

But there were other factors involved. The U.S. deficit has its counterpart in foreign surpluses. Foreign countries, with the possible exception of Germany, *wanted* surpluses and pursued policies to obtain them. As long as their policies succeeded the U.S. could not correct the balance of payments deficit no matter what actions were taken. If U.S. monetary policy tightened, foreign monetary policies would tighten to protect their surpluses. It was becoming increasingly clear that the effect of U.S. monetary policy was *not* to correct the U.S. balance of payments, but to affect monetary policy all over the world.

Shades of the sterling standard. Recent studies had recognized that the credit policy of the Bank of England in the nineteenth century did not operate as the Cunliffe Committee report asserted it would, and that it was not a matter of deflating when there was a deficit, and inflating when there was a surplus. Gold flows were rather directed toward Britain when there was a boom and away from Britain when there was a recession; and the policy of the Bank of England exerted its influence primarily on the money markets throughout the world. The new view of the nineteenth century gold standard is a system dominated by sterling; and that domination was essential to the smooth operation of the system.

#### IV. THE NEW VIEW OF THE SYSTEM

This reinterpretation was of enormous importance, for if it applied to Britain in the nineteenth century, why should it not apply to the U.S., the country that had replaced Britain as the center of the system, in the post-1945 system. If true it meant that American financial policy, instead of worrying about its gold stock or its balance of payments, over which *other countries* have primary control, should be addressed to the need for non-inflationary, non-recessive pressures in the world as a whole. The world, or at least the Atlantic countries, should be looked at as a single monetary system, and the U.S. Federal Reserve authorities should, in short, act as if it were the world central bank that it was in fact becoming.

The U.S. deficit then acquired a quite different interpretation. It is not something to be corrected; it is rather a variable that determines the rate of expansion of foreign-held world money. Dollars are the world money and they are held both by U.S. residents and by foreigners. The dollar supply then should be increased or reduced according to whether it is desirable to introduce monetary ease or tightness in the world economy. The deficit is merely that part of U.S. monetary expansion that the rest of the world uses to add to its reserves.

How large the deficit is is not within the control of the U.S. The U.S. authorities determine the rate at which monetary liabilities of the Federal Reserve expand, but not that fraction of it that is taken up by central banks and commercial banks in the rest of the world.

Let us check this interpretation against the facts to see to what extent the U.S. was fulfilling the duties thrust upon her. In 1966 the world economy was inflating excessively. The Federal Reserve stepped on the brakes and reduced the rate of expansion of world money.

By December, 1966, weaknesses had appeared in the world economy, and the Fed reversed its tight money policy. This reversal, while harmful to the U.S. balance of payments, was needed because the three largest economies, the U.S., the U.K. and Germany, showed signs of recessive tendencies, while France, whose current account balance had become unfavorable, was beginning to contract. Monetary ease was, therefore, the appropriate policy for the world economy and the Federal Reserve authorities "obliged." The system, by 1967, was now beginning, perhaps for the first time, to work well, looking at it in this new light. The Federal Reserve authorities showed signs, by their actions if not their words, that they were reacting to the signals.

For the monetary mechanism can, indeed, be looked on as an information system, supplying signals for policies. The signals from abroad came from the gold conversions. When a European country converts dollars into gold it is telling the U.S. "It is in our interest if you contract." And when they convert gold into dollars, as France did last month, they are saying, "It is in our interest if you expand."

Of course central bankers have not exactly looked upon the system in just this way. Their gold-dollar policies may appear to be motivated by entirely different considerations. Each central bank may be acting in its own selfish interest, while still fulfilling the hidden designs of the world system. They are, of course, not so hard to see as Adam Smith's invisible hand; it is more like Ariadne's thread!

What concerns us, however, is the transition from one system to another and