort or a more generous approach to social legislation, or a higher level of private consumption. The entire world would gain, economically, because every country would experience greater and more profitable export markets, improved development prospects, and the means for financial solvency of debtor countries.

Budget balance would be restored with full employment. The U.S. budget deficit was 1.3 percent of GNP in 1980, 1.0 percent in 1981, and 3.7

percent in 1982; in none of those years was the U.S. close to full employment. The full employment budget would probably be in surplus despite the cuts in tax rates, if due allowance is made for reductions in social entitlements and higher revenues of a fully employed and expanding U.S. economy. But a zero budget balance is not necessary or desirable in a growing economy where the government is producing or acquiring durable goods and services yielding future benefits that should be amortized partly over the future. It is necessary also to leave room for that part of the deficit which can be financed by non-inflationary high-powered monetary expansion. Except in countries where the government debt is too large a proportion of GNP or total financial assets, or where securities markets for government paper do not exist because of inflationary expectations, an annual growth in the real public debt not exceeding the growth rate of the economy should not be thought of as a violation of the principles of sound finance. Budget deficit reduction will emerge with the solution to the problem of world recession.

III. High Interest Rates

There are those who maintain that budget deficits are the cause of excessively high interest rates. There are some circumstances in which this possibility has a basis in fact. If there is no market in government bonds the deficit would have to be financed by money creation, causing inflation and nominal interest rates high enough to allow for an expected inflation premium to offset nominal capital losses on securities denominated in the national currency. Where monetary discipline is enforced, fiscal discipline follows because no government can expect to market government bonds at low interest rates beyond a point of satiation. In this sense budget deficits that compel monetization of the deficit are a cause of high nominal interest rates because they destroy monetary discipline, while those that don't, eventually destroy the public confidence in bond futures.

Budget deficits, however, are not necessarily associated with high real interest rates. If budget deficits require monetization they can be the cause of *low* real interest rates if nominal rates rise less than the expected inflation rate. Budget deficits can of course be the cause of high real interest rates when there is no monetization of the deficit. But generally interest rates are determined by equality between the demand for and supply of securities. Non-monetized budget deficits absorb part of the voluntary saving that is represented by the flow demand for securities.

In a non-inflationary environment, such as that which prevails under fixed exchange rates and a gold standard, budget deficits are ordinarily associated with low interest rates, and budget surpluses with high interest rates. This is because the budget deficit is high during recessions and low during booms. This pattern has held up even after the breakdown of the gold exchange standard in 1971; in the 1974-5 recession and also in 1982 interest rates came down as the world recession unfolded just when the budget deficits reached their highest levels.

A major cause of high interest rates is inflationary expectations, which are always high when there is no *explicit* barrier to high *future* rates of monetary expansion and future inflation. The best way to get interest rates down is to restore confidence in a *future* monetary policy. Interest rates in the United States today depend more on what the public expects monetary policy (and also tax policy) to be in the years 1983-2000 that it does on immediate credit policies of the Federal Reserve System.

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IV. Monetarist Rules in a Global Economy

There is, I suppose, little controversy concerning the above review of the causes of high interest rates. The controversy over interest rate policy stems from the means by which confidence in future monetary policy is to be secured. The flexible exchange rate monetarists argue that confidence can best be secured by a monetary rule governing the growth rate of monetary aggregates. But the public has no faith that the monetary rule will be kept or that different definitions of money, going from M_1, M_2 ... to a broad concept of liquid assets, move in different directions over the cycle and with monetary innovations. For example, the rates of change of M_1 and M_2 rose rapidly from April to November 1982. But the rates of change of M_3 and liquid assets rose rapidly from April to August, but fell as rapidly from August to December. In October the Federal Reserve had to change its monetary policy, giving up its experiment with monetarism. It would have otherwise been faced with soaring short-term interest rates in the middle of the steep recession. The rule of monetarism is over.

This does not change, however, the need for some rule by which markets can predict future monetary policy. Flexible-exchange-rate monetarism did not work well because the public shifts its choice of financial assets with the pattern of interest rates, exchange rates, and inflationary expectations. A national monetary rule applied to aggregates might work better in a closed economy, but it does not work in a open economy. The only closed economy is the world.

Global monetarism makes more sense than national monetarism. National currencies are close substitutes, from the standpoint of abodes of liquidity. A large part of the U.S. money supply--whatever definition of it is used--is held abroad. The pools of liquidity in the U.S. and in Europe (and elsewhere) are intimately connected; the level in one cannot be controlled without controlling the total. A control over the world money supply by a monetary rule makes much more sense than trying to control liquidity in one corner of the world and expecting--assuming it could be done at all--the rule to attain the proclaimed objectives of reduced spending. But there are grave practical difficulties associated with controlling a global monetary aggregate. It would even be complicated to agree on an appropriate definition or concept of the world money supply and the means of measuring it, more complicated than controlling a national component of it.

V. Gold Versus a New World Currency

It was the genius of natural selection that led to the adoption of standards based on the precious metals in earlier times. The silver standards of the past, and the gold standards of the 19th and 20th centuries resulted in a growth of the money supplies of countries on gold or silver standards more or less in proportion to the output of these metals. World monetary growth was thus limited by the growth of the precious metals, and gold price levels were fairly stable over the long-run, with secular periods of slow deflation being followed by periods of slow inflation. The major variations from price level stability in the 19th century occurred when countries went off the gold or silver standards creating global changes in world demand for and supply of the two metals.

The gold standard of the 19th century, especially after 1870, was more or less centered in London, which had become the principal capital market in the world economy. But London gradually lost its dominance to New

York as the U.S. emerged in the 20th century as a supereconomy and the U.S. dollar became the principal currency of account and settlements. The gold standard ratified at Bretton Woods built upon the Tripartite Agreement of 1936 and was based on the dollar. When after a quarter of a century the dollar became inconvertible in 1971, and the price of gold in the free market rose, the world economy was left without an effective world currency. Both gold and dollars were weaker in isolation that they were when they complemented each other. Gold was no longer actively traded among central banks and was unusable as an active reserve; the SDR became a miniscule proportion of international reserves; and the dollar was subject to the whims of the Federal Reserve ~~System.~~ Board.

The problem with controlling the world money supply today, and thus with monetary stability, lies in controlling the value of international reserves. These are composed principally of dollars and gold, although other currencies are also held in central bank portfolios. The main variation of reserves is due to the volatile gyrations in the price of gold, and to a much lesser extent in the growth of foreign exchange reserves. No effort to reduce the fluctuations in the value of reserves can succeed without reducing the instability of the price of gold, and letting the consequences of intervention in the gold market to be felt by the banking system without being offset by countervailing movements of Federal Reserve policy.

Thus, had the Treasury sold gold between 1979 and early 1980 when the price of gold was shooting up from $200 to over $800, the growth of the reserve base of the U.S. money supply would have been smaller and inflation would not have shot up to over 15 percent. And when the price of gold fell to under $300 in 1982, Treasury purchases of gold could have offset some of the overly tight monetary policy which contributed to the overkilling of inflationary expectations in that period. A better balance of policies could also have been achieved had the price of gold not been allowed to shoot up by more than $200 an ounce between July 1982 and January 1983, and then fall back to about $400.

Stabilization of the price of gold is not an end in itself, but rather, it is a means toward achieving a better monetary policy. It would also reduce the damaging fluctuations in the level of international reserves that have created global economic instability.

Neither gold alone nor dollars alone can be the foundation of a stable and effective international monetary system today. Both are needed for different reasons. There is no feasible substitute for gold at the present time as an abode of value for central banks and the fact that they now hold almost 1 billion ounces of the metal--perhaps 30 years supply of gold from the mines--makes it compulsory to harness its usefulness in improving global monetary performance. Nor is there a feasible substitute for dollars at the present time as a unit of account, vehicle currency, and operational means of settlement. But gold and dollars are more than twice as good when they work together than they are when they work at cross purposes. If the dollar price of gold were stabilized, the world's monetary problems would fall into place and become manageable.

The problems would not entirely disappear. Change is inevitable and problems are transformed rather than solved. The international monetary reforms that were enacted in the First and Second Amendments to the Articles of Agreement of the International Monetary Fund testify to the need for a response to some of the problems of the gold exchange standard. The First Amendment established the SDR, the embryo of a world ink or electronic currency. It took several years to negotiate among the major nations and there is no reason why we should not build upon the new base rather than start again, throwing away the fruit of hard work invested by the pioneers of that development. For cosmetic reasons alone an SDR is a useful facility. Respect for national sovereignties suggest that a gold-dollar system should evolve into a gold-SDR system with the dollar being utilized as the principal, but not the sole, link between SDRs, gold, and the markets for other currencies. From a purely formal or de jure standpoint it is the SDR value of gold that should be stabilized, while the dollar is stabilized to the SDR, like other currencies. But it might take too long to rebuild confidence in the SDR whose definition has shifted from a quasi-reserve-asset with a gold-weight guarantee to a basket of sixteen currencies to a basket of five currencies. If the dollar were made convertible into such a flaky drawing right, the economic gains from a gold convertible dollar would be lost. It might instead be better to reverse the procedure and make the SDR convertible into the dollar for purposes of those countries in which an SDR standard is more suitable.

VI. Benefits from a Gold-Stable Dollar

The interchangeability of the dollar into gold would go far toward reviving confidence in it and thus restore the credit of the U.S., as measured by the rate of interest on government debt. Confidence in a gold-convertible dollar would greatly increase the global demand for government bonds and lower interest rates to the level typical of gold standards, i.e., to 6 percent or less. The same holds for all securities fixed in relation to the dollar. The general fall in dollar interest rates--both nominal and real--would lower interest rates all over the world. A solid basis for recovery from the Great World Recession would be established.

Other countries would likewise benefit from the monetary reform. The other powers should be an integral part of the reform because they hold the bulk of their reserves in gold and dollars, and account for half of all gold held. Any change in their portfolios of gold and dollars would have an effect upon the U.S. The U.S. would not want to buy up the entire stock of monetary gold in the world any more than the U.S. would want to sell all its monetary gold depleting its impressive current stockpile of 264 million ounces. The major gold holders are as follows:

U.S.	264.0	million	ounces
Germany	95.2	"	"
Switzerland	83.3	"	"
France	81.9	"	"
Italy	66.7	"	"
Netherlands	43.9	"	"
Belgium	34.2	"	"
Japan	24.2	"	"
Portugal	22.2	"	"
Austria	21.1	"	"
U.K.	19.0	"	"
Canada	20.3	"	"
Spain	14.6	"	"
Venezuela	11.5	"	"
All Countries	949.1	"	"

In addition to this country total we have to take account of the institutions. The IMF had 103.0 million and the EMCF (European Monetary Cooperation Fund) had about 85.7 million ounces at the end of 1982. The world total (excluding non-members of the IMF) was 1137.7 million ounces. Solid estimates of Soviet-held gold stocks are hard to find but are probably less than 50 million ounces.

With the fall in interest rates there would be a great drop in the servicing costs of the third-world debt and less chance of bankruptcy. The service costs of the U.S. public debt would likewise go down, reducing the budget deficit. Other nations would find it worthwhile to establish dollar-gold parities in order to lower their interest rates to the U.S. level and stimulate their own economic recoveries from the recession. The prices of internationally-traded commodities would no longer bounce up and down. In short, the five major problems outlined at the beginning of the paper would find a natural solution.

VII. Some Objections and Some Answers

An objection to a gold stabilization arrangement has been made along the following lines. There are some who argue that because the gold standard or the gold exchange standard broke down in the past it is bound to break down again. The logic of the arguement is not convincing; by the same logic one could argue that the gold standard developed in the past and so will be developed again, or that because there was a war in the past there will be a war again. Without denying patterns in history, we should recognize that the present opportunity for establishing a new gold-based dollar standard is unique. The world is now in a state of comparative peace; the "Opec decade" is over; there is some semblance of balance-of-power equilibrium; there is the challenge to devise a facility for handling third world debts; inflation has subsided; there are a billion ounces of unutilized gold in the hands of central bankers; there is growing disenchantment with floating exchange rate monetarism; there is a reluctance to return to the massive government spending policies of the early Keynesians; and there is an understood need for low interest rates now and later in the recovery if and when it gets under way. After the three great recessions of 1970-2, 1974-6 and 1980-83, after each of which we emerged with higher inflation and higher unemployment, the public will be willing to endorse a new social experiment in conservative finance, especially one that enjoyed such a high reputation in the past. To return to gold standard expectations and interest rates is a long-sought consummation of a generation of international monetary reformers.

There are additional reasons why a new gold standard system combined with fixed exchange rates could be successful today even though it broke down in the past. Increasingly, scholars have come to understand that the gold standard mechanism broke down when its principles had been violated by the overriding exigencies of world war. After the outbreak of World War I most countries went off the gold standard and gold drifted to the United States where it was centralized and embargoed as a war measure; inflationary wartime finance led to a doubling of the dollar price level which persisted long after the war. When European countries returned to the gold standard some of the gold reserves had to be shifted to Europe, creating a tightness in money growth that nipped the speculative Wall Street boom and culminated in the deflation of 1930-33. The gold standard did not cause the Great Depression. The latter was the reaction to World War I inflation.

When the new gold standard was restored in 1934 at a price almost 75 percent above the old price of $20.67 an ounce, overvalued gold and stability of the dollar combined to keep interest rates below 4 percent for about 15 years. But the World War II inflation gradually eliminated the excess gold reserves held by the U.S., and the Korean War inflation made gold again on a par with the dollar. The dollar shortage gave way to a gold shortage. The gold standard broke down during the Vietnam War at a time when gold was repressed below its market equilibrium. For gold to be used as a money its price has to be above, not below, its value as a commodity.

It is possible to imagine a possibility in which, following a new gold standard based on a higher price of gold than before, a new world war broke out involving inflationary finance on a scale sufficient to again undervalue gold. Monetary systems cannot generally be made warproof, and a gold standard is no exception. But this is an argument against war, not against the gold standard.

Another objection to a gold standard is that to maintain it in operation over time it is not enough to stabilize the price of gold. Monetary discipline based on gold has to be developed in order to keep the dollar convertible into gold. When the U.S. buys gold it should not fully offset the monetary effect of this purchase on bank reserves, and when it sells gold it should not buy an equal quantity of bonds to sterilize the gold imports. Intervention in the gold market should supplement, refine, and improve monetary policy. This is perfectly correct, but it is an advantage, not a disadvantage of the gold standard. Gold purchases and sales at the lower and upper buying and selling points are signals of possible errors in Federal Reserve policy. The gold standard mechanism is an information apparatus that automatically offsets monetary errors of the central bank, and the open market committee; it acts as an intelligent shadow open market committee. The error signals are warning devices that should be paid heed to, not ignored. The only case for sterilizing or neutralizing the monetary effects of gold sales and purchases would be if sudden changes in demand or supply were brought about by the action of an enemy to weaken the system.

A further argument made against the gold standard system combined with fixed exchange rates is that if countries were to maintain fixed exchanged rates and at least one currency, the dollar, were stabilized in terms of gold, central banks would have to buy foreign exchange when their currencies were appreciating or when they had surpluses in their balances of payments, and sell foreign exchange when their currencies were depreciating or they had deficits in their balances of payments. Similarly, the U.S. (and perhaps the European Monetary Bloc) would have to sell gold when the U.S. had a deficit and buy gold when it had a surplus resisting both inflationary pressures on the one hand and deflationary pressures on the other.

Now--it is admitted--this is a very sensible stabilization policy for central banks since it leads to monetary equilibrium without inflation or deflation. But--it is now argued--if central banks would act in this way who needs the gold standard? This relevant question has been asked by Dr. Edward M. Bernstein and others.

There are two answers to this important question. One is that if the gold standard makes central banks behave sensibly it should not be scorned on that account. At worst it could be charged with being redundant. It is true that a monetary system when operating at the peak of its efficiency is scarcely noticeable. Economists like Alfred Marshall, Keynes's teacher, who grew up during the gold standard paid little attention to currency theory and even dismissed it as unimportant:

> I am never weary of preaching in the wilderness (that) the only very important thing to be said about currency is that it is not nearly as important as it looks. (A. Marshall, 1899)

Such a statement could not have been made after 1914.

But it is a mistake to think that a gold standard or gold exchange standard is redundant if central bankers are taught to follow its leadership in guiding monetary policy. After the failure of flexible-exchange-rate monetarism in October 1982, the Federal Reserve System was left high and dry without a guideline for its policy. Stabilization of gold focuses attention on the appropriate direction for Fed policy. The gold standard is not redundant just because the Fed heeds the information of the gold market any more than a treaty is redundant because signatories adhere to its clauses, or a marriage is redundant because parties abide by its mores.

Intervention in the gold market is a means by which the signal is acted upon. In the absence of gold market intervention (by the Treasury) the Fed should certainly be tightening its monetary policy before gold reaches, say, $600 and easing monetary policy before it falls below $300. These are wide outside limits that represent danger signals, and they could be narrowed substantially. Intervention in the gold market by the Treasury could put the policy in much sharper focus in case the Treasury disagreed with the Federal Reserve Board of Governors by imposing, say a $350 to $550 trading range at the start and gradually narrowing this range as it got the feel of the market. These are questions that should be worked out in collaboration with the Federal Reserve as well as U.S. trading partners.

It would be desirable if the European countries stabilized the trading range of the ECU in terms of gold, possibly through purchases and sales of gold for ECU currencies by the EMCF; and similarly by the IMF for SDR currencies. There is no doubt about the ability of the U.S. Treasury, the EMCF and the IMF to control the price bearing in mind that these three agencies alone have 452 million ounces of gold, equivalent perhaps to 15 years annual production. When the gold holdings of the countries represented by the ECU are taken into account the available gold available for buffer stock purchases and sales represent over 90 percent of the world's monetary gold. Switzerland might also be interested in participating in the International Gold Pool.

There are two further objections raised against a Gold Stabilization Agreement. One is that there is not enough gold in the hands of official institutions; the other is that there is too much! These objections (which are often raised by the same high official or economist at the same time) cancel one another out.

Nevertheless it is a serious question whether there is either too little gold or too much gold. It is argued, for example, that there are perhaps four or five trillion dollars worth of dollar debts or assets outstanding and that these could not possibly be converted into gold all at once at existing or any feasible gold prices. One could go further and say that our planet is worth about $100 trillion dollars and that there would not be enough gold to buy it.

Good!

The other objection is that there is too much gold around, if we add to the 1.1 billion ounces of monetary gold in central banks and international institutions another half trillion or more in gold hoards, and a few trillion ounces unmined beneath the world's surface. If the authorities create a new international gold pool to stabilize the price is it not possible that the pool would run the risk of having to buy up a substantial fraction of hoarded gold? Once the expectations of gold price rising to the stratesphere are scotched by the concerted weight of overhanging official gold stocks would there not be a gold scare unmatched since 1937?

Thus it would seem that on the one hand there is a hopeless shortage of gold to cope with the potential demand for gold conversions against debts, whereas on the other hand there is an impossible redundancy of the yellow metal which could not possibly be absorbed by the authorities or in the public's appetite for gold coins. The bulls and the bears will have to sort it out!

VIII. Conclusions

The basic problem of the world economy at the present time is the recession and the cost it imposes in sacrifice of potential purchasing power. The problem is to manage the recovery without accelerating world inflation and allowing interest rates to climb so high that the boom will be aborted before full employment is reached. The solution requires that interest rates be kept down by measures that reawaken confidence in long-term monetary policy. The experiment with flexible-exchange-rate monetarism has been a failure and reviving it by a new set of monetarist rules will only end once more in defeat. It is time to cut our losses with flexible-exchange-rate monetarism and go back to the internationalist approach to dealing with inflation that was successful in the heyday of gold and Bretton Woods. That approach involves readoption of a system of exchange rate parities by convertibility of a major currency or collective reserve asset into gold. If the dollar is stabilized in terms of gold, the other countries should fix their exchange rates to the dollar using the balance of payments as the guide to appropriate monetary policy. For its part the United States should commit its monetary policy to stabilization of the price of gold.

It is possible to integrate this framework with an institutional improvement in the system starting with an International Gold Pool that includes the U.S. and leading members of the IMF, possibly acting in coordination with the IMF itself, which could agree to stabilize the SDR also in terms of gold. The EMCF, may also wish to stabilize the Ecu to gold or the dollar. An agreement in principle on these lines could be initiated at the Williamsburg Summit, discussed among Central Bankers at the Annual Basle meeting of the BIS in June, and proposed through the Interim Committee of the IMF. By the end of the summer the approach should be advanced explicitly for consideration at the Washington meeting of the Board of Governors of the IMF and/or the IBRD. Prior to that meeting, which will occur in September 1983, the major countries could work informally together on intervention policies in order to lay the practical groundwork necessary for specific proposals by September.

The long-run debt crisis would be ameliorated by a recovery and even more by the stabilization of exchange rates with the consequent fall in interest rates to levels appropriate to the new gold exchange standard. But steps should be taken toward a World Central Bank that would integrate the activities of the IMF, IBRD, and subsidiary banks and deal with the new wider issue of bank solvency and debt repayment. It is time to prepare the groundwork for an imaginative solution involving a world central bank that acts as an ultimate lender of last resort and has at its command the resources to cope with the problems of a growing debt problem of third world countries. A central bank with assets of about $1 trillion will be necessary. In order to integrate this new institution with those already existing the meetings at Williamsburg in May, at Basle of BIS in June, of the Interim Committee and the IMF in September, should start the process toward a plenary congress of the nations dealing with the new institutions necessary to stabilize the economic milieu, consolidate the gains of the past decades, and prepare for the broader challenges of the future.

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RECEIVED 25 MAR 83 15

TO CLARK FROM BAILEY DOCDATE 25 MAR 83

KEYWORDS: WILLIAMSBURG SUMMIT ECONOMICS MUNDELL, ROBERT

SUBJECT: MUNDELL PAPER ON AGENDA FOR WILLIAMSBURG SUMMIT

ACTION: FOR INFORMATION DUE: STATUS IX FILES

FOR ACTION	FOR CONCURRENCE	FOR INFO
CLARK		NAU

COMMENTS

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Bailey	S APR 0 4 1983	further action	4/6	
Clark	IX 4/6	for information		
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MEMORANDUM

NATIONAL SECURITY COUNCIL

April 6, 1983

INFORMATION

MEMORANDUM FOR WILLIAM P. CLARK

FROM: NORMAN A. BAILEY NB

SUBJECT: Mundell Summit Paper

NOTED

This memo is in response to your question "Why are Wallis and Sprinkel not interested?" (Tab I). The answer is that there are two kinds of conservative economists on monetary matters -- hard money economists and those who believe that money is a commodity like all others and thus its "price" should be permitted to fluctuate freely. This is a fallacy easy to refute theoretically and amply demonstrated in practice since the world went off any monetary standard in 1971 (a result that was our fault). The so-called floating-rate "system," which is no system at all, has been an unmitigated disaster.

Both Wallis and Sprinkel are soft-money economists. These people dominate economic policy-making in this Administration and have from the beginning, when the hard money people were excluded or quickly forced out.

The attached memo to Henry Nau may elucidate matters further.

Attachments
- Tab I My Memo of of March 25
- Tab II Memo to Nau

MW

1988

MEMORANDUM

NATIONAL SECURITY COUNCIL

March 25, 1983

INFORMATION

MEMORANDUM FOR WILLIAM P. CLARK

WPC HAS SEEN

FROM: NORMAN A. BAILEY NB

SUBJECT: Mundell Williamsburg Memo

The attached memo (Tab I) on the Williamsburg Summit was written by Professor Robert Mundell of Columbia University and discussed at a Lehrman Institute roundtable on March 23. Mundell's main point is that monetary instability since 1971 is the principal cause of the economic ills of the Western world. Thus, an initiative towards exchange rate stability is the most forward-looking thing the President could propose at Williamsburg. I agree, but Wallis and Sprinkel do not. Nevertheless, we will try to get a cautious, phased initiative adopted by our side. I have given copies to Don Regan and Henry Nau.

Attachment
Tab I Mundell Memo

The Lehrman Institute
Critical Economic Issues Round Table
Session #1: March 23, 1983

ECONOMIC AGENDA FOR WILLIAMSBURG *

by

Robert Mundell
Columbia University

*The views expressed in this paper are the authors' own and should not be taken to represent the views of the Institute.

I. Introduction: Five Economic Problems

The economic problems with which the major industrial countries are currently confronted include (1) the economic recession with its high unemployment, (2) the instability of the prices of internationally-traded commodities which hover on a razor's edge between inflation and deflation, (3) stagnation in six of the seven major countries, (4) high real interest rates, and (5) a world debt crisis. These problems should be on the agenda for the Williamsburg Summit Meeting. The purpose of this paper is to outline steps that could practically be taken to initiate solutions.

The problems are related to one another. Policies designed to cope with them must take into account the general equilibrium nature of the problem of matching policies to problems, instuments to targets. It is not very useful to say that budget deficits should be reduced outside the framework of the specific measures expected to achieve that result because direct attacks on the budget may deepen the world recession (e.g., if accomplished through higher tax rates or lower government spending) or accelerated inflation (if accomplished through acceleration of the money supply). The same holds for lower interest rates, which, except for the rediscount rate, are not directly under the control of monetary authorities; there exists considerable controversy over whether interest rates are lowered by increasing or decreasing the rate of monetary expansion.

The five economic problems have both domestic and international political repercussions. The world debt crisis would probably recede for awhile if the world economy were operating closer to full capacity. In the

U.S. the goals of better defense or increased social services would appear less out of reach if the U.S. economy could count on the utilization of the extra $500 billion of output that a successful prosperity would bring. Similarly an improvement in the global propects for a secure military peace would reduce the trauma of an accelerating international arms race and help all countries to devote a larger share of resources toward the solution of economic and social problems. By focusing attention on the economic nature of the agenda we should not lose sight of the important political problems raised by wars in Afghanistan, Central America, and the Middle East or by the urgency of defense in Europe, economic development of the Caribbean (and Africa, South America, and South Asia). We assume that the Western Summit will devote time to the possibility of a global summit meeting that includes the Soviet Union, China, and India as well as Japan, Western Europe, and the U.S. The economic agenda is therefore a complement to, not a substitute for, the complete agenda in this up-coming summit.

There are different levels at which economic debate on the five subjects can be conducted. There is no time for esoteric arcanities of economic models, the idealogueries of emotional fanaticism, or blueprints of unreachable utopias to which there is no transition. We have to start from the present and show how steps taken now will build a sequence of transitions to new plateaux of performance, where the goals suit a broad consensus.

In our present preliminary discussions of the agenda, it is not feasible to cover all subjects or deal with all points of view. There are some who still believe that flexible-exchange-rate monetarism gives us the best possible of worlds. For them the only job of cooperative policy-making at the international level is to share information about better methods of defining national money supplies, or changing the amount of reserves supplied to the banking system by the monetary authorities. If this were the case there would be no reason for deep discussion of the international monetary system; their minds would not budge. It is probable that the minds of those who are dogmatically committed to a set of ideas learned in their intellectual childhood would not be much altered by new information about the state of the world or improvements in economic theory. There are equally those who only want an isolationist monetary standard and would reject the implications of international interdependence. A national gold standard, however, would crash, just as world trade would collapse with a steepening of protection at the national level. If we wish the free world to maintain a high standard of economic welfare we may have to accept more rather than less interdependence in trade, capital and money flows, and less isolationism in economic policy-making. Exchange rates are by definition international and there are as many gold prices as there are currencies. The exchange rate(s) is (are) a policy matter that is by definition international and an appropriate subject for policy coordination whether achieved by intervention in the foreign exchange markets, in the bond markets, or the gold markets.

It cannot be our purpose to develop a detailed policy program of recommendations for each of the seven countries, or their smaller neighbors, to pursue in seeking their own internal balance. But the policies of the biggest countries are an international affair because of their great weight and influence in the world economy. The policy mix of monetary, fiscal, exchange rate, and gold policies cannot be ignored insofar as they impinge on the composition of the balance of payments and therefore on each of the other individual countries. This is especially true for the United States. When the Federal Reserve system tightens its monetary policy, the price of gold--and therefore the market value of world gold reserves--goes down. When monetary policy was eased in the third and fourth quarters of 1982 the market price of gold shot up from under $300 an ounce to over $500, adding $200 billion to international reserves, which represent high-powered money in the global monetary system. But when the Fed was expected to tighten monetary policy in early 1983 the price of gold dropped quickly by $100. This price instability because it affects the global money supply demoralizes capital markets, investment planning, and prospects for future GNP. U.S. monetary, fiscal, exchange rate, and gold policies have international ramifications that are not reduced by flexible exchange rates.

The same holds, to some extent, for the other countries. The seven country summit is a meeting of the big; over half world production is represented. Their business cycles are global. Their economic policies determine the exports of the rest of the countries. Their policies are crucial to equilibrium in the oil, gold, and primary products markets of the world economy, not to mention manufacturing output itself.

II. The Overriding Short-Run Issue of the Recession

The most important short-run issue by far is the cyclical problem of the great world recession, which is the greatest in world history judged by the loss of potential output, although it is still not as large proportionately as the Great Depression of fifty years ago. A rough idea of the gap can be got by starting with underutilization figures in the U.S. At the beginning of 1983, U.S. unemployment was over 10 percent of the labor force and manufacturing capacity utilization was less that 70 percent. There are various means of relating this shortfall in utilization to the output gap, ranging from "Okun's Law" (which equates the output gap to the unemployment rate according to the formula $g - 3.2(u - .04)$ to more sophisticated measures that take into account production functions, leisure-work choices, inflation pressures, etc. Very few measures of the gap would place it at less that 10 percent or more than 20 percent. This means that the loss of potential output would be between $300 and $600 billion.

Similar approximations can be made for the other countries, where, except for Japan, the unemployment and underutilization situation is equally bad. The published Japanese unemployment figure is put at less than 3 percent, but a method of calculating the figure comparable to the other countries would probably raise it by a factor of two or even three. In the OECD countries, total unemployment is over 35 million. U.S. unemployment therefore accounts for about a third of OECD unemployment, which suggests a gap in the OECD output of perhaps $1 trillion bearing in mind the lower per capita productivity of some of the poorer OECD countries.

The purpose of the above calculation is not to derive an exact estimate, but only to stress the overwhelming importance of putting the unemployment and recession problem in perspective. <u>It is by far the most important short-run problem of the major countries outside of defense.</u> If this gap were closed there would be ample resources for a much greater defense effort or a more generous approach to social legislation, or a higher level of private consumption. The entire world would gain, economically, because every country would experience greater and more profitable export markets, improved development prospects, and the means for financial solvency of debtor countries.

Budget balance would be restored with full employment. The U.S. budget deficit was 1.3 percent of GNP in 1980, 1.0 percent in 1981, and 3.7

percent in 1982; in none of those years was the U.S. close to full employment. The full employment budget would probably be in surplus despite the cuts in tax rates, if due allowance is made for reductions in social entitlements and higher revenues of a fully employed and expanding U.S. economy. But a zero budget balance is not necessary or desirable in a growing economy where the government is producing or acquiring durable goods and services yielding future benefits that should be amortized partly over the future. It is necessary also to leave room for that part of the deficit which can be financed by non-inflationary high-powered monetary expansion. Except in countries where the government debt is too large a proportion of GNP or total financial assets, or where securities markets for government paper do not exist because of inflationary expectations, an annual growth in the real public debt not exceeding the growth rate of the economy should not be thought of as a violation of the principles of sound finance. Budget deficit reduction will emerge with the solution to the problem of world recession.

III. High Interest Rates

There are those who maintain that budget deficits are the cause of excessively high interest rates. There are some circumstances in which this possibility has a basis in fact. If there is no market in government bonds the deficit would have to be financed by money creation, causing inflation and nominal interest rates high enough to allow for an expected inflation premium to offset nominal capital losses on securities denominated in the national currency. Where monetary discipline is enforced, fiscal discipline follows because no government can expect to market government bonds at low interest rates beyond a point of satiation. In this sense budget deficits that compel monetization of the deficit are a cause of high nominal interest rates because they destroy monetary discipline, while those that don't, eventually destroy the public confidence in bond futures.

Budget deficits, however, are not necessarily associated with high real interest rates. If budget deficits require monetization they can be the cause of <u>low</u> real interest rates if nominal rates rise less than the expected inflation rate. Budget deficits can of course be the cause of high real interest rates when there is no monetization of the deficit. But generally interest rates are determined by equality between the demand for and supply of securities. Non-monetized budget deficits absorb part of the voluntary saving that is represented by the flow demand for securities.

In a non-inflationary environment, such as that which prevails under fixed exchange rates and a gold standard, budget deficits are ordinarily associated with low interest rates, and budget surpluses with high interest rates. This is because the budget deficit is high during recessions and low during booms. This pattern has held up even after the breakdown of the gold exchange standard in 1971; in the 1974-5 recession and also in 1982 interest rates came down as the world recession unfolded just when the budget deficits reached their highest levels.

A major cause of high interest rates is inflationary expectations, which are always high when there is no <u>explicit</u> barrier to high <u>future</u> rates of monetary expansion and future inflation. The best way to get interest rates down is to restore confidence in a <u>future</u> monetary policy. Interest rates in the United States today depend more on what the public expects monetary policy (and also tax policy) to be in the years 1983-2000 that it does on immediate credit policies of the Federal Reserve System.

not short-term
supply & demand

IV. Monetarist Rules in a Global Economy

There is, I suppose, little controversy concerning the above review of the causes of high interest rates. The controversy over interest rate policy stems from the means by which confidence in future monetary policy is to be secured. The flexible exchange rate monetarists argue that confidence can best be secured by a monetary rule governing the growth rate of monetary aggregates. But the public has no faith that the monetary rule will be kept or that different definitions of money, going from M_1, M_2 ... to a broad concept of liquid assets, move in different directions over the cycle and with monetary innovations. For example, the rates of change of M_1 and M_2 rose rapidly from April to November 1982. But the rates of change of M_3 and liquid assets rose rapidly from April to August, but fell as rapidly from August to December. In October the Federal Reserve had to change its monetary policy, giving up its experiment with monetarism. It would have otherwise been faced with soaring short-term interest rates in the middle of the steep recession. The rule of monetarism is over.

This does not change, however, the need for some rule by which markets can predict future monetary policy. Flexible-exchange-rate monetarism did not work well because the public shifts its choice of financial assets with the pattern of interest rates, exchange rates, and inflationary expectations. A national monetary rule applied to aggregates might work better in a closed economy, but it does not work in a open economy. The only closed economy is the world.

Global monetarism makes more sense than national monetarism. National currencies are close substitutes, from the standpoint of abodes of liquidity. A large part of the U.S. money supply--whatever definition of it is used--is held abroad. The pools of liquidity in the U.S. and in Europe (and elsewhere) are intimately connected; the level in one cannot be controlled without controlling the total. A control over the world money supply by a monetary rule makes much more sense than trying to control liquidity in one corner of the world and expecting--assuming it could be done at all--the rule to attain the proclaimed objectives of reduced spending. But there are grave practical difficulties associated with controlling a global monetary aggregate. It would even be complicated to agree on an appropriate definition or concept of the world money supply and the means of measuring it, more complicated than controlling a national component of it.

V. Gold Versus a New World Currency

It was the genius of natural selection that led to the adoption of standards based on the precious metals in earlier times. The silver standards of the past, and the gold standards of the 19th and 20th centuries resulted in a growth of the money supplies of countries on gold or silver standards more or less in proportion to the output of these metals. World monetary growth was thus limited by the growth of the precious metals, and gold price levels were fairly stable over the long-run, with secular periods of slow deflation being followed by periods of slow inflation. The major variations from price level stability in the 19th century occurred when countries went off the gold or silver standards creating global changes in world demand for and supply of the two metals.

The gold standard of the 19th century, especially after 1870, was more or less centered in London, which had become the principal capital market in the world economy. But London gradually lost its dominance to New

York as the U.S. emerged in the 20th century as a supereconomy and the U.S. dollar became the principal currency of account and settlements. The gold standard ratified at Bretton Woods built upon the Tripartite Agreement of 1936 and was based on the dollar. When after a quarter of a century the dollar became inconvertible in 1971, and the price of gold in the free market rose, the world economy was left without an effective world currency. Both gold and dollars were weaker in isolation that they were when they complemented each other. Gold was no longer actively traded among central banks and was unusable as an active reserve; the SDR became a miniscule proportion of international reserves; and the dollar was subject to the whims of the Federal Reserve ~~System.~~ Board.

The problem with controlling the world money supply today, and thus with monetary stability, lies in controlling the value of international reserves. These are composed principally of dollars and gold, although other currencies are also held in central bank portfolios. The main variation of reserves is due to the volatile gyrations in the price of gold, and to a much lesser extent in the growth of foreign exchange reserves. No effort to reduce the fluctuations in the value of reserves can succeed without reducing the instability of the price of gold, and letting the consequences of intervention in the gold market to be felt by the banking system without being offset by countervailing movements of Federal Reserve policy.

Thus, had the Treasury sold gold between 1979 and early 1980 when the price of gold was shooting up from $200 to over $800, the growth of the reserve base of the U.S. money supply would have been smaller and inflation would not have shot up to over 15 percent. And when the price of gold fell to under $300 in 1982, Treasury purchases of gold could have offset some of the overly tight monetary policy which contributed to the overkilling of inflationary expectations in that period. A better balance of policies could also have been achieved had the price of gold not been allowed to shoot up by more than \$200 an ounce between July 1982 and January 1983, and then fall back to about \$400.

Stabilization of the price of gold is not an end in itself, but rather, it is a means toward achieving a better monetary policy. It would also reduce the damaging fluctuations in the level of international reserves that have created global economic instability.

Neither gold alone nor dollars alone can be the foundation of a stable and effective international monetary system today. Both are needed for different reasons. There is no feasible substitute for gold at the present time as an abode of value for central banks and the fact that they now hold almost 1 billion ounces of the metal--perhaps 30 years supply of gold from the mines--makes it compulsory to harness its usefulness in improving global monetary performance. Nor is there a feasible substitute for dollars at the present time as a unit of account, vehicle currency, and operational means of settlement. But gold and dollars are more than twice as good when they work together than they are when they work at cross purposes. If the dollar price of gold were stabilized, the world's monetary problems would fall into place and become manageable.

The problems would not entirely disappear. Change is inevitable and problems are transformed rather than solved. The international monetary reforms that were enacted in the First and Second Amendments to the Articles of Agreement of the International Monetary Fund testify to the need for a response to some of the problems of the gold exchange standard. The First Amendment established the SDR, the embryo of a world ink or electronic currency. It took several years to negotiate among the major nations and there is no reason why we should not build upon the new base rather than start again, throwing away the fruit of hard work invested by the pioneers of that development. For cosmetic reasons alone an SDR is a useful facility. Respect for national sovereignties suggest that a gold-dollar system should evolve into a gold-SDR system with the dollar being utilized as the principal, but not the sole, link between SDRs, gold, and the markets for other currencies. From a purely formal or de jure standpoint it is the SDR value of gold that should be stabilized, while the dollar is stabilized to the SDR, like other currencies. But it might take too long to rebuild confidence in the SDR whose definition has shifted from a quasi-reserve-asset with a gold-weight guarantee to a basket of sixteen currencies to a basket of five currencies. If the dollar were made convertible into such a flaky drawing right, the economic gains from a gold convertible dollar would be lost. It might instead be better to reverse the procedure and make the SDR convertible into the dollar for purposes of those countries in which an SDR standard is more suitable.

VI. Benefits from a Gold-Stable Dollar

The interchangeability of the dollar into gold would go far toward reviving confidence in it and thus restore the credit of the U.S., as measured by the rate of interest on government debt. Confidence in a gold-convertible dollar would greatly increase the global demand for government bonds and lower interest rates to the level typical of gold standards, i.e., to 6 percent or less. The same holds for all securities fixed in relation to the dollar. The general fall in dollar interest rates--both nominal and real--would lower interest rates all over the world. A solid basis for recovery from the Great World Recession would be established.

Other countries would likewise benefit from the monetary reform. The other powers should be an integral part of the reform because they hold the bulk of their reserves in gold and dollars, and account for half of all gold held. Any change in their portfolios of gold and dollars would have an effect upon the U.S. The U.S. would not want to buy up the entire stock of monetary gold in the world any more than the U.S. would want to sell all its monetary gold depleting its impressive current stockpile of 264 million ounces. The major gold holders are as follows:

U.S.	264.0	million ounces
Germany	95.2	" "
Switzerland	83.3	" "
France	81.9	" "
Italy	66.7	" "
Netherlands	43.9	" "
Belgium	34.2	" "
Japan	24.2	" "
Portugal	22.2	" "
Austria	21.1	" "
U.K.	19.0	" "
Canada	20.3	" "
Spain	14.6	" "
Venezuela	11.5	" "
All Countries	949.1	" "

In addition to this country total we have to take account of the institutions. The IMF had 103.0 million and the EMCF (European Monetary Cooperation Fund) had about 85.7 million ounces at the end of 1982. The world total (excluding non-members of the IMF) was 1137.7 million ounces. Solid estimates of Soviet-held gold stocks are hard to find but are probably less than 50 million ounces.

With the fall in interest rates there would be a great drop in the servicing costs of the third-world debt and less chance of bankruptcy. The service costs of the U.S. public debt would likewise go down, reducing the budget deficit. Other nations would find it worthwhile to establish dollar-gold parities in order to lower their interest rates to the U.S. level and stimulate their own economic recoveries from the recession. The prices of internationally-traded commodities would no longer bounce up and down. In short, the five major problems outlined at the beginning of the paper would find a natural solution.

VII. Some Objections and Some Answers

An objection to a gold stabilization arrangement has been made along the following lines. There are some who argue that because the gold standard or the gold exchange standard broke down in the past it is bound to break down again. The logic of the arguement is not convincing; by the same logic one could argue that the gold standard developed in the past and so will be developed again, or that because there was a war in the past there will be a war again. Without denying patterns in history, we should recognize that the present opportunity for establishing a new gold-based dollar standard is unique. The world is now in a state of comparative peace; the "Opec decade" is over; there is some semblance of balance-of-power equilibrium; there is the challenge to devise a facility for handling third world debts; inflation has subsided; there are a billion ounces of unutilized gold in the hands of central bankers; there is growing disenchantment with floating exchange rate monetarism; there is a reluctance to return to the massive government spending policies of the early Keynesians; and there is an understood need for low interest rates now and later in the recovery if and when it gets under way. After the three great recessions of 1970-2, 1974-6 and 1980-83, after each of which we emerged with higher inflation and higher unemployment, the public will be willing to endorse a new social experiment in conservative finance, especially one that enjoyed such a high reputation in the past. To return to gold standard expectations and interest rates is a long-sought consummation of a generation of international monetary reformers.

There are additional reasons why a new gold standard system combined with fixed exchange rates could be successful today even though it broke down in the past. Increasingly, scholars have come to understand that the gold standard mechanism broke down when its principles had been violated by the overriding exigencies of world war. After the outbreak of World War I most countries went off the gold standard and gold drifted to the United States where it was centralized and embargoed as a war measure; inflationary wartime finance led to a doubling of the dollar price level which persisted long after the war. When European countries returned to the gold standard some of the gold reserves had to be shifted to Europe, creating a tightness in money growth that nipped the speculative Wall Street boom and culminated in the deflation of 1930-33. The gold standard did not cause the Great Depression. The latter was the reaction to World War I inflation.

When the new gold standard was restored in 1934 at a price almost 75 percent above the old price of $20.67 an ounce, overvalued gold and stability of the dollar combined to keep interest rates below 4 percent for about 15 years. But the World War II inflation gradually eliminated the excess gold reserves held by the U.S., and the Korean War inflation made gold again on a par with the dollar. The dollar shortage gave way to a gold shortage. The gold standard broke down during the Vietnam War at a time when gold was repressed below its market equilibrium. For gold to be used as a money its price has to be above, not below, its value as a commodity.

It is possible to imagine a possibility in which, following a new gold standard based on a higher price of gold than before, a new world war broke out involving inflationary finance on a scale sufficient to again undervalue gold. Monetary systems cannot generally be made warproof, and a gold standard is no exception. But this is an argument against war, not against the gold standard.

Another objection to a gold standard is that to maintain it in operation over time it is not enough to stabilize the price of gold. Monetary discipline based on gold has to be developed in order to keep the dollar convertible into gold. When the U.S. buys gold it should not fully offset the monetary effect of this purchase on bank reserves, and when it sells gold it should not buy an equal quantity of bonds to sterilize the gold imports. Intervention in the gold market should supplement, refine, and improve monetary policy. This is perfectly correct, but it is an advantage, not a disadvantage of the gold standard. Gold purchases and sales at the lower and upper buying and selling points are signals of possible errors in Federal Reserve policy. The gold standard mechanism is an information apparatus that automatically offsets monetary errors of the central bank, and the open market committee; it acts as an intelligent shadow open market committee. The error signals are warning devices that should be paid heed to, not ignored. The only case for sterilizing or neutralizing the monetary effects of gold sales and purchases would be if sudden changes in demand or supply were brought about by the action of an enemy to weaken the system.

A further argument made against the gold standard system combined with fixed exchange rates is that if countries were to maintain fixed exchanged rates and at least one currency, the dollar, were stabilized in terms of gold, central banks would have to buy foreign exchange when their currencies were appreciating or when they had surpluses in their balances of payments, and sell foreign exchange when their currencies were depreciating or they had deficits in their balances of payments. Similarly, the U.S. (and perhaps the European Monetary Bloc) would have to sell gold when the U.S. had a deficit and buy gold when it had a surplus resisting both inflationary pressures on the one hand and deflationary pressures on the other.

Now--it is admitted--this is a very sensible stabilization policy for central banks since it leads to monetary equilibrium without inflation or deflation. But--it is now argued--if central banks would act in this way who needs the gold standard? This relevant question has been asked by Dr. Edward M. Bernstein and others.

There are two answers to this important question. One is that if the gold standard makes central banks behave sensibly it should not be scorned on that account. At worst it could be charged with being redundant. It is true that a monetary system when operating at the peak of its efficiency is scarcely noticeable. Economists like Alfred Marshall, Keynes's teacher, who grew up during the gold standard paid little attention to currency theory and even dismissed it as unimportant:

> I am never weary of preaching in the wilderness (that) the only very important thing to be said about currency is that it is not nearly as important as it looks. (A. Marshall, 1899)

Such a statement could not have been made after 1914.

But it is a mistake to think that a gold standard or gold exchange standard is redundant if central bankers are taught to follow its leadership in guiding monetary policy. After the failure of flexible-exchange-rate monetarism in October 1982, the Federal Reserve System was left high and dry without a guideline for its policy. Stabilization of gold focuses attention on the appropriate direction for Fed policy. The gold standard is not redundant just because the Fed heeds the information of the gold market any more than a treaty is redundant because signatories adhere to its clauses, or a marriage is redundant because parties abide by its mores.

Intervention in the gold market is a means by which the signal is acted upon. In the absence of gold market intervention (by the Treasury) the Fed should certainly be tightening its monetary policy before gold reaches, say, \$600 and easing monetary policy before it falls below \$300. These are wide outside limits that represent danger signals, and they could be narrowed substantially. Intervention in the gold market by the Treasury could put the policy in much sharper focus in case the Treasury disagreed with the Federal Reserve Board of Governors by imposing, say a \$350 to \$550 trading range at the start and gradually narrowing this range as it got the feel of the market. These are questions that should be worked out in collaboration with the Federal Reserve as well as U.S. trading partners.

It would be desirable if the European countries stabilized the trading range of the ECU in terms of gold, possibly through purchases and sales of gold for ECU currencies by the EMCF; and similarly by the IMF for SDR currencies. There is no doubt about the ability of the U.S. Treasury, the EMCF and the IMF to control the price bearing in mind that these three agencies alone have 452 million ounces of gold, equivalent perhaps to 15 years annual production. When the gold holdings of the countries represented by the ECU are taken into account the available gold available for buffer stock purchases and sales represent over 90 percent of the world's monetary gold. Switzerland might also be interested in participating in the International Gold Pool.

There are two further objections raised against a Gold Stabilization Agreement. One is that there is not enough gold in the hands of official institutions; the other is that there is too much! These objections (which are often raised by the same high official or economist at the same time) cancel one another out.

Nevertheless it is a serious question whether there is either too little gold or too much gold. It is argued, for example, that there are perhaps four or five trillion dollars worth of dollar debts or assets outstanding and that these could not possibly be converted into gold all at once at existing or any feasible gold prices. One could go further and say that our planet is worth about $100 trillion dollars and that there would not be enough gold to buy it.

Good!

The other objection is that there is too much gold around, if we add to the 1.1 billion ounces of monetary gold in central banks and international institutions another half trillion or more in gold hoards, and a few trillion ounces unmined beneath the world's surface. If the authorities create a new international gold pool to stabilize the price is it not possible that the pool would run the risk of having to buy up a substantial fraction of hoarded gold? Once the expectations of gold price rising to the stratesphere are scotched by the concerted weight of overhanging official gold stocks would there not be a gold scare unmatched since 1937?

Thus it would seem that on the one hand there is a hopeless shortage of gold to cope with the potential demand for gold conversions against debts, whereas on the other hand there is an impossible redundancy of the yellow metal which could not possibly be absorbed by the authorities or in the public's appetite for gold coins. The bulls and the bears will have to sort it out!

VIII. Conclusions

The basic problem of the world economy at the present time is the recession and the cost it imposes in sacrifice of potential purchasing power. The problem is to manage the recovery without accelerating world inflation and allowing interest rates to climb so high that the boom will be aborted before full employment is reached. The solution requires that interest rates be kept down by measures that reawaken confidence in long-term monetary policy. The experiment with flexible-exchange-rate monetarism has been a failure and reviving it by a new set of monetarist rules will only end once more in defeat. It is time to cut our losses with flexible-exchange-rate monetarism and go back to the internationalist approach to dealing with inflation that was successful in the heyday of gold and Bretton Woods. That approach involves readoption of a system of exchange rate parities by convertibility of a major currency or collective reserve asset into gold. If the dollar is stabilized in terms of gold, the other countries should fix their exchange rates to the dollar using the balance of payments as the guide to appropriate monetary policy. For its part the United States should commit its monetary policy to stabilization of the price of gold.

It is possible to integrate this framework with an institutional improvement in the system starting with an International Gold Pool that includes the U.S. and leading members of the IMF, possibly acting in coordination with the IMF itself, which could agree to stabilize the SDR also in terms of gold. The EMCF, may also wish to stabilize the Ecu to gold or the dollar. An agreement in principle on these lines could be initiated at the Williamsburg Summit, discussed among Central Bankers at the Annual Basle meeting of the BIS in June, and proposed through the Interim Committee of the IMF. By the end of the summer the approach should be advanced explicitly for consideration at the Washington meeting of the Board of Governors of the IMF and/or the IBRD. Prior to that meeting, which will occur in September 1983, the major countries could work informally together on intervention policies in order to lay the practical groundwork necessary for specific proposals by September.

The long-run debt crisis would be ameliorated by a recovery and even more by the stabilization of exchange rates with the consequent fall in interest rates to levels appropriate to the new gold exchange standard. But steps should be taken toward a World Central Bank that would integrate the activities of the IMF, IBRD, and subsidiary banks and deal with the new wider issue of bank solvency and debt repayment. It is time to prepare the groundwork for an imaginative solution involving a world central bank that acts as an ultimate lender of last resort and has at its command the resources to cope with the problems of a growing debt problem of third world countries. A central bank with assets of about $1 trillion will be necessary. In order to integrate this new institution with those already existing the meetings at Williamsburg in May, at Basle of BIS in June, of the Interim Committee and the IMF in September, should start the process toward a plenary congress of the nations dealing with the new institutions necessary to stabilize the economic milieu, consolidate the gains of the past decades, and prepare for the broader challenges of the future.

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Chron

MEMORANDUM

NATIONAL SECURITY COUNCIL

~~CONFIDENTIAL~~

April 5, 1983

INFORMATION

MEMORANDUM FOR HENRY NAU

FROM: NORMAN A. BAILEY NB

SUBJECT: April 5 Summit Planning Meeting

Since I will have to attend a USJEWG meeting at 4:00 p.m. I will not be able to come to the 3:30 summit meeting. I would make the following comments on the papers you circulated:

-- The domestic policy/monetary stability question is a false dichotomy. The Bretton Woods monetary system fell apart because the United States, issuer of the exchange part of what was a gold-exchange standard made the conscious political decision under Johnson to finance the Vietnam War and the Great Society by debasing the currency. It need not have been done that way, as evidenced by the fact that the U.S. maintained gold convertibility throughout the second world war which was the only major war in recent history financed (by us) in a non-inflationary fashion. Now that the resulting inflationary spiral is being wound down here, we can move back to something like Bretton Woods. It does not require that all major countries do the same, only the country issuing the linchpin currency. Even the EMS, which doesn't have a linchpin currency, is doing (imperfectly) what it is supposed to do -- namely force appropriate domestic adjustment, as the French are trying to do.

What I conclude from the above is that the most important contribution the U.S. can make at Williamsburg is to take advantage of the present window of opportunity to propose a recreation of the Bretton Woods system through the convening of an international conference.

-- I disagree with the State position that OHT is a bottom-line item on East-West. On the contrary it is a giveaway item. I mean this literally. To continue to insist on it jeopardizes much more important agreements.

cc: R. Robinson
C. Tyson
D. Blair
D. Fortier
W. Martin

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National Security Council
The White House

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John Poindexter	1	P	I
Bud McFarlane	4	M	
Jacque Hill	2	✓	
Judge Clark	3	✓	I
John Poindexter			
Staff Secretary			
Sit Room			

I-Information A-Action R-Retain D-Dispatch N-No further Action

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cc: VP Meese Baker Deaver Other________

COMMENTS