essence of his prepared statement. After Mr. Mundell's presentation, I think the most useful way to proceed would be for any and all members of the panel to be heard from on the general, "Where do we go from here," subject matter.

Mr. Mundell, will you begin, please?

(The prepared statement of Mr. Mundell follows:)

PREPARED STATEMENT OF PROFESSOR ROBERT A. MUNDELL, THE UNIVERSITY OF CHICAGO

Mr. Chairman, the successful operation of the gold exchange standard requires a specific set of monetary and fiscal policy "rules of the game" in both the key currency ("inner") country and the non-reserve ("outer") countries. At the heart of the system lies the role of the size and composition of the deficit of the inner country.

The outer countries peg their currencies (directly or indirectly) to the inner country's currency (the dollar) and thus act as residual purchasers or sellers of dollars, while the inner country (the U.S.) pegs the dollar to the ultimate asset (gold), and thus acts as the residual buyer or seller of *gold*. This means that the *size* of the U.S. deficit determines the increase in reserves of the rest of the world, while its *composition* determines the change in reserves of the U.S., given the rate of increase of monetary gold holdings in the world.

When U.S. monetary policy is very expansive the outer countries have to buy up large amounts of dollars and this has direct and indirect *inflationary* consequences for the outer countries; similarly, when U.S. monetary policy is restrictive there is a scarcity of dollars and this has deflationary consequences for the rest of the world.

The outer countries' protection against an excessive or deficient flow of dollars is to alter the *composition* of the U.S. deficit and thus affect the reserve position of the U.S. When U.S. monetary policy is excessively expansive the outer countries can convert dollars into gold; this leaves the aggregate level of their own reserves unchanged, but it destroys world reserves because it reduces U.S. reserves. And similarly, when U.S. policy is unduly restrictive, the outer countries can convert gold into dollars, leaving their own reserves unchanged, but *improving* the reserve position of the U.S. The *composition* of the U.S. deficit, which is under the control of the outer countries, is the mechanism by which the outer countries, in their role as governors of the gold exchange standard system, cast their votes with respect to the appropriateness or inappropriateness of the aggregate size of the U.S. deficit.

The *vigor* with which the votes are cast, however, is circumscribed by the attachment of the inner and outer countries alike to the existing system. The outer countries can *warn* the U.S. by gold conversions, but they cannot lower the U.S. gold stock below the point at which it no longer pays the U.S. to continue running it; overly aggressive conversions would reinforce the go-it-alone forces in the U.S. represented by Professors Despres, Kindleberger and Salant. On the other hand, the U.S. freedom of action is also circumscribed in the sense that U.S. monetary policy must not be so inimical to the interests of the rest of the world that the outer countries decide, in their own protection, to opt out of the system by abandoning the dollar for gold.

This is the system as it is supposed to operate. But within these constraints monetary and fiscal policies have to be carefully coordinated as both the U.S. and the outer countries try to preserve internal balance (full employment without inflation) and external equilibrium (reserves increasing at the rate countries desire them to increase). The correct set of policies to achieve these goals, under fixed exchange rates, is for the authorities to run a budget surplus when there is inflation and a budget deficit when there is unemployment; and to have easy money when there is an "excessive" balance of payments surplus and tight money when there is an "excessive" balance of payments deficit.

There are definite criteria that can be applied to determine whether the deficit is "excessive". When the U.S. and Europe both have high unemployment the U.S. deficit should be large to encourage fiscal and monetary expansion in Europe as well as the U.S., while the Europeans should be willing to part with gold to free the U.S. from concern over its gold constraint. On the other hand, when the U.S. and Europe both experience inflationary pressures, the U.S. deficit should be small to encourage contraction in Europe as well as in the U.S., while Europe