

A MONEY STANDARD FOR THE TRANSITION TO
A MARKET-ORIENTED SOCIAL ECONOMY

The Key Questions with Responses by
Governor Wayne D. Angell, Member,
Board of Governors of the
Federal Reserve System

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Q. Mr. Angell, here in the Soviet Union you are known not only as a Federal Reserve Governor, but also as an economist, author of papers on monetary policy and payments systems, as well as your recent paper on the transition from centralized planning to a market-oriented economy. The transition problems for the U.S.S.R., as you have probably realized during your stay in Moscow, are most acute at the present stage of the economic reform in our country. Now we are seeking optimum ways of economic renewal.

In this connection our readers would be interested to know the opinion of a man "with a fresh view" of the present state of the Soviet economy and possible ways of its market reorientation. What in your opinion is necessary to cure the ills of the Soviet economy, to put it "on new rails"?

A. You cannot address the apparent ills of the Soviet economy without first introducing a monetary standard of value. I believe the first thing your government should do is define your monetary unit of account, the rouble, in terms of a fixed weight of gold, and make it convertible at that weight to Soviet citizens, as well as to the rest of the world.

Q. A gold-convertible rouble is a most unusual proposal. We have heard convertibility proposed as an eventual goal but not as a first step. Why do you think it should be done first?

A. Your perestroika reforms face many difficult adjustment problems as you move toward market-oriented socialism. These become impossible problems without a monetary standard of value, that is recognized as having predictable value throughout the Soviet Union--and the rest of the world--now and in the future. Having such a standard for your money would ease the difficulties of all your adjustment problems.

Q. Do you mean perestroika cannot succeed without a gold-convertible rouble?

A. Some believe it might succeed with a mark, yen, or dollar-convertible rouble, but they realize it would take many years for the Gosbank to obtain central bank powers and credibility to enable the rouble to trade as a hard currency. Yes, it is my belief that without an honest money, Soviet citizens cannot be expected to respond to the reforms as they do not have a meaningful incentive. A gold-backed rouble would be seen as an honest money at home and would immediately trade as a convertible currency internationally. Indeed, I have offered a prediction to several officials of the Soviet Government that on the present slow course, the reforms run a very high risk of being set back by a general collapse of confidence in the rouble--an inflationary disintegration.

Q. Why is that?

A. As long as the Soviet economy was completely controlled at the center, the absence of a real money merely caused a gradual decline in efficiency of your economy relative to the western market economies. Now that you have decided to move toward growth and competitiveness with the West, opening up market opportunities through cooperatives and other market-oriented initiatives, your system has been divided in half. One still relies on wage and price controls and a state budget allocation system in roubles, the other unleashes individual incentives and is dominated by an attempt to obtain hard currencies, especially the dollar.

Q. How does this effect the confidence of the rouble?

A. The two systems compete and the market system every day wins new followers because it is more efficient. So each day the rouble system loses a fragment of its utility. The Soviet government, meanwhile, further subsidizes the rouble system by increasing the budget deficit. The budget deficit is funded by issuing more rouble bank notes and accounts. Thus, even as demand for the rouble declines, the supply increases. Where you had been deteriorating at an arithmetic pace, you are on the verge of deteriorating at a geometric pace.

Q. If this is true, inflation will accelerate?

A. Exactly. I have advised officials of your Gosbank of my analysis--that unless something is done quickly, the Soviet economy will face increasing difficulties.

Q. Why do you say a gold standard for the U.S.S.R. is called for? No other country is now on such a convertible standard.

A. The western economies have at least a history of gold convertibility which enabled their currency to start with a base value as they abandoned the Bretton Woods System in 1971. So, the Soviet people can gain if their government issues an understandable monetary unit of value based on gold. Besides, your State Bank does not have the power or authority to limit the growth of bank notes or rouble accounts so as to stabilize the rouble's value. Even if it were to get that authority from the government, it is not likely to have the independence to use it. In any case, it would be a "second-best" solution even if the Gosbank did have the power and independence to refuse to finance the state budget with more printed roubles. It would be second best because Soviet citizens and world markets would have doubts which would necessarily require a large interest rate premium.

- Q. Why do you, a central banker in a country that has demonetized gold, select gold in advising the U.S.S.R.?
- A. For one thing, I believe gold and other commodity price signals have become much more important to U.S. policymaking in recent years, as we have experienced inflation pains under a floating exchange rate system. Gold, after all, remains the most monetary of all commodities, therefore is the best single conveyor of information as to the appropriate scarcity of money. Secondly, a single commodity with the universal monetary role of gold is much more simple than attempting to explain a properly weighted commodity price index base. Thirdly, the U.S.S.R. has vast gold monetary reserves it is not now using effectively. Your government is one of the largest holders of gold bullion in the world, which would give it great power to establish the credibility of such a policy. Also, the Soviet Union is second in the world in gold production and may have the potential to match South Africa production. This means that the Soviet Union has the ability to smooth out instability in world gold supplies.
- Q. Wouldn't you fear these reserves would be stripped from the government as Soviet citizens sought to convert surplus roubles into gold?

A. That depends entirely on two questions that the government could easily answer. The first is the rouble/gold exchange rate that the government would announce it would accommodate and defend with its resources. It cannot be too low or reserves will spill out. It cannot be too high or it will force additional inflation on the society, robbing Soviet savers of roubles of the rewards of their past labors. The second is the willingness of the U.S.S.R. to commit itself to the discipline of confining government deficits to the level limited by the gold payments of principal and interest required of the gold bonds. You cannot go on a gold standard, then continue to fund unlimited budget deficits with State Bank money creation.

Q. How do you then arrive at the correct exchange rate?

A. This is both an engineering question and a policy-choice question, not one of basic architecture in design of the system. The rouble exchange rate of 65 kopeks to the dollar is clearly too low given the experience of all Soviet citizens with the "street rate" of 10 or more roubles to the dollar. World ratios of gold/commodity prices and gold price/quality of labor adjusted wage rates can provide clues as to a price-level stabilization rate.

Q. What is your thinking, as one such expert?

A. I believe the optimum price--one that achieves a balance between rouble debtors and rouble creditors--is probably somewhere halfway between the official rate and the black market rate. My suggestion is that the government officials observe the gold market within the Soviet Union for a starting point in answering this question. My own limited inquiries suggest that speculators may have fixed on 45 to 47 roubles per gold gram, which implies 1450 roubles per ounce, which would currently be equivalent to a dollar exchange rate around 4 roubles per dollar.

Q. If you were setting the rate, is this where you would set it?

A. If I were forced to do it without further study, to do it quickly, that would be a starting point. But it would be a starting point which would let the potential inflation from the large rouble overhang show through. My tendency is to think that a rate lower than the present gold market rate, perhaps two roubles or three roubles per dollar, would be more appropriate for purposes of fairness to savers, who have accumulated perhaps over 300 billion roubles of savings by now.

Q. Could you guarantee that by introducing rouble convertibility the U.S.S.R. gold reserves would not flow out of the country?

A. All gold reserves will not flow out of the country or flow into hoards held by Soviet citizens provided that the State Bank not accommodate the government budget deficit. This means that the current domestic deficit must be financed with bonds, which of course become readily marketable in Moscow, Leningrad, New York, and London if the bonds carry the promise to pay principal and interest in gold. Indeed, I would expect the Soviet Union could step to the front of the line in seeking credit at the lowest possible interest rate. I would bet such bonds would be snapped up around 3 percent, which would be the lowest governmental interest rate on earth, including Japan's. As markets gain experience with Soviet gold backed bonds, interest on the bonds could be expected to decline, perhaps approaching 2 percent, the going rate for U.S. gold mining company gold bonds.

Q. What interest rate would Soviet bonds need if the Gosbank had an independent monetary power similar to the Federal Reserve?

A. The exercise of such independent monetary power would require years to gain credibility. In the meantime, Soviet

bonds would require an inflation offsetting premium and an uncertainty premium of perhaps 4 to 6 percent over that of gold bonds. For instance, if Soviet inflation is currently at 10 percent, then the expected interest rate would be initially around 18 percent. If the inflation rate is higher, then it would take proportionally higher interest rates to stabilize the rate of inflation. But, most importantly, the State Bank cannot exercise monetary power without instruments. Unfortunately, in the current economic circumstances of the U.S.S.R. you cannot meaningfully legislate into existence a commercial banking system with reserve requirements or a government bond market in which the central bank can exercise the power of open market operations.

Q. Other experts in the West advise that the Soviet Union cannot move to rouble convertibility unless there are more consumer goods in our stores, to "mop-up" the surplus rouble overhang. Does not this concern you?

A. My point is that in a modern industrial economy consumer goods will not be produced unless there is a predictable monetary value reward. Once the government of the U.S.S.R. announces that it will maintain the rouble's gold value with its considerable resources, demand for the rouble will climb. Soviet citizens and others around the world will

want to acquire roubles--not get rid of them. The only way to acquire roubles is to work to get them or, as foreigners, exchange foreign work income for them in the form of foreign exchange. Undoubtedly over time there would be a reserve currency demand for the gold rouble, particularly among countries with close economic and political ties to the U.S.S.R.

- Q. How soon do you think it would be before we would see palpable benefits from your plan?
- A. My guess is that the simple announcement would generate instant enthusiasm, a feeling of well-being, among the citizens of the U.S.S.R. The tension between the rouble system and the street dollar system would shift to the rouble system. Street speculation would disappear overnight and the so-called rouble "overhang" would be willingly held in deposits by Soviet citizens.
- Q. This sounds very optimistic. Would this be all you think is required to assure the success of perestroika?
- A. Not at all. There are important, critical questions of implementing market-oriented reforms leading to the role of prices in allocating resources and providing incentives and of tax policies that will have to be set right as well. But I advise that your government establish a monetary standard,

so that you will be less likely to make unnecessary and costly errors on these other important decisions. Without a hard rouble, Soviet planners and economic agents are denied an opportunity to ascertain real economic forces. To restructure without a monetary standard of value loses once and for all this enormous opportunity to reap timely rewards by harnessing market forces to accomplish your goals.