of growth in Western Europe and tight money cum inflation here might curtail capital outflow more than it reduces our export surplus.

Chairman REUSS. Mr. Mundell?

Mr. MUNDELL. Well, there are many issues running around.

Chairman REUSS. Pick those that attract you the most.

Mr. MUNDELL. I can just grab three of them. One concerns the way in which the system is supposed to work. I want to pick up the point that Professor Despres made. I think he greatly underestimates the gravity of the current situation, and he underestimates the threat to the price of gold in it.

If the U.S. dollar were the sole international reserve asset, then there would be no gold problem, of course. The United States could follow its own monetary policy and other countries would keep their exchange rates pegged to the dollar. They would have to inflate when we do, have a depression when we have one, and so on. So that if there were no gold question, monetary policy of the world would be completely determined by the Federal Reserve System, the central bank of the United States.

Now, if we decided to inflate at, say, 5 percent a year, the world would inflate at a rate of more or less 5 percent a year also, and so on. The key element in the present system is that the gold tie represents a protection that Europeans have against excessively bad policies on the part of the United States. If the United States is depressed, and the authorities respond by expanding, the Europeans have to exercise great caution in converting dollars into gold, because they have to recognize that the stability of the U.S. economy is vital for the stability of the world.

But if the U.S. policy is excessively inflationary even in U.S. interests, as well as their own, Europeans have every right to warn the United States that the policy that the United States is following gives them grave difficulties then. Accordingly, they convert dollars into gold.

Now if they convert dollars into gold at an excessive rate, this will bring about a collapse of the system. What Professors Despres and Kindleberger and Salant have urged is that if they detonate a collapse of the system in this way we will just have to go along, continue with a policy for domestic stability, and let the rest of the world adjust.

Up until 1964 the United States had a very good case, and a very good reason to be angry at France and the European countries. Since that period they have not had a good reason to be angry. Other countries are simply taking more of their surpluses out in the form of gold now to warn the United States that our policy has been too expansionary.

September and October 1966 is, I think, a transitional period in the world economy. We have built into the system the mistakes of the past policies of the United States, which have, I think, been too expansive. Likewise Europe failed to raise taxes when they should have, bringing on an enormous squeeze in European capital markets.

Professor Despres said that any country with a good credit standing can always get credit. But interest rates on state bonds are 10 percent in Germany; they were 6 percent 2 years ago. This is a sympton of a fantastic credit squeeze that has been partly caused by the anticipations of inflation that have in turn had their roots in the U.S. balance-of-payments deficit.