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MEMORANDUM FROM GOTTFRIED HABERLER

Please find enclosed a slightly changed version of the introduction. Some of us felt that the first paragraph in the earlier version might give a wrong impression. It was therefore put at the end together with a qualifying sentence which was not contained in the first version.

In addition, some slight stylistic changes have been made.

The new version has been submitted to Mr. Greenspan.

There is also enclosed a correction in Part II.

INTRODUCTION AND SUMMARY

Our balance of payments position is much more precarious than is indicated by the official statistics. Basically it has worsened and not improved since January 1968. Assuming that there is no crisis before January 20, the new administration will have to face a fundamental decision. It will have to decide whether it wishes to make a major change in our international monetary relations soon after it takes over, or whether it will make such a change only if and when the present system will have become clearly unworkable. It can suspend convertibility of the dollar within a few weeks of assuming office, throwing the responsibility upon its predecessor. Or it can maintain convertibility at the present price of gold accepting the economic and political constraints of doing so, with the risk of having to suspend anyhow some time later, presumably in the midst of a crisis which would have developed under the new administration.

If a crisis should break out before January 20, it would be highly desirable to suspend the convertibility of the dollar into gold before our gold stock declines much below 10 billions; but only President Johnson could do that, and the President-elect could only bring his influence to bear in this direction.

Domestic inflation has been excessive and must clearly be brought under control. Most of the members of this study group doubt, however, that disinflationary monetary and fiscal policies alone will be sufficient to hold the international value of the dollar without permanent controls and threats of crisis. The present inflation may have already gone too far. If this turns out to be the case, then gold convertibility of the dollar at $35 an ounce must yield to more important objectives. However, we realize that the timing involves important political considerations to which economic judgment may have to yield.

As is discussed in Part I of this report, the operation of the international monetary system in recent years has left much to be desired. The problem which will face the new administration is not just to cure the U.S. balance of payments deficit, but also to bring about a more efficiently operating international monetary system. Major policy actions should take both objectives into account. The question of the appropriate kind of action must be faced by the new administration even if it should be decided that action will not be taken promptly, because even then it will be necessary to be properly prepared for the later necessity of making a major change.

Our major policy options (including that of continuing present policies and waiting for disinflationary measures to bring relief) are discussed in Part II.

One type of change would involve an adjustment of the exchange-rate structure, and possibly a general (though not uniform) increase of the price of gold, within a system in which the dollar is convertible into gold, or partly into "paper gold."

It would be desirable from the U.S. point of view for exchange rate realignments to be brought about by appreciation of foreign currencies such as the German mark, but we fear that a solution along these lines may prove impossible to attain. A perhaps more promising avenue for bringing about exchange rate adjustment would be to work toward introducing greater exchange rate flexibility into the Bretton Woods system.

Any change in the price of gold, including a unilateral devaluation of the dollar, requires Congressional action and thus becomes a political decision. It also requires negotiation with foreign countries to the extent that exchange rate realignments are involved. These discussions could go forward only under the cover of suspension of gold convertibility.

This brings us to a second type of change which is an alternative to that just outlined. A policy of inconvertibility could be adopted not just temporarily. Decisions on the price of gold and on exchange rates could be postponed indefinitely. This would allow other countries to decide whether they want to peg to the dollar or allow it to float. In fact, suspension of convertibility, if coupled with reasonable monetary and fiscal policies on the part of the United States and close international consultation and cooperation, might prove a viable long-run system under which most countries would continue pegging their currencies to the dollar.

Exchange rates have proved decisive for the success of a regime. General de Gaulle devalued the franc upon assuming office and, with the help of sound fiscal and monetary policies, provided himself with a strong financial base for his foreign and domestic policies. Prime Minister Wilson decided not to devalue and found himself hampered in all his policies by the consequences of that decision. In the end, he had to devalue anyhow and had to shoulder the political onus of the action. This points up the political importance of a speedy solution for the balance of payments problem. It does not necessarily mean that devaluation (lowering of the dollar rate) is the only possible answer.

SUBSTITUTE THE FOLLOWING FOR THE FIRST THREE SENTENCES IN THE SECOND FULL PARAGRAPH ON PAGE 12, PART II

It is therefore necessary to allow parities to change gradually in response to market trends. This can be achieved in different ways, but requires a second change in the IMF Charter. One method would be to adjust parities automatically at frequent intervals to a moving average of the market rate prevailing during, say, the preceding twelve months. Another would be to change the rate by small steps, say, 2 percent a year or one-sixth of one percent a month, if it has remained for some specified time at the upper or lower end of the band and had to be supported by the central bank.

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INTRODUCTION AND SUMMARY

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Our balance of payments position is much more precarious than is indicated by the official statistics. Basically it has worsened and not improved since January 1968. Assuming that there is no crisis before January 20, the new administration will have to face a fundamental decision. It will have to decide whether it wishes to make a major change in our international monetary relations <u>soon after it takes over</u>, or whether it will make such a change only <u>if</u> <u>and</u> <u>when</u> the present system will have become clearly unworkable. It can suspend convertibility of the dollar within a few weeks of assuming office, throwing the responsibility upon its predecessor. Or it can maintain convertibility at the present price of gold accepting the economic and political constraints of doing so, with the risk of having to suspend anyhow some time later, presumably in the midst of a crisis which would have developed under the new administration.

If a crisis should break out <u>before</u> January 20, it would be highly desirable to suspend the convertibility of the dollar into gold before our gold stock declines much below 10 billions; but only President Johnson could do that, and the President-elect could only bring his influence to bear in this direction.

Domestic inflation has been excessive and must clearly be brought under control. Most of the members of this task force doubt, however, that disinflationary monetary and fiscal policies alone will be sufficient to hold the international value of the dollar without permanent controls and threats of crisis. The present inflation may have already gone too far. If this is the case, then gold convertibility of the dollar at $35 an ounce must eventually yield to more important objectives. Yet there may be merit in avoiding immediate suspension of convertibility and "playing for time" until the situation becomes clearer. We realize that this is a political decision in which economic judgment may have to yield.

As is discussed in Part I of this report, the operation of the international monetary system in recent years has left much to be desired. The problem which will face the new administration is not just to cure the U.S. balance of payments deficit, but also to bring about a more efficiently operating international monetary system. Major policy actions should take both objectives into account. The question of the appropriate <u>kind of action</u> must be faced by the new administration even if it should be decided that action will not be taken promptly, because even then it will be necessary to be properly prepared for the later necessity of making a major change.

Our major policy options (including that of continuing present policies and waiting for disinflationary measures to bring relief) are discussed in Part II.

One type of change would involve an adjustment of the exchange-rate structure, and possibly a general (though not uniform) increase of the price of gold, within a system in which the dollar is convertible into gold, or partly into "paper gold."

It would be desirable from the U.S. point of view for exchange rate realignments to be brought about by appreciation of foreign currencies such as the German mark, but we are broadly of the opinion that a solution along these lines may prove impossible to attain. A perhaps more promising avenue for bringing about exchange rate adjustment would be to work toward introducing greater exchange rate flexibility into the Bretton Woods system.

Any change in the price of gold, including a unilateral devaluation of the dollar, requires Congressional action and thus becomes a political decision. It also requires negotiation with foreign countries to the extent that exchange rate realignments are involved. These discussions could go forward only under the cover of suspension of gold convertibility.

Decisions on the price of gold and on exchange rates could be postponed indefinitely under a policy of inconvertibility which would allow other countries to decide whether they want to peg to the dollar or allow it to float. In fact, suspension of convertibility, if coupled with reasonable monetary and fiscal policies on the part of the United States and close international consultation and cooperation, might prove to be not just a transitional solution, but a viable long-run system under which most countries would continue pegging their currencies to the dollar.

PART I

ANALYSIS OF RECENT DEVELOPMENTS AND POLICIES AND STATEMENT OF POLICY OBJECTIVES

PAST DEVELOPMENTS AND POLICIES

The American balance of payments has been in large deficit from 1958 to 1968, 11 years in a row, not to mention a series of smaller deficits from 1950 to 1956. The cumulative effect has been to reduce the gold stock from $21 billion in 1958 to a little over $10 billion by mid-1968. At the same time "liquid liabilites" have risen from $17 billion (of which $9. $9.14 billion were foreign official holdings) in 1958 to $33 billion (of which $14 billion were official holdings) at mid-1968.

The Overhang of Foreign Owned Dollar Balances

This "overhang" of foreign owned dollars in excess of our gold stock makes maintaining confidence in the dollar essential if we are to preserve the free convertibility of these dollars into gold. While even a basically sound balance of payments position may not always be sufficient to remove the threat posed by the existing overhang of foreign held dollars, a basically weak position clearly strengthens such a threat. We cannot finance a substantial deficit forever. We cannot expect foreign central banks to continue to absorb large quantities of unwanted surplus dollars and our ability to finance deficits through further gold losses is severely limited.

In fact, as is indicated by the figures cited in the first paragraph, the United States is in the position of a banker who has over-extended his liabilities. If a run began on the dollar, i.e., if large scale conversion of dollars into gold were to occur, the United States would not have enough gold to meet all potential demands. The closing of the London gold pool in March 1968 and the initiation of the two tier gold price system has presently eliminated the danger of a run on the dollar by private gold speculators. But private dollar holders may switch into other currencies and in that case the threat of conversion of dollars into gold by foreign central banks would increase.

As is discussed further below, there is a distinct possibility for which we ought to be prepared that unless fundamental corrective action is taken very soon such a crisis will occur at some time during the next Administration.

Our Present Balance of Payments Position

Contrary to the impression one gets from official statements, our balance of payments position has not improved but has further deteriorated in the first half of 1968. True, the deficit on the so-called "liquidity basis" has dropped from $3.6 billion in 1967 and $2.6 billion in the first quarter of 1968 to $680 million (seasonally adjusted annual rate) in the second quarter of 1968. But this was largely due to "special transactions" with foreign governments and banks which are arbitrarily excluded from the deficit. Without such "window dressing" the deficit would remain of the same order of magnitude as last year. Furthermore, ~~much of~~ a sharp [illegible] ~~the "improvement"~~ in the liuqidity balance was pre [illegible] caused by unusually large ~~temporary~~ inflows of foreign capital caused by such factors as exceptionally high interest rates in the United States, and the New York stock market boom attracting capital, the political upheaval in France leading to considerable capital flight out of that country and the tight controls placed on U. S. direct foreign investment. The richest country in the world in the role of a net importer of long-term capital on a large scale is an unnatural phenomenon which cannot be expected to continue.

Meanwhile, our traditionally strong trade surplus has deteriorated to almost zero in the first half of 1968, largely as a consequence of our accelerating inflation and unsustainable growth rate. The balance on goods and services has fallen from $8.5 billion in 1964 to less than $2 billion (annual rate) in the first half of 1968. This is a sharp drop even from the 1967 figure of $4.7 billion, and the drop would have been even sharper had not an increase in foreign investment income, the fruit of U. S. capital exports in past years, offset a part of the worsening of the trade balance.

This is a very precarious position. The surplus on goods and services is grossly inadequate to cover government expenditures abroad and normal capital exports. If nothing decisive is done to improve the trade balance a sharp deterioration of the overall balance must be expected as soon as the abnormal inflow of foreign capital comes to an end. Such a deterioration is very likely to trigger an acute confidence crisis and run on the dollar.

The Failure of Past Balance of Payments Policies

It is clear from the above discussion that U. S. balance of payments policies over the past few years have completely failed of their purpose to restore equilibrium. Most measures taken have been of the nature of specific controls designed to influence directly particular segments or even individual items of balance of payments.

American foreign aid has been increasingly tied in contradiction to the principles of multilateralism and nondiscrimination which traditionally have governed U. S. foreign economic policy. Buy-American policies applied to government expenditures require purchases of goods at home which may cost up to 50 per cent more than similar foreign-made products thus increasing budgetary costs and sharply reducing the real aid given to the recipients. Duty-free allowances for U.S. tourists abroad have been progressively reduced and it was even proposed that taxes be imposed on foreign travel of Americans.

On capital account, the "temporary" Interest Equalization Tax placed on U. S. purchases of foreign long-term securities has been broadened and extended. The "temporary" voluntary controls placed on U.S. direct foreign investment have likewise been extended and made more stringent and in 1968 this de facto exchange control was made mandatory on direct investment by a Presidential order authorized under "national emergency" legislation.

The policy of specific controls which has been pursued in recent years must be judged a failure. The promised restoration of balance in the international accounts has not been achieved and "temporary" controls had to be multiplied, tightened, and extended. The truth of two general principles has again been demonstrated, first, the "fungibility of money" which enables it to flow around road blocks set up by artificial restrictions and, second, the tendency of specific and temporary controls to spread, expand, multiply, tighten, and become permanent unless decisive action is taken either by disinflation or a change in the exchange rate.

United States balance-of-payments policy since 1959 may be characterized largely as a combination of short-sighted expedients with little emphasis on longer-term solutions. Most of these policies were designed to buy time. Unfortunately, little productive use has been made of this time as far as fundamental corrections are concerned. This is not a situation which can be prolonged much longer.

Parallels From the British Experience

The problem of balance of payments deficits is not peculiar to the United States. In part, it is due to an inadequacy in the manner in which our present international monetary system has evolved out of the Bretton Woods Agreement of 1944.

Exchange rates between countries have become much more rigid than was originally anticipated by the designers of our international monetary system. As a result, changes in exchange rate by a country with a balance of payments deficit have become a major political event, not just an economic adjustment. There has thus been a tendency to maintain exchange rates which have become clearly overvalued. This is well illustrated by the recent British experience. For years, the British policy has been to impose more and more controls, pursue stop and go financial policies and use other distasteful means of "defending the price of the pound" before finally devaluing in 1967. Once an administration affirms as a goal the defense of the present parity of its country's currency, maintenance of such a policy becomes an end in itself. Then only with a change in administration does a change in exchange rate policy become an alternative which may not bear considerable political costs, i.e., which will not be generally considered as an admission of a major failure on the part of the administration in power.

As is indicated by both the British and U.S. experiences, if the use of exchange-rate policy is ruled out countries which are not willing to tolerate a high level of unemployment must resort to various forms of controls or special taxes as the only remaining ways to suppress a balance of payments deficit. Thus in the 1960's we have witnessed a drastic reversal of the postwar trend toward liberalization of international payments which had led to an unprecedented growth of world trade greatly benefiting all participating countries and a substitution for that beneficent trend of an increasingly tight and stifling network of specific controls and restrictions.

Special Drawing Rights and International Liquidity

A less pressing problem that has faced the international monetary system is, that for growth in international reserves the world has had to rely upon uncertain and haphazard sources such as the output of South African gold mines, the vagaries of Russian gold sales and the changing deficits in the U.S. balance of payments.

This problem of international liquidity has received a good deal of attention, in fact more than the basic problem of balance of payments adjustment. The concern about international liquidity has eventually led to the adoption of a plan to put the creation of international liquidity on a rational basis through the systematic creation by the IMF of a new reserve asset called Special Drawing Rights (SDRs.). The prospects look bright for ratification of this extention of the IMF machinery by the member countries of the Fund.

While the SDR scheme undoubtedly will be a very welcome improvement of the international monetary system, it must be stressed that by itself it does not offer a solution of the two most pressing problems -- correction of the U.S. deficit and the removal of the threat of an acute confidence crisis posed by the overhang of foreign owned dollar balances.

The solution of these two problems depends primarily on American decisions and policies. The nature of these decisions and policies as we see them is discussed in the following pages.

POLICY OBJECTIVES

The primary objective, thus, is to restore at long last equilibrium in the U.S. balance of payments. This does not mean that the deficit, as conventionally defined (stripped of window dressing) must be completely eliminated; it means that it be reduced to a level compatible with the willingness of the rest of the world to increase their dollar holdings, in line with the needs of growing world trade.

This goal must be achieved without violating major objectives of domestic economic policy, in particular the objective of maintaining a high level of employment and a rapid rate of growth at stable prices. Furthermore, equilibrium in the balance of payments must be restored without ad hoc restrictions on international trade, international travel and international capital movements. Existing restrictions should be rapidly eliminated, because they are wasteful and inefficient, undermine our free enterprise system and thus reduce the rate of growth of the economy. Some of ~~our~~ these controls may have afforded some amount of balance of payments relief in the short run, but we are already beginning to feel their delayed adverse effect on our balance of payments, especially those ~~of the~~ on direct investment controls.

Curbing Inflation Indispensable for Restoring the Strength of the Dollar

If external equilibrium in the sense defined and the strength of the dollar in world markets are to be restored without direct controls of trade and payment, curbing inflation is a necessary although probably not a sufficient condition.

From 1958 to late 1964 prices were reasonably stable and from 1960 to 1964 the balance of payments improved greatly. Then inflation set in again as a consequence of rapid monetary growth and huge deficits in the federal budget caused by tax reductions and a veritable expenditure explosion for war and domestic purposes. During the first 7 months of 1968 the consumer price index has been rising at a rate of over 5 per cent.

This rate of inflation clearly is intolerable from the point of view of the internal economy as well as on balance of payments grounds.

The tax increase earlier this year was a step in the right direction, but it came too late and the promised overall cut in government expenditures has not been achieved. Furthermore, monetary growth at a very high rate until Summer 1968 threatens to nullify the anti-inflationary braking effect of the tax increase. The moderation of monetary expansion since July is still to have its effect to reduce inflationary pressure.

This task force is concerned with the balance of payments. It is possible to restore equilibrium in the balance of payments by a sufficiently vigorous anti-inflation policy. But we cannot disregard overriding internal policy objectives -- high employment and growth. True, for the time being there is no conflict between the directions which financial policy should take to achieve both external and internal objectives, because the present rate of inflation is not only imcompatible with balance of payments equilibrium but also intolerable in its effects on the domestic economy on equity and efficiency grounds.

Curbing Inflation Probably Insufficient[1] to Cure our Immediate Balance of Payments Difficulties

~~However,~~ The degree of disinflation necessary to achieve rapid balance of payments equilibrium would probably be greater than is tolerable on domestic grounds. What is relevant for our trade balance is the actual level of prices not just their rate of change. Our price level may already be too high for equilibrium at present exchange rates even if inflation were successfully halted. Deflationary policies strong enough to lower the price level would create an intolerable amount of unemployment.

Because of the inflationary expectations incorporated into present wage and price policies, even a moderate curbing of inflation will entail, in all probability, a temporary rise in unemployment and a temporary reduction in the growth rate. Subsequently the employment situation should improve, since when it becomes generally realized that the inflation will be curbed and reasonable price stability restored, wages will increase less rapidly even at high levels of employment.

Not only will it take time for the effects of anti-inflationary policies to be reflected in prices, but it will take even longer for the effects to be transmitted to our trade balance.

A determined effort to curb inflation should bring some immediate benefits. By creating a generally favorable climate at home and abroad and so increasing the attractiveness of the dollar as an international

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1 The following members of the Task Force believe that curbing inflation will almost certainly be insufficient by itself: William Fellner, Gottfried Haberler, Hendrik Houthakker, Wilson Schmidt, Henry Wallich, Thomas Willett. (Herbert Prochnow)

The following members of the Task Force believe that curbing inflation might well prove to be sufficient by itself: Tilford Gaines, Walter Hoadley.

reserve asset, it may well induce surplus countries to add to their dollar balances, limit our gold losses and provide a breathing spell. But even the restoration of a basically sound balance of payments position will not free us from concern over the existing overhang of foreign held dollars.

We Cannot Count on Foreign Actions to Substantially Improve Our Balance of Payments in the Short Term

Our balance of payments, of course, depends not only on American developments but also on what happens abroad, primarily in the economies of our principal markets, Western Europe, Canada and Japan. If they pursue sufficiently expansionary (inflationary) policies or reduce their import restrictions (tariffs, etc.) substantially, curbing inflation here may be sufficient to restore a sound balance of payments position.

It is clearly unrealistic to expect foreign countries to have additional inflation for the sole purpose of relieving us of our balance of payments difficulties.

It would be helpful if the surplus countries could be persuaded to reduce their trade barriers drastically on a nonreciprocal basis. But again it would be entirely unrealistic to expect much help from that source. Unilateral reduction of trade barriers for balance of payments support of other countries is not part of the existing code of international good behavior as laid down in the IMF Charter and GATT rules. Nevertheless, the efforts to secure nondiscriminatory treatment of American exports should be pursued vigorously.

A revaluation of the German mark, the principal surplus currency, would considerably help our trade position. But such a move is highly unlikely, at least until after the Federal elections in September 1969. On the other hand, should continued weakness of the franc lead to a French devaluation, the world monetary situation would worsen.

In the short run, the most important way in which foreign surplus countries can affect our balance of payments position will be their continued willingness to accumulate dollar balances rather than demand payment in gold.

Part II

Policy Alternatives

Section A. Maintaining the Present Kind of "Convertibility into Gold" at $35 an Ounce Under the Two-Tier System.

This policy is one of those open to the new Administration on January 20. It amounts to the continuation of the present system in which convertibility has become largely fictitious. We convert only the dollars of official holders who commit themselves not to sell it at its market price; we dissuade even these official holders from converting, with distinctly harmful consequences for our international political relations; and all informed individuals know that if conversion nevertheless took place on an appreciable scale, then the system would collapse. In spite of these defects the incoming President will be under strong pressure to continue this strategy and it is therefore necessary to evaluate its chances of success.

At the time this is being written the foreign exchange markets are quieter than they have been for some time. Since the sharp deterioration in our trade account has been temporarily offset by a large inflow of European capital and by new exchange controls the dollar is not under any particular pressure. The free gold market is in the doldrums. Sterling has shown more strength as the favorable effects of last year's devaluation on British exports become apparent. The speculation on a revaluation of the German mark has receded, but the French franc remains under suspicion.

It must be feared that this calm is deceptive. Every one of the world's four major currencies has been under severe speculative pressure during the last twelve months. The apparent improvement in the dollar may turn into renewed weakness as soon as the foreign buyers of American securities change their minds; in any case, they can hardly be expected to continue their purchases at the present rate. The exchange controls introduced by President Johnson on January 1, 1968, will ultimately weaken the dollar by making it appear an undesirable "soft" currency. These measures are incompatible with free enterprise and with the efficient use of resources. Yet in the short run the removal of exchange controls, thoroughly desirable though it is, will probably have an adverse effect on the dollar.

The situation abroad also presents real dangers. The weakness of the French franc, in particular, is still likely to lead to a devaluation, since the French have traditionally preferred an undervalued to an overvalued currency, and since they may wish to restore their depleted reserves by running a surplus. Any French move would have wide repercussions because of the choices with which the other Common Market countries will then be faced. Germany, for instance, is not likely to follow the French, but a French devaluation would probably rule out the German revaluation that is greatly to be desired from our point of view. Sterling might then also be devalued again. The net result would therefore be a further weakening of the dollar.

One strategy would be to wait for all these dangers to materialize on the grounds that none of them is certain and that any major change in international monetary relations might do more harm than good. This strategy would necessarily be based on the forecast that, by curbing inflation, the supply of dollars to foreigners can be reduced sufficiently to remove the threat of large-scale conversion into gold, and to remove also the danger that foreign markets and monetary agencies will become unwilling to accept additional dollars under the present system.

Most members of our Task Force feel sceptical about a policy based on this hope.[1] To be sure, a collapse of the system has so far been avoided, even though inflation has been accelerating, but our gold stock has shrunk to about 10 billions and it would be unsafe to let it decline much below this figure. Considering that our employment and growth objectives set limits to the speed with which thoroughgoing anti-inflationary objectives can be achieved, chances are that the policy now considered cannot be made successful by reasonable anti-inflationary policies alone. As may be seen from the footnote on page 10, Part I, not all members of the Task Force feel equally pessimistic about these chances, but all agree on the following: If it becomes clear that the present type of convertibility can be maintained only at the expense of the goals of high employment and rapid phasing out of the existing balance of payments controls, then we recommend that these latter objectives be given priority and the present policy of gold convertibility be abandoned.

Quite aside from the question of just how high or how low the chances are of the present policy remaining technically feasible for

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[1] See footnote on p. 10, Part I, for the position of individual members.

long, it should be borne in mind that the policy has these drawbacks:

(1) If a crisis broke out again there would this time be an even more severe blow to confidence than on previous occasions. The remaining faith in the ability of the system to weather crises would disappear. New arrangements would have to be worked out under intolerable pressure.

(2) The President would no longer be in a position to blame the crisis on his predecessors. If Harold Wilson had devalued the pound sterling upon taking office it would have been greeted as an act of statesmanship; when he was forced to do so after three years of ruinous delaying tactics his public image suffered greatly. Conversely, the French devaluation of 1958 freed De Gaulle from international economic constraints until the middle of the nineteen-sixties, thus enabling him to pursue the policies he considered desirable.

Even if the strategy just discussed were adopted, the new Administration should in our opinion get thoroughly familiar with the lines of policy to which it would be necessary to shift if and when this strategy becomes unworkable. In that event the choice should not be left to a haphazard, last-minute decision.[1]

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[1] In the event of a crisis prior to January 20, it would in our opinion be a serious mistake not to turn <u>promptly</u> to one of the alternatives discussed below. To be specific, in this case the present Administration should terminate convertibility into gold before our gold stock declines much below 10 billions, because we would need funds later for selective defense of the dollar. The President-elect could in this case merely bring his influence to bear in the right direction.

SECTION B. DEVALUATION OF THE DOLLAR IN RELATION TO OTHER CURRENCIES WITHOUT A GENERAL RISE IN THE PRICE OF GOLD

As was pointed out in Part I, under the Bretton Woods system the devaluation of any important currency has become a major operation which is invariably preceded by a more or less protracted period of disturbing speculation. Under the Articles of Agreement of the IMF, the Fund cannot object if a country proposes to change the initial par value of its currency by not more than 10 per cent for the purpose of correcting a "fundamental disequilibrium." The U.S. dollar could thus be devalued by 10 per cent while almost all other countries would require permission from the Fund, because they have used up the allowable margin by previous devaluations. In practice, however, the Fund has found it impossible to deny such permission.

A devaluation of the dollar by 10 per cent relatively to other currencies would greatly strengthen our balance of payments by stimulating exports and checking imports. The latter effect would appreciably reduce the strong pressure in the U.S. for the imposition of import restrictions and so make it easier for the Administration to continue our traditional liberal trade policy. Since imports have a small weight in our cost of living, we would not encounter the difficulty which other countries have to face when they devalue their currency, namely, an immediate sharp rise in the cost of living.

It is doubtful, however, whether an outright devaluation of the dollar could be made effective. A very large number of countries would almost automatically devalue their currencies in step with the dollar: Canada, Great Britain, Japan, France, the Scandinavian countries, Australia, Latin America and many others.

Two or three strong currencies, to wit, the German mark, Italian lira and Swiss franc, would perhaps not match the American devaluation and thus appreciate vis-à-vis the dollar and all other currencies that would follow the dollar.

As mentioned above, German officials until now have firmly rejected the suggestion that they should appreciate the German mark. Would they accept appreciation, if it came in the form of a depreciation of all other currencies save perhaps the lira and Swiss franc? Perhaps they would. But there are two other very serious difficulties about such a realignment of exchange rates: First, nobody can be sure that 10 per cent would be too much, too little or, by chance, just about right to substantially correct the existing imbalance. Second, the realignment would involve a 10 per cent rise of the price of gold in terms of dollars and other depreciated currencies. The implied small rise in value of international gold reserves would, however, in all probability be outweighed by increased gold hoarding which the move would bring about by stimulating the appetite of the speculators.

SECTION C. REALIGNMENT OF EXCHANGE RATES COMBINED WITH A GENERAL RISE IN THE GOLD PRICE

Several experts have suggested that the difficulties of a realignment of exchange rates, including a devaluation of the dollar, could be largely overcome if the realignment was combined with a general rise in the price of gold. The price of gold would be, say, doubled in terms of all currencies, except that in terms of the two or three strong currencies the price of gold would be raised only by, say, 90 per cent.

This operation would presumably put an end to gold hoarding and would provide an ample increase in international reserves. This would facilitate the financing and absorption of disequilibria that would persist in case the realignment of exchange rates turned out to be either excessive or insufficient.

A sharp increase in the price of gold has, however, serious disadvantages: Its benefits would be distributed unevenly and inequitably; gold producers and large gold holders would be favored and countries which responded to U.S. pleas not to convert dollars into gold would be penalized. This would raise difficult questions of compensation. It would add fuel for world-wide inflation and interrupt the trend toward a reduction of the wasteful use of gold for international reserves. Furthermore, it would leave unsolved the problem of providing systematic growth of reserves over time. As mentioned earlier, the SDR scheme is a cheaper and more rational method of reserve creation.

However, situations could arise in which doubling of the price of gold would be the lesser evil. Suppose no international agreement concerning activitation of the SDRs or some other more comprehensive scheme of reserve creation or other type of reform of the international monetary system, such as greater flexibility of exchange rates (see Section F. below), can be reached. Suppose, furthermore, we are unwilling to suspend unilaterally the convertibility of the dollar into gold. In that case, we may well be faced with the choice between (a) more and more controls of international trade and payments, possibly combined with excessive unemployment and creeping inflation and (b) a doubling of the price of gold and some open inflation. If it comes to that choice, doubling of the price of gold would be the lesser evil.

It must be emphasized, however, that we are by no means forced to accept this dilemma. We can at any time get out of it by suspending convertibility of the dollar into gold.

This policy option is discussed in the two following sections.

Section D. Suspension of Gold Convertibility of the Dollar May Be Necessary as a Temporary Measure.

The policy alternatives discussed in Sections B and C would require more or less protracted international negotiations and Congressional action. This most probably would lead to large speculative movements of funds and possibly to a massive run on the dollar, especially if action was postponed until it became apparent that anti-inflationary policies alone do not improve our balance of payments sufficiently fast. It might therefore be necessary to terminate the present, largely fictitious convertibility into gold in order to create a period of transition during which our gold stock would be protected and new arrangements could be negotiated safely. When this period of transition should begin depends of course on whether the new Administration decides to make a major change in our international monetary relations promptly, or only if and when the present type of policy has become unworkable.

The immediate outcome of the termination of "convertibility" might be an unchanging dollar rate, or a somewhat reduced rate, depending in large part on how the other countries appraise our presumptive dollar supply to them, i.e., depending largely on their appraisal of our presumptive monetary and fiscal policies. If it were generally believed that we are resolved to adopt a policy of reasonable restraints, then the dollar would not decline appreciably, and it might very well remain unchanged. Even if there should take place a small reduction of the rate, this, as was said above, would help us balance our international accounts and the effects of the change on the American cost of living would be very small. We should recognize that in the contemporary world permanently fixed exchange rates are incompatible with the requirements of international equilibrium because in the various countries money-wage trends develop differently in relation to productivity trends, and it is hopeless to try to coordinate these trends for all major countries.

During the period of transition it would be possible to work toward arrangements involving a subsequent resumption of convertibility, along the lines of Section B or C. But the difficulties of these arrangements may not become sufficiently reduced, and the period of transition could alternatively be used for moving in another direction.

Section E. Cooperative International Arrangements Without Convertibility.

The dollar being the most widely used currency in the world, most countries might find it quite satisfactory even in the long run to peg to the dollar, notwithstanding the suspension of the present type of largely fictitious convertibility. But this would presuppose constant close contacts between the U. S. and the other major countries concerning our monetary policies and our presumptive dollar supply to the rest of the world, and also concerning the policies of the most important foreign countries toward the dollar. It is possible that during the period of transition, as described in the preceding Section, a tradition of such contacts would start developing. In this case even the long run solution would not necessarily have to imply the resumption of convertibility, at a guaranteed price, into gold or into any other medium.

It is difficult to imagine that at present the foreign valuation of the dollar would have much to do with the kind of "convertibility" that has existed since March 1968. To arrive at a well-functioning system, foreign countries must be made aware of how our monetary and fiscal policies are apt to shape up, and we must be aware of how alternative lines of American policy are apt to influence the valuation of the dollar abroad. But this does not necessarily lead to the conclusion that a well-functioning system requires convertibility of the dollar into some medium at a guaranteed price.

SECTION F. LIMITED EXCHANGE FLEXIBILITY

Badly needed changes in exchange rates have become exceedingly difficult to achieve because,as was pointed out earlier, under the existing regime of rigid exchange rates any change in the international value of an important currency is a major operation preceded and often followed by highly disturbing shifts of speculative funds. A radical solution for this problem, favored by many experts, would be the general introduction of freely floating exchange rates.

Such a radical change of existing practices is, however, hardly negotiable except in isolated cases. Without going into the merits or demerits of the radical solution, we wish to point out that between the two extremes of rigidly fixed exchanges and freely floating rates there is a middle ground which has recently attracted favorable attention in official and financial circles. It is not necessary to go all the way to freely floating rates to overcome the excessive rigidity of the present system, nor is it necessary to accept frequent crises as the price for reasonable certainty in exchange rates. A system can be devised that combines smooth adjustment to the ever-changing forces of supply and demand with the over-all stability on which international finance has come to depend. This can be achieved by two comparatively minor changes in the IMF Charter.

The first of these two changes would widen the "band," that is the margin between which exchange rates can fluctuate. This margin is now one percent each way, which is not enough to make a useful contribution to the adjustment process. By widening the band to say three or four per cent each side of parity meaningful fluctuations would be permitted without scrapping the whole system. Further study of the "band" proposal has recently been urged by a subcommittee of the Joint Economic Committee and endorsed by several speakers at the IMF meeting.

But widening the band is not likely to be adequate by itself. As long as parities remain fixed (subject to spasmodic changes in the midst of a crisis) there still remains the problem of trends in the factors determining a country's competitive position in world trade. Some countries are chronically less successful than others in resisting cost-push inflation and maintaining approximate price stability. Even if a country had no more inflation than its trading partners, it might still find its currency growing ever weaker or ever stronger as a result of gradual changes in the world demand for its imports. Thus it appears that the steady deterioration of the pound sterling is attributable in large part to the tendency of British exports to grow more slowly than British imports.

It is therefore necessary to allow parities to change gradually in response to market trends. This can be done through a second change in the IMF Charter, which would make the parity at any time equal to a moving average of the market rates prevailing in, say, the past year. Thus if a currency had been at its lower limit for some considerable time the parity would gradually decline at a maximum rate of, say, 2 percent a year. Such small adjustments of rate, unlike the big changes under the present system, would not give rise to massive flows of speculative funds because the inducement for such flows could be offset by suitable interest changes.

This system, which may be described as a "self-adjusting peg," would reduce the need for international reserves, though it would not eliminate this need. Combined with the usual transactions in the forward exchange market, it would provide importers and exporters with a sufficiently stable financial environment in which speculation would have much less scope than it has now.

Limited flexibility is meant to be a long-run solution of the problem of speedier balance of payments adjustment. As such it could be introduced after an initial realignment of exchange rate as discussed above in Sections B and C. It could also be used as a device for approaching a new and hopefully more durable pattern of par values.

Limited flexibility is not a cure for balance of payments troubles due to rapid inflation afflicting many less developed countries. But for the milder kind of maladjustment normally found among the industrial countries it would be an adequate remedy.

The scheme requires further study and the details would have to be negotiated. The dollar could retain its present central role in financial and commercial transactions, and the gold market could ultimately be restored to normal operations without the two-price feature.

Draft by William Fellner

Part II

(If Haberler-Willett draft is called Part I, this should be "Part II". A few duplications need to be eliminated because the two drafts were prepared simultaneously)

Section ~~III~~

Possible Lines of Policy: A Discussion of Specific Measures

All Subsections should become "Sections", since this draft will become "Part II".

Subsection A. Maintaining the Present Kind of "Convertibility into Gold" at $35 an Ounce Under the Two-Tier System.

Explanatory Note: ~~Part of the title of this Subsection is placed in quotes, because~~ Convertibility has become ~~now is~~ largely fictitious. We convert only the dollars of official holders who commit themselves not to sell it at its market price; we dissuade even these official holders from converting; and all informed individuals know that if conversion nevertheless took place on an appreciable scale, then the system would collapse. ~~The ratio of the U.S. gold stock to our short-term liabilities has become very unfavorable.~~ In spite of these defects the next President will be under strong pressure to continue this strategy, and it is therefore necessary to evaluate its chances of success.

how to HHP i top

(1) ~~In spite of what was said in the preceding Sections of this paper,~~ This policy is ~~described by the title of the present Subsection will be~~ one of those ~~the policies~~ open to the new Administration on January 20. It amounts to a continuation of present policy, in which ~~except if a crisis should develop in the meantime and if our gold stock should start diminishing at an appreciable rate.~~ In the event of ~~such~~ a crisis prior to January 20, it would in our opinion be a serious ~~big~~ mistake not to turn promptly to one of the alternatives discussed ~~in Subsection C,~~ below. To be specific, in this case the present Administration should terminate convertibility into gold before our gold stock declines much below 10 billions, because we would need funds later for selective defense of the dollar. But the President-elect, who in such circumstances would obviously want to avoid making any public statement on what the Administration should do, could merely urge the outgoing President to suspend convertibility and he could promise to express his ex post facto approval of that measure ("given the antecedents").

becomes footnote on p. 4 below

~~Aside from the possibility of a crisis before January 20,~~ the policy line consi~~dered in the present Subsect~~ion would ~~presumably~~ necessarily be based on ~~the hope~~ a forecast that, by curbing inflation, the supply of dollars to foreigners can be reduced sufficiently to remove the threat of large-scale conversion into gold, and to remove also the danger that foreign markets and monetary agencies will become unwilling to accept additional dollars under the present system.

(2) Most members of our Task Force feel sceptical about a policy based on this hope.[1] To be sure, a collapse of the system has so far been avoided, even though inflation has been accelerating, but our gold stock has shrunk to about 10 billions and it would be quite unreasonable to let it decline much below this figure. Considering that our employment and growth objectives set limits to the speed with which thoroughgoing anti-inflationary objectives can be achieved, chances are that the policy of this Subsection cannot be made successful by reasonable anti-inflationary policies alone.

A continuation of present policy ..

to HH p. 2

(3) Therefore, if the policy line of this Subsection were followed, the temptation would be great to extend the scope of our administrative controls and of various restrictive measures which have proved largely ineffective even by their own questionable standards. These measures are incompatible with free enterprise and with the principle of letting the most efficient users of resources put these to the employment favored by the market. Reliance on these controls makes the dollar appear an undesirable

1/ See footnote 1 on page 10 for the position of individual members.

"soft" currency. It should be one of our most significant objectives to increase the attractiveness of the dollar to domestic and to foreign holders. Our inefficient direct controls should be ~~gradually~~ abolished rather than further extended, but it will be difficult to abolish them if an attempt were to be made to follow the policy line of this Subsection. Hence the argument for making a major change promptly is strong.

(4) On the other hand, there is of course wisdom in the saying that bridges should be crossed when they are reached. Hence one might take the position that, in spite of the misgivings here expressed, we should follow the policy line of the present Subsection, provided that a strong effort were made to phase out our direct controls regardless of resistance from some quarters. This amounts to taking the position that we should turn to other policies (see Subsections B through D) only if and when a renewed gold drain and flight from the dollar make the failure of this policy obvious to the naked eye.

This is a possible line of approach. But, in the first place, if the direct controls and restrictive measures were extended rather than phased out, then the consequences of this approach would turn out to be very harmful; and, secondly, the probability of having to make a major change later in the midst of a future crisis would be high. It is all right to say that bridges should be crossed when reached, but it is equally a piece of wisdom that one should try to avoid having to act in the midst of a crisis. As for the political aspect of the matter, a major change made during a future crisis would be blamed on the new Administration, while a major change made shortly after January 20 could be justified by explaining that the new Administration inherited a situation which in spite of the window-dressing devices of the past few years had to be recognized as untenable.

(5) Even if the Strategy just decided ~~policy of this Subsection~~ were adopted, the new Administration should in our opinion get thoroughly familiar with the lines of policy to which it would be necessary to shift if and when thes Strategy ~~policy discussed in the foregoing pages~~ becomes unworkable. In that event the choice should not be left to a haphazard, last-minute decision.*/

*/ From p. 1 above.

Subsection B. Downward Adjustment of the Dollar Rate in Relation to Some Other Currencies, in a System in Which the U. S. Would Continue to Link the Dollar to Gold.

(1) Since the beginning of the Bretton Woods era there have occurred many major changes of exchange rates. All of these were abrupt changes undertaken by countries other than the U. S., and they all took place after sustained speculative activity in the currency markets. While according to the Articles of Agreement of the IMF changes exceeding 10 per cent in relation to the initial Bretton Woods parities require approval of the Fund, in practice ~~the workings of the system have been such that~~ it has never been possible to deny approval.

The U. S. ~~could~~ has the right to devalue the dollar in relation to gold by 10 per cent ~~even~~ without asking for IMF approval, but only by congressional action. Such devaluation would increase our exports in relation to our imports, and it therefore would strengthen our balance of payments. During the past two decades most major currencies were devalued in relation to the dollar, and a 10 per cent devaluation of the dollar would be a plausible step in the equilibrating direction. Imports have a very small weight in our "cost of living," and hence one of the difficulties which most other countries face in the event of devaluation would not have to bother us much. However, other difficulties do need to be considered here, and we shall make a few observations on possible ways of reducing these.

(2) In the first place, other countries might also devalue in relation to gold, in order to prevent us from improving our competitive position. This would express an inconsistent attitude on their part, since they are insisting on an American effort to balance our international accounts. While inconsistent attitudes mayof course be encountered, it seems very likely that in such a situation some major foreign currencies would not be devalued. It might nevertheless be easier to achieve a satisfactory, systematic readjustment of the dollar rate relative to other currencies if the price of monetary gold were increased in all countries by a percentage which is not uniform across the board. In this case all countries would acquire larger reserves in terms of their own currencies.

(3) If the policy of the present Subsection were adopted, a general (though not uniform) increase of the price of monetary gold would also alleviate another difficulty, namely, that arising from the

fact that a 10 per cent increase of the official dollar price of gold would not only be insufficient to suppress bullish expectations in the gold market but would probably reinforce such expectations. Also with a 10 per cent increase the U. S. would remain in a highly precarious reserve position, while with a much larger increase we would obtain, for some considerable period to come, a manageable relationship between reserves and dollar liabilities. To be sure, even a general and uniform increase of the price of monetary gold would achieve this latter objective, but if the exchange-rate structure were not revised, then the essential balance-of-payments adjustment processes would not be promoted but would probably be further retarded (most countries would feel they have gained time and imbalances would grow further with severe delayed consequences). Some of the difficulties of exchange-rate readjustment would become reduced if the readjustment were combined with a general increase of the price of gold.

(4) However, if the readjustment of the exchange-rate structure took place along with a general (but not uniform) increase of the price of gold, and if the increase were large enough to stop bullish expectations in the gold market and to get us out of our highly vulnerable reserve position, then a significant inflationary tendency would develop on a world-wide scale. Not only would the reserves of all countries increase immediately, but the current gold production would increase in quantity as well as in value, and (last but not least) very large quantities of gold might become dishoarded by speculators. The monetary authorities would make an effort to "sterilize" part of this gold, i.e., to prevent it

from leading to a corresponding increase in money expenditures, but it is questionable how near the authorities could get to full success in this regard.

(5) In principle, it would be possible to launch and to operate a system combining convertibility into gold metal with convertibility into "paper gold" in such a way that including these paper reserves the reserves-to-liabilities ratio of the U. S. should become adequate without the revaluation of gold. The same reform could place the other countries also in acceptable reserve positions. If the public were thoroughly convinced that arrangements of this sort have solved the problems discussed in the present paper, the gold market might even become bearish. Exchange-rate readjustments would still be needed to restore international equilibrium but the complications arising as a result of the insufficiency of gold reserves at the present official price of gold could then be circumvented.

However, we feel convinced that at present reforms of this sort are not feasible on the scale required for getting near the solution of the problems we face.

(6) In the foregoing paragraphs the system was represented as remaining one of "fixed exchange-rates," though with readjusted ones. We place the term "fixed rates" in quotes because experience shows clearly that such a system is in reality one of occasional, abrupt, major changes of exchange rates by arbitrarily determined margins. These changes always take place belatedly, in the midst of a wave of currency speculation, and

usually after ill-advised attempts to cope with a disequilibrium by means of restrictive measures. Indeed, in the present era it is difficult to imagine a system of truly fixed rates, since the relationship between money-wage trends and productivity trends develops differently in different countries. While a rather high degree of coordination of these trends may be possible in "blocs" consisting of several countries, world-wide (or even intercontinental) coordination of these trends can hardly be carried to the point where truly fixed exchange-rates would become compatible with international equilibrium. Something must "give," and in the present world the money-wage trends of the countries do not in fact "give" to the extent required for the smooth functioning of a fixed-rates system.

The difficulties to which this gives rise could be alleviated significantly by modifying the fixed-rates system (after the parity-readjustments here envisaged) in such a way as to let exchange-rates move freely, in response to market forces, within limits that are more distant from one another than are the upper and lower support points stipulated by the Bretton Woods agreement. At the same time parity levels could be made to adjust gradually and very slowly when the rates ruling over past periods indicate that for the time being the midpoint of the range between the two limits has ceased to be the equilibrium rate around which the oscillations take place. There is more willingness now among central bankers to consider such a reform than was the case some years ago.

(7) In the present Subsection we presented our argument as if prior agreement could be reached with the other major countries on the procedures that would have to be followed in order to achieve a readjustment of exchange-rates and to achieve also a satisfactory reserves-to-liabilities ratio for the U. S. Yet most members of our group feel that it would be exceedingly difficult to reach such prior agreement. One of several reasons for this is that it is impossible to discuss with other countries the problem of exchange-rate readjustments and of gold-revaluation without generating a crisis in the currency markets. Consequently, the question arises what the proper temporary measure would be for bringing about a period of transition during which arrangements could be worked out with the other major countries (see Subsection C).

The arrangements toward which the countries could be working during the transition period could be those outlined in the present Subsection, and a joint effort could be made to overcome or reduce the difficulties here discussed. But in Subsection D we shall see that this is not the only direction in which it would be possible to move during a transition period.

Subsection C. Measures That Could Bring About a Period of Transition for Working Out New Arrangements.

(1) One member of our group feels that there would be merit in trying to reach prior agreement on a 5 to 10 per cent uniform surcharge on American imports. If, after a while, our balance of payments should

improve sufficiently, we could simply remove the surcharge; if not it would subsequently be easier to negotiate a downward adjustment of the dollar rate in lieu of the surcharge. Most members of the group feel opposed to this idea. Most of us feel that emergency surcharges show a country up as one having a "soft" currency that is about to be devalued. Hence an American surcharge would be quite likely to weaken the position of the dollar instead of strengthening it. Other temporary measures seem more appropriate to most members of our Task Force. This will be explained in the remaining paragraphs of the present Subsection which relate to the termination of convertibility into gold.

(2) If for the time being the policy line of Subsection A were to be followed, and major changes were to be adopted only if and when the situation became untenable, then the natural course of events would determine the policy measure that would bring about the period of transition. Termination of the largely fictitious convertibility of the dollar into gold at $35 an ounce would be the measure that would have to be adopted. However, most members of our group feel that it would be desirable to put this measure into effect even if the new Administration should decide not to muddle through until we again start losing gold on a major scale, but should decide to make a new start immediately after the change of Administration.

(3) It is very probable that the immediate reaction to the ending of the dollar's "convertibility into gold" would be that the other countries would continue to peg to the dollar at approximately the present exchange rates, presumably with some adjustments in the international structure of exchange rates. This statement might suggest that it would

be left entirely to the other countries to set the dollar rate in terms of their currencies, but unless we made the mistake of letting our gold stock decline to small size before terminating convertibility, we would of course have a sizable fund which could be used for counteracting any harmful foreign policies. In the event of the termination of convertibility we would have to serve notice that we consider ourselves and the other countries no longer committed to abstention from the sale of gold in the free market.

The immediate outcome of the termination of "convertibility" might be an unchanging dollar rate, or a somewhat reduced rate, depending in large part on how the other countries appraise our presumptive dollar supply to them, i.e., depending largely on their appraisal of our presumptive monetary policies. If it were generally believe that we are resolved to adopt a policy of reasonable monetary restraints, then the dollar rate would not decline appreciably, and it might very well remain unchanged. Even if there should take place a small reduction of the rate, this (as was said above) would help us balance our international accounts and the effects of the change on the American cost of living would be very small indeed.

(4) Mere suspension of convertibility, along with strong assurances that we are resolved to follow a policy of monetary restraint, would mark the beginning of a periof of transition, during which our gold stock would be protected and durable arrangements could be safely negotiated. These longer run arrangements <u>could</u> be those discussed in Subsection B,

above. Indeed, given sufficient time for these negotiations, the "paper gold" constituent of the monetary reserves could acquire greater prominence than that suggested by the somewhat sceptical remarks in paragraph (5), Subsection B, since solutions appearing as wholly unrealistic at present might become negotiable during the period of transition considered in the present paragraph.

(5) But while during a period of transition it would be possible to work toward arrangements along the lines of Subsection B, it is questionable whether this would be the most constructive way of trying to find a satisfactory durable solution. The difficulties discussed in paragraph (4) of B are great; the difficulties of the "paper gold" schemes considered in (5) of B are quite likely to remain substantial even during a somewhat extended transition period; and it is doubtful whether the disadvantages of so-called fixed rates (that in reality "break" rather frequently) could be reduced in a sufficient degree by the method outlined in (7) of B. At any rate, an alternative must not be overlooked.

Subsection D. Other Arrangements Toward Which It Would Be Possible to Work During the Period of Transition.

The dollar being the most widely used currency in the world, most countries might find it quite satisfactory even in the long run to peg to the dollar, notwithstanding the suspension of the present type of largely fictitious convertibility. But this would presuppose constant close contacts between the U. S. and the other major countries concerning our monetary policies and our presumptive dollar supply to the rest of the world, and also concerning the policies of the most important foreign countries toward the dollar. It is possible that during the period of transition, as described in the preceding Subsection, a tradition of such contacts would start developing. In this case even the long run solution would not necessarily have to imply the resumption of convertibility into gold.

It is difficult to imagine that at present the foreign valuation of the dollar would have much to do with the kind of "convertibility" that has existed since March 1968. To arrive at a well-functioning system, foreign countries must be made aware of how our monetary policies are apt to shape up, and _we_ must be aware of how alternative lines of American monetary policy are apt to influence the valuation of the dollar abroad. But this does not necessarily lead to the conclusion that a well-functioning system requires convertibility of the dollar into some medium at a guaranteed price.

October 22, 1968

Draft: HSH 10/21/68

~~The Risks of Doing Nothing~~

At the time this is being written the foreign exchange markets are quieter than they have been for some time. Since the sharp deterioration in our trade account has been temporarily offset by a large inflow of European capital and by new exchange controls the dollar is not under any particular pressure. The free gold market is in the doldrums. Sterling has shown more strength as the favorable effects of last year's devaluation on British exports become apparent. The speculation on a revaluation of the German mark has receded, but the French franc remains under suspicion.

It must be feared that this calm is deceptive. Every one of the world's four major currencies has been ~~in crisis~~ under severe speculative pressure during the last twelve months, but ~~and only in the case of sterling has anything been done to rectify the underlying causes~~ have corrective actions begun to show an effect. The apparent improvement in the dollar may turn into renewed weakness as soon as the foreign buyers of American securities change their minds; in any case, they can hardly be expected to continue their purchases at the present rate. The exchange controls introduced by President Johnson on January 1, 1968, will ultimately weaken the dollar by making it appear an undesirable "soft" currency. These measures are incompatible with free enterprise and with the efficient use of resources. Yet in the short run, ~~making it less attractive to hold, especially to multinational corporations. The full implications of the virtual disappearance of our trade surplus for the future of the dollar have not yet been generally realized. The uncertainties connected with a change in the Presidency may also bring about a new attack on the dollar.~~ the removal of exchange controls, thoroughly desirable though it is, will probably have an adverse effect on the dollar~~, in the short run~~.

The situation abroad also presents real dangers. The weakness of the French franc, in particular, is still likely to lead to a devaluation, since the French have traditionally preferred an undervalued to an overvalued currency, and since they may wish to restore their depleted reserves by running a surplus.

Any French move would have wide repercussions because of the choices with which the other Common Market countries will then be faced. Germany, for instance, is not likely to follow the French, but a French devaluation would probably rule out the German revaluation that is greatly to be desired from our point of view. ~~Italy and the Netherlands will probably stay with Germany, but it is not clear what Belgium would do. In any case,~~ The net result of a French devaluation would therefore be a further weakening of the dollar. Sterling might then also be devalued again.

One strategy would be to wait for all these dangers to materialize, on the grounds that none of them are certain and that ~~any corrective move~~ any major intervention in international monetary relations might do more harm than good. ~~Accommodation, present poli~~ This strategy presents ~~four~~ major drawbacks:

from WF p.2 first para

~~(1) Any attempt to temporize would preclude the removal of existing controls, and indeed would require strengthening and expanding them.~~

~~For these reasons we are convinced that continuation of the Kennedy-Johnson policy of defending the $35 gold price by controls of various sorts cannot be recommended.~~

~~(2) It would mean abandoning the initiative to other countries (notably France) and to faceless speculators.~~

(1) If a crisis ~~does break~~ broke again out this time there would be an ~~a~~ even more severe blow to confidence than on previous occasions. ~~and~~ The remaining faith in the stability of the international system to weather crises would disappear. New arrangements would have to be worked out under intolerable pressure.

(2) The ~~Administration~~ President would no longer be in a position to blame the crisis on ~~its~~ his predecessors. If Harold Wilson had devalued the pound sterling upon taking office it would have been greeted as an act of statesmanship; when he was forced to do so after three years of ruinous delaying tactics ~~it destroyed what little prestige he had left~~ his public image suffered greatly. Conversely, the French devaluation of 1958 freed De Gaulle from international economic constraints ~~for several years~~ until the mid 1960's, thus enabling him to pursue the policies he considered desirable.

~~(4) Any attempt to temporize would preclude the removal of existing controls, and indeed would require strengthening and expanding them.~~

turn to p4 of WF (5)

For these reasons we are convinced that continuation of the Kennedy-Johnson policy of defending the $35 gold price by controls of various sorts cannot be recommended.

Wilson Schmidt 10/15/68

DRAFT

Introduction

Your objective in respect to the balance of payments should be to restore equilibrium without the use of direct controls on foreign trade and payments and without sacrificing our paramount objectives of high employment and rapid growth.

Our balance of payments eventually must be brought under control. We cannot finance a deficit forever. We do not have an infinite supply of gold to feed to foreign central banks. We cannot expect them continuously to absorb unwanted surplus dollars.

In our judgment, it is not unlikely that sometime in your administration you will be faced with a run on the dollar. No one can be certain of this for it depends upon events at home and abroad which you cannot control. But the persistence of the deficit over ten years suggests that the problem will not go away by itself. And, as our gold stock continues to shrink, the pace at which we lose gold is likely to quicken for that is the nature of runs on currencies -- the remaining stock of reserves goes faster.

You face a choice between waiting until the run starts and accepting the blame for the measures you must take to staunch the outflow of gold or of taking action in the early days of your administration. Prime Minister Wilson could have devalued the pound when he assumed office in the Fall of 1964, blaming the need for this drastic action on the inept policies of his predecessors. But he chose to temporize, imposing slow growth and unemployment upon his nation, and, in the end was forced to devalue anyway at great cost to his party. We urge early surgery.

Specifically, we urge that (1) you immediately pursue monetary and fiscal policies designed to halt inflation, (2) you immediately prohibit further sales of gold for dollars in order to preserve our remaining gold stock for the selective defense of the dollar, and (3) having obtained freedom of action and negotiating strength by ending the sales of gold, you propose certain fundamental changes in the international monetary system to be worked out with foreign countries, namely a widening of the range over which exchange rates may fluctuate and a system for shifting automatically the range over which they move in order to improve the balance of payments adjustment mechanism.

Policy Objectives

As stated above, you should restore equilibrium without the use of direct controls and without reducing employment significantly or retarding growth. The existing *ad hoc* restrictions on international trade, international travel, and international capital movements should be rapidly eliminated, for these restrictions are wasteful and inefficient, they tend to undermine our free enterprise system and thus reduce the rate of growth of the economy. And some of these, especially the direct investment controls, although they may afford some balance of payments relief in the short run, undoubtedly hurt our balance of payments in the somewhat longer run.

We are convinced that these objectives can be achieved although, for two reasons, the job is somewhat greater than the official figure of the current balance of payments deficit suggests. The first reason is that "cosmetic" devices have been used to make the deficit appear smaller than it actually is. The other reason is that the current deficit may have been kept at a somewhat lower level by the numerous payment restrictions just mentioned.

Stopping Inflation

If external equilibrium is to be restored without direct controls of trade and payments, stopping inflation is a necessary although almost certainly not a sufficient condition.

From 1958 to late 1964 prices were reasonably stable and from 1960 to 1964 the balance of payments improved greatly. Then inflation set in again as a consequence of rapid monetary growth and huge deficits in the federal budget caused by tax reductions and a veritable expenditure explosion for war and "Great Society" purposes. During the first 7 months of 1968 the consumer price index has been rising at a record rate of over 5 per cent.

This rate of inflation is intolerable from the point of view of the internal economy as well as on balance of payments grounds.

The tax increase earlier this year was a step in the right direction, but it came too late and the promised cut in government expenditures has not been fully carried out. Furthermore, monetary expansion after a slight moderation early this year has been resumed at a very high rate, thus threatening to nullify the anti-inflationary braking effect of the budgetary measures.

This panel is concerned with the balance of payments. It is always possible to restore equilibrium in the balance of payments by a sufficiently vigorous anti-inflation policy. But we cannot disregard overriding internal objectives of policies, high employment and growth. True, for the time being there is no conflict between external and internal policy objectives, because the present rate of inflation (consumer prices rising 4-5 per cent per annum) is not only incompatible with balance of payments equilibrium but also intolerable on equity and efficiency grounds.

A determined effort to curb inflation will improve the balance of payments. In addition, by creating a generally favorable climate at home and abroad and increasing the attractiveness of the dollar as an international reserve asset, it will induce surplus countries to add to their dollar balances, reduce our gold losses and provide a breathing spell for orderly restoration of equilibrium.

But for various reasons we cannot confine our balance of payments efforts to curbing inflation.

Curbing inflation in all probability will entail a temporary rise in unemployment and a temporary reduction in the growth rate. The reason is that during the long period of inflation a pattern of wage settlements involving a rise in labor cost of well above 6 per cent has been established. This is incompatible with non-inflationary growth and it will take some temporary increase in unemployment to change that pattern. It is to be expected that if and when it becomes generally realized that the inflation has been halted and price stability restored unions will moderate their wage demands and a pattern of wage settlements compatible with price stability will evolve. We cannot be sure, however, that the solution of the inflation problem will be sufficiently fast and complete to substantially eliminate our balance of payments difficulties.

Even under the most optimistic assumption that price stability can be achieved quickly, we cannot be sure that the balance of payments problems will disappear. Inflation may have gone too far for external equilibrium so that price stability may not be sufficient and a rollback of prices (deflation) would be required. Real deflation is, however, out of the question.

Moreover, it must be remembered that our balance of payments depends not only on American developments but also on what happens abroad, primarily in the economies of our principal competitors, Western Europe and Japan. If they pursue sufficiently expansionary (inflationary) policies or reduce their import restrictions (tariffs, etc.) substantially, curbing inflation here may be sufficient to restore balance of payments equilibrium at current exchange rates.

But we cannot ask them reasonably and realistically for more than that they refrain from pursuing outright deflationary policies and from raising trade restrictions. We cannot ask for outright inflationary policies on their part, and substantial reduction of trade barriers for balance of payments reasons is not part of the existing code of international behavior as laid down in the IMF Charter and GATT rules.

Many experts have thus reached the conclusion that the essential objectives of American economic policy mentioned above cannot be achieved with guaranteed gold convertibility at $35 an ounce (a convertibility that has become in any event largely fictitious as will be seen later). Nor can it be achieved with an inflexible international structure of exchange rates in a world in which it is impossible properly to coordinate and mutually adjust trends of prices, wages and costs in various countries. What we need is a set of arrangements that do not institutionally exclude a response of the exchange rate structure to market forces.

The Likelihood of a Crisis

This section is, I believe, being drafted by H. Houthakker.

Ending Gold Convertibility

Having shown that in all likelihood you will face a balance of payments crisis during your administration, the question remains of what you should do about it.

The simplest and easiest action is for you to cease converting dollars into gold at a fixed price of $35 per ounce. The Trading with the Enemy Act gives you the power to do this unilaterally. Other countries should be informed at the same time that the U. S. is firmly resolved to regulate its monetary and fiscal policies in such a way as to make the dollar a very desirable currency to foreigners. We could phase out our foreign investment and lending controls and the interest-equalization tax as quickly as possible, but we would remain in constant close contact with the major foreign monetary authorities concerning our monetary policies, and we would take a cooperative attitude, not excluding the possibility that our behavior in relation to the supply of dollars and the valuation which other countries place on the dollar will later again become somewhat more formalized.

Under the present international monetary arrangements, foreign monetary authorities buy and sell dollars in exchange for their own currencies in order to keep the price of a dollar in terms of their own currencies within a small range. We in turn buy and sell gold at $35 dollars per ounce in transactions with those monetary authorities. Thus, foreign currencies, the dollar, and gold all have fixed prices in terms of one another by virtue of their convertibility. But the convertibility of the dollar into gold is largely fictitious. While in principle we stand ready to sell gold for dollars to foreign monetary authorities, we have quietly entreated foreign governments not to exercise their option. We have pressed them to hold their dollar assets in less liquid form. It is generally known that if the major holders started converting on an appreciable scale, then the system would collapse. The consequences of this "convertibility" are nevertheless harmful because the threat of conversion has let to highly undesirable controls and to strong protectionist pressures, and because such a system is highly crisis-prone.

If you end this convertibility, foreign monetary authorities will have a choice between two policies. They can continue to buy and sell dollars in terms of their own currencies in order to keep the price of the dollar within a small range. Or they can refuse to buy or sell dollars, in which case the price of the dollar will rise and fall with supply and demand.

Under either policy, your problems with the balance of payments disappear. In the event of a deficit in the U. S. balance of payments such that we pay out more dollars than foreigners wish to hold, the monetary authorities of those countries which decide to peg their currencies to the dollar will simply have to absorb the surplus dollars. Alternatively, they may peg the dollar at a lower level. Their goods will become more expensive to Americans, cutting U.S. imports, and our products become cheaper to them, stimulating U. S. exports; as a consequence, the deficit is reduced if not erased. For those countries who refuse to peg, the value of the dollar will decline in terms of their currencies, which likewise will close the gap between payments and receipts.

It is our judgment that it is very likely that after your unilateral declaration of inconvertibility of the dollar into gold, most other countries would continue to peg their currencies to the dollar, approximately at the present exchange rates, though presumably some adjustments in the international structure of exchange rates will occur. This is especially true if combined with a strong statement about controlling inflation.

The international value of the dollar under this proposal would depend largely on the decisions of foreign authorities. (Though by controlling monetary and fiscal policies to limit the supply of excess dollars you would greatly affect their actions.) However, we would have about $10 billion in gold which should be amply sufficient to protect our interests. If the value of the dollar in terms of a currency fell too much we could buy up the surplus dollars with part of our gold.

In the event that exchange rates shifted, it is likely that the dollar price of gold would rise somewhat. Foreign monetary authorities who, at our urging, hold dollars instead of converting them to gold will therefore suffer some paper and possibly real losses. The paper losses stem from the necessity of writing down the value of their dollar holdings. The real losses derive from the reduced command of the dollar over foreign goods and services. While the present and previous Administrations have promised to maintain the dollar price of gold, compensation for losses as a result of exchange rate adjustments has no postwar precedent. Furthermore, in no sense have we ever entered into any formal guarantee of the value of the dollar. Finally, those monetary authorities holding dollars will have gained far more in interest on the dollars they have held than the losses they would have ~~gained~~ avoided if they had held gold instead. There is no compelling case for restitution of the real value of their dollar assets.

Further Steps

With the cessation of gold convertibility, the initiative for any further changes in the international monetary system will rest with the foreigners. It is not unlikely that foreign monetary authorities will wish to regularize international monetary relations. You will, however, have enormous bargaining strength in negotiations on those changes compared to what otherwise would prevail because you will have solved the balance of payments problem.

The basic problem with the present international financial system is that the countries in surplus do not wish to inflate their price levels while the deficit countries do not really want to deflate their internal price and employment levels. Wage trends and productivity trends in various countries cannot be properly coordinated and, insisting in these circumstances on a rigid exchange rate structure means inviting highly inefficient direct controls and restrictive measures of all kinds. In short, the balance of payments adjustment mechanism is not working.

There is a fairly general agreement among experts that if we wish to reserve the trend towards more and more controls, the system of fixed exchange rates which has become unduly rigid must be loosened up either by more frequent changes of exchange rates (as was envisaged under the Bretton Woods Charter) or by making exchange rates flexible. We therefore believe that the American Government should urge upon the IMF to give this matter prompt consideration. We believe that such an American initiative would find wide support among the IMF membership.

Three major proposals have been made to change the international financial arrangements which prevail today.

1. A substantial increase in the price of gold
2. A unilateral devaluation of the dollar
3. Cessation of all government control over exchange rates

Only the third proposal requires your acceptance of our advice to cease exchanging gold for dollars. The first two could be undertaken while maintaining the tie to gold. Therefore, they could be considered as alternatives to our main proposal but, as we shall see, not very satisfactory ones.

Increasing the Price of Gold

A policy which is often mentioned is to increase the official price of gold. An increase in the price of gold vis-à-vis all currencies would do nothing to correct the U. S. deficit unless the price were raised by different amounts for different currencies so as to reduce the price of the dollar vis-à-vis other currencies. What it could do is increase international liquidity and the value of the U. S. gold stock relative to the value of our liquid liabilities to foreigners. As such it could be a method of buying additional time during which the deficit could be attacked by other means. It has also been proposed by some that an increase in the price of gold be combined with a devaluation of the dollar vis-à-vis other currencies. For purposes of evaluation, one can consider separately the two policies of increasing the official price of gold and of devaluing the dollar in terms of other currencies and we do so here.

There are a number of objections to increasing the official price of gold. One of the most undesirable features of such a policy is the uneven distribution of the increase in reserves which would result. The benefits from such an increase would, of course, accrue to gold producers and to other countries in proportion to their initial gold holdings. This means that among the largest beneficiaries in addition to the United States would be France, Russia, and South Africa and that the largest losers would be those governments that have responded to the U. S. pleas not to convert their dollars into gold.

A doubling or tripling of the price of gold would undoubtedly be highly inflationary. Some countries with large gold reserves would find it difficult to resist the temptation to relax resistance to inflationary demands. Billions of dollars of privately hoarded gold would come out of hiding. While successful gold speculators would certainly not wish to go on a gigantic spending spree but would rather invest in other assets, they may well kindle a boom which many central banks would find very difficult to control.

Increasing the price of gold would reverse the present trend away from the wasteful use of gold as money. It is clearly wasteful to expend valuable resources in digging up, transporting, and then reburying gold when international reserves can be created by fiat at almost zero cost.

Furthermore, an increase in the price of gold would leave unsolved the problem of providing for a systematic growth of international reserves over time. The growth of reserves would still be tied to the vagaries of gold production, private industrial needs and the whims of speculative gold hoarders. It would be sheer chance if the proper price increase to remedy the overhang problem would also yield a proper rate of growth.

A much better way to increase international liquidity is through SDRs which could be provided in predetermined amounts. It should be remembered, however, that SDRs will not correct our balance of payments deficit nor will they do much toward removing the potential crisis problem caused by the high level of U. S. liquid liabilities to foreigners relative to our gold stock.

Unless you adopt our recommendation to cut the fixed tie between gold and the dollar, there is also another very important pragmatic objection to universal increase in the price of gold. It would seem almost impossible to reach unilateral agreement on increasing the price of gold without substantial rumor circulating and threatening a run on the dollar and other currencies.

Unilateral Devaluation. A one-shot devaluation of the dollar to a new fixed level vis-a-vis other currencies might seem to be the simplest and most straightforward method of dealing with the American deficit. It would be in the spirit of the Articles of Agreement of the IMF. In fact, according to Article IV, Section 5(c)1, the Fund could not object if the U.S. proposed a devaluation of not more than 10 per cent while most other countries, having used up the allowable margin, require permission by the Fund. A 10 per cent devaluation would probably be sufficient to restore equilibrium.

We believe, however, that this solution is not workable, for two reasons: First, we cannot be sure that 10 per cent is about right. It may well be too much; in other words, it may turn our deficit into a surplus and thus put other countries in deficit. By continuing to rely on a system of exchange rates fixed at new levels we court recurring balance of payments disequilibrium. Second, whatever their rights under the IMF Charter, most other counrties, except perhaps two or three European surplus countries, would simply follow suit, so that the net effect would be an appreciation of two or three currencies in terms of others and a 10 per cent rise in the gold price in terms of all currencies except two or three.

Much is to be said for an appreciation of the currencies of the few large surplus countries. But it would be awkward to bring it about indirectly by attempting to devalue the dollar. It would be difficult, on the other hand, to bring it about directly because, again, nobody can tell by how much the currencies of the surplus countries would have to be appreciated to eliminate the surplus. Furthermore, it seems clear that the main surplus countries do not wish to appreciate.

Floating Dollar. There is much to be said for stopping virtually all government intervention in foreign exchange markets, thus allowing individual currencies to seek their own value in the market place with occasional guidance from the monetary authorities. Several members of the Task Force strongly prefer this solution above all others. However, there are fears on the part of others both within the Task Force and outside that such a system would engender excessive fluctuations in the exchange rate through speculation and that the foreign exchange markets could not presently handle the increased volumes of transactions that would ensue. As the proposal is not likely to gain wide acceptance, it is not pressed here.

Limited Felexibility. Between the two extremes of fixed exchanges and freely floating rates there is a middle ground which has recently attracted favorable attention in official and financial circles. It is not necessary to go all the way to freely floating rates to overcome the excessive rigidity of the present system, nor is it necessary to accept frequent crises as the price for reasonable certainty in exchange rates. What we need is a system that combines smooth adjustment to the ever-changing forces of supply and demand with the over-all stability on which international finance has come to depend. This can be achieved by two changes in the charter of the International Monetary Fund.

The first of these two changes would widen the "band," that is the margin between which exchange rates can fluctuate. This margin is now one percent each way, which is not enough to make a useful contribution to the adjustment process. By widening the band to say three per cent each way, meaningful fluctuations would be permitted without scrapping the whole system. Further study of the "band" proposal has recently been urged by a subcommittee of the Joint Economic Committee and endorsed by Secretary Fowler in his speech at the IMF meeting.

But widening the band is not likely to be adequate by itself. As long as parities remain fixed (subject to spasmodic changes in the midst of a crisis) there still remains the problem of trends in the factors determining a country's competitive position in world trade. Even if a country grew no more rapidly than its trading partners and had no more inflation it might still find its currency growing ever weaker or ever stronger as a result of gradual changes in the world demand for its imports. Thus it appears that the steady deterioration of the pound sterling is attributable in large part to the tendency of British exports to grow more slowly than British imports, despite slow growth in the British economy itself. A similar pattern may be among the causes of our own balance-of-payments problem.

It is therefore necessary to allow parities to change gradually in response to market trends. This can be done through the second change in the IMF charter, which would make the parity around which the exchange rate fluctuates at any time equal to a moving average of the market rates prevailing in (say) the past year. Thus if a currency had been near its lower limit for some considerable time the parity would gradually decline. In the extreme case of a currency which had been at its lower limit for the whole year the parity could decline six per cent per year.

This system, which may be described as a "self-adjusting peg," would also reduce the need for international reserves, though it would not eliminate this need. Combined with the usual transactions in the forward exchange market it would provide importers and exporters with a sufficiently stable financial environment in which speculation would have less scope than it has now. Although the details would have to be negotiated it is quite conceivable that the dollar could retain its present central role in financial transactions, and that the gold market could ultimately be restored to normal operation without the two-price feature. Alternatively it would be possible to anchor exchange rates to some other standard value.

~~CONFIDENTIAL~~

MEMO TO TASK FORCE FROM T.D.W.

In light of the comments of Paul and Mr. Loomis at the last meeting, it seems that in our report we should especially emphasize that:

1. we do have an important international monetary problem which has not been solved by the two tiered gold system, the prospects for ratification of the SDR scheme, and the favorable figures on the measured deficit in the first half of 1968;

2. and that if a major policy change is to be made there are strong advantages to taking such action soon after taking office.

Otherwise, it appears from Mr. Loomis' remarks that it is unlikely that quick attention would be paid to the subject of our report and the most propitious time for action might well slip by.

It also strikes me that as some of the proposal we are considering involved alterations in our international monetary system we should include some discussion specifically on the problem with the manner in which the system now operates, i.e., our problem is broader than just the U.S. deficit.

In the enclosed very rough draft, I have attempted to indicate one way in which some of the above points could be covered and also to distinguish between the adjustment, confidence, and long-run liquidity problems. I think making these distinctions would be useful, especially for our discussion of cutting convertibility and how this would help us whether foreigners continued to peg to the dollar at the current rate or not.

Somewhere should we discuss the Reserve Settlement Account proposals of Bernstein, Machlup, and Triffin? Such a plan has been advocated by the JEC subcommittee.

~~CONFIDENTIAL~~ Tentative Draft -- Tom Willett

A BRIEF OVERVIEW OF THE KEY PROBLEMS WHICH WILL FACE THE UNITED STATES AND OUR INTERNATIONAL MONETARY SYSTEM IN 1969

Three major types of problems face our international monetary system as it has evolved out of the Bretton Woods Agreement of 1944.

1. The Problem of Balance of Payments Adjustment

Exchange rates between countries have become much more rigid than was originally anticipated by the designers of our international monetary system at Bretton Woods. As a result, devaluation of a currency with a balance of payments deficit has become a major political event, not just an economic adjustment. This is clearly indicated by the recent British experience. Because of this there has been a tendency to attempt to maintain exchange rates which have become clearly overvalued. The British struggled under this situation for years: adopting controls, stop and go financial policies and other distasteful means of "defending the price of the pound" before finally devaluing in 1967.

As is described in section , U.S. policies have been following a course very similar to that of the British. Once an administration affirms as a goal the defense of the present parity of its country's currency, maintenace of such a policy becomes an evil in itself. Then only with a change in administration does a change in exchange rate policy become an alternative which may not bear considerable political costs. As is indicated by both the British and U.S. experience, this limitation of the use of exchange rate policy means that countries which are not willing to tolerate a high level of unemployment must resort to various forms of controls or special taxes to suppress a balance of payments deficit. Thus in the 1960's we have witnessed a drastic reversal of the postwar trend toward liberalization of international trade and payments. Despite the superficial appearance of improvement in the U.S. balance of payments during 1968, the problem of actually correcting the U.S. deficit remains very real. (This is discussed further in section .) ?

2. The Crises or Confidence Problem

Because under the present system international reserves are held in several forms, primarily dollars, gold, and pounds, there always exists the potential danger of sudden shifts between the reserve assets. The U.S. gold stock is considerably smaller than the number of dollars held abroad, yet under the present system foreign held dollars are supposed to be freely convertible into gold. Thus if a run began on the dollar, i.e. if foreigners demanded gold for their dollars, the United States would not have sufficient gold to meet all potential demands. In good times, this is little of a problem, but when the dollar is in a precarious position and there is a widespread feeling that the price of gold relative to the dollar might be increased, then a run on the dollar which we do not have sufficient gold to stop becomes a distinct possibility. The closing of the London gold pool in March 1968 and the initiation of the two tier price of gold system has diminished the danger to the United States of a run from dollars to gold by private speculators, but the threat of official conversions by foreign central banks remains.

/Mention de facto inconvertibility here?/

The adjustment and confidence problems are, of course, interrelated. While a basically sound balance of payments position may not always be sufficient to remove the threat posed by the existing overhang of foreign held dollars, a basically weak position clearly strengthens such a threat.

3. Providing for Systematic Increases in International Liquidity Over Time

A less pressing problem which has faced the international monetary system is that for growth in international reserves the world has had to rely upon haphazard sources such as the output of South African gold mines, the vagaries of Russian gold sales, and the changing deficits in the U.S. balance of payments. A much better method to assure the needed growth in reserves over time is to consciously agree to systematic reserve creation through some international body. This approach has been adopted in the proposed amendment to the Articles of Agreement of the International Monetary Fund to create supplementary international reserves called Special Drawing Rights (SDRs). The prospects look bright for ratification of this amendment by the member countries of the Fund. It must be stressed, however, that the SDRs are not a solution to our two most pressing problems -- correction of the U.S. deficit and removal of the crisis threat -- and in fact agreement on activation of the SDR plan may well be contingent upon correction of this first problem.

II

In Section I we commented on the difficulties to which a rigid structure of exchange rates gives rise in a world in which the relationship between wage-trends and productivity trends develops differently in different countries. Yet even if we should remain in the framework of the "Bretton Woods System" (rather than terminate the convertibility of the dollar into gold), the difficulties would become less acute if the present exchange rate structure were readjusted, though further adjustments -- partly perhaps in reverse direction -- would then be needed at future times. <u>At present</u> our balance-of-payments situation would be helped by a downward adjustment of the dollar rate in relation to some foreign currencies.

According to the Bretton Woods agreement we have the right to devalue the dollar by 10 per cent in relation to gold. Devaluation from the initial parity levels by this margin does not require the approval of other countries. Quite aside from this, the question of approval presents no problem, because IMF approval has always been given even for devaluations exceeding the 10 per cent margin in relation to the original Bretton Woods parities. What does pose a problem is the possibility that the other countries might follow suit, in which case the exchange-rate structure would remain unchanged. This many other countries might do in order to prevent the U.S. from becoming more competitive, though it would be inconsistent on their part to insist on an American effort to balance our international accounts and yet to want to prevent us from improving our competitive position. There is reason to assume that several major countries would <u>not</u> match a 10 per cent American devaluation.

However, if the solution were to be sought along these general lines, then the best procedure would be to reach an agreement with the other major countries in the Bretton Woods framework before we devalue the dollar in relation to gold, and to agree with them on a general but <u>not uniform</u> increase in the price of gold, so that for the time being the dollar rate should become somewhat reduced relative to some other major countries.

An increase in the price of gold, without exchange-rate adjustments, would merely increase world liquidity and would not promote (would, in fact, retard) balance-of-payments adjustments. It would therefore be essential to couple the measure with changes in exchange-rates. On the other hand, if exchange rates were to be readjusted in what essentially would remain a system of "fixed rates with occasional abrupt adjustments" then the increase in liquidity brought about by a higher gold price would be helpful, because at the present price new gold will not become available to the monetary authorities in sufficient quantities, and because the as yet untried Special Drawing Rights will in the near future not be issued on a scale such as would take care of the problem.

Increasing the price of gold by per cent would place the U.S. in a position in which our short-term dollar-liabilities would cease to be troublesome. Given such an increase, the gold price would of course rise beyond the present free-market price. The money value of the present gold stock of all countries would increase, and the value of the newly mined gold would increase not only because a given quantity of gold would be worth more but also because larger quantities of gold would be mined. Also, quite a bit of gold might become dishoarded. Controlling the resulting inflationary tendency by the appropriate sterilization policies would create problems of some difficulty, and this is one reason why several members of our group -- [names] -- have a preference for the solution described in Section I over the solution here discussed.

We said that the solution discussed in the present Section is one of fixed exchange rates with occasional abrupt adjustments. It should, however, be added that the disadvantages of such a system could be reduced by choosing a somewhat modified version that would allow for automatic exchange-rate flexibility, in response to market forces, within a specified range of some width around the parity points, and would allow also for an automatic, very slow adjustment of parity levels when market forces tend to press a currency level below the lower support point or beyond the upper support. Such a modification, or relaxation, of the Bretton Woods system of pegged rates would require international agreement, but there are some signs that major foreign central banks are willing to consider such proposals. See Section , below. [Alternatively, instead of developing this in a separate section, we could say here quite briefly what is implied in margin-flexibility and in the crawling peg.]

October 8, 1968

We should use here the Houthakker draft which I just received!

Tentative Draft of a Section of the Task-Force Paper

by

William Fellner

We now turn to specific proposals. In I we shall discuss solutions involving the termination of the convertibility of the dollar into gold, and in II solutions of a different sort which involve an increase of the price of monetary gold coupled with adjustments in the exchange-rate structure. [N.B. Members of the group whose ideas are not adequately described by I or II may wish to add either further Sections on the same level with these two or Sections in which they present other proposals as "variants" or modifications of I or II.]

I

Terminating the Convertibility of the Dollar into Gold

We begin with a general argument applying to both ~~to~~ Version A and B, below.

While every informed person knows that the present kind of convertibility into gold is largely fictitious, this convertibility nevertheless has very harmful consequences. Convertibility is largely fictitious because we convert only the dollars of those countries which are committed to not selling gold at its market price; and we dissuade countries from converting even if they accept this commitment; and it is generally known that if the major holders started converting on an appreciable scale, then the system would collapse. The consequences of this "convertibility" are nevertheless harmful because the threat of conversion has led to highly undesirable controls and to strong protectionist pressures, and because such a system is highly crisis-prone.

Version A. Convertibility could be terminated promptly (in January) and the other countries could be informed at the same time that the U. S. is firmly resolved to regulate the dollar supply in such a way as to make the dollar a very desirable currency to foreigners. We would phase out our foreign investment and lending controls and the interest-equalization tax as quickly possible, but we would remain in constant close contact with the major fo[illegible] monetary authorities concerning our monetary policies, and we would take a cooperative attitude, not excluding the possibility that our behavior i[illegible] tion to the supply of dollars and the valuation which other countries [illegible] the dollar will later again become somewhat more formalized.

Our group considers it very likely that after such a unilateral [illegible] tion most other countries would continue to peg their currencies to the do[illegible] approximately at the present exchange rates, though presumably with so[illegible] justments in the international structure of exchange rates. Foreign [illegible] of the dollar would then depend largely on the decisions of foreign auth[illegible] but we would have about 10 billions' worth of gold which should be amply [illegible] ficient to protect our interests. In order to be able to do so we sho[illegible] however, declare that we consider ourselves and the other countries no [illegible] committed to abstaining from the sale of gold in the free market.

In the opinion of this group moderate changes in the foreign value [illegible] of the dollar -- perhaps sometimes downward, at other times upward -- wou[illegible] not harm American interests but, on the contrary, might promote the balan[illegible] of-payments adjustment process. The wage trends and the productivity [illegible] of the various countries cannot be properly coordinated, and insisting i[illegible] circumstances on a rigid exchange-rate structure means inviting highly [illegible] direct controls and restrictive measures of all kinds.

Possible Objections to Version A even if the suspension of convertibility is contemplated.

It may perhaps be argued that making such a unilateral declarat[illegible] promptly, at a time when there was no gold outflow in the recent past, [illegible] a "brusque" move, regardless of the degree of emphasis placed on co[illegible] attitudes and on our resolve to regulate the supply of dollars in a way [illegible] factory also to other countries. It may perhaps also be argued that a[illegible] the suspension of convertibility at this time would make it a requirem[illegible] fairness to pay some amount of compensation to the foreign official d[illegible] holders, this not being possible without Congressional approval. Whi[illegible] arguments can be used for contradicting these objections, it remains a [illegible] of personal judgment whether one does or does not attribute importa[illegible]

Version B. . Though we should at any event phase out our foreign in-vestment and lending controls as quickly as possible, we might not suspend convertibility at this time, but make secretly the decision to do so when our monetary gold stock declines distinctly below 10 billions (say, to 9 From this time on the program would involve precisely those steps which described in Version A, above. However, the justification of the move in this case include the statement that the recent past demonstrates the lack of workability of the present arrangements: while we are indeed firmly solved to regulate the dollar supply so as to make the dollar a highly currency to other countries, we find ourselves unable to adjust the supply a reasonable estimate of the demand for dollars as long as it is possible move from dollars into gold and then again back into dollars at a guaranteed price.

Some observations were made in this paper on possible advantages of Version B over Version A. On the other hand, Version B has the disadvantage of a move made at a time when symptoms of speculation "against the dollar" more generally visible. Version A involves timing that coincides with the change of Administrations.

II

Increase of the Price of Monetary Gold Coupled with Exchange-Rate Adjustments

[N.B. Am I right in assuming that this will be drafted in Cambridge, i.e., is not my assignment?]

October 4, 1968

Task Force

MEETING, SEPTEMBER 20, 1968
CAMBRIDGE, 2.30 to 7 p.m.

Present: William J. Fellner
Gottfried Haberler, Chairman
Hendrik S. Houthakker
Henry C. Wallich
Thomas D. Willett, Secretary

Absent: Walter Hoadley (who has not yet officially agreed to serve)
Wilson Schmidt (who was unable to attend)

Next Meeting: October 3, 2.30 p.m.
at the Chairman's home,
2 Mercer Circle, Cambridge, Mass.

We had a general discussion on the Structure of the Report.

It was agreed that the report should begin with a very brief description of recent balance of payments developments and critical analysis of balance of payments policies. (A draft will be prepared by Haberler and Willett.)

This will be followed by a short statement of Policy Objectives.

The trend towards increasingly illiberal trade and payments policies must be reversed and the existing controls and restrictions (capital controls, interest equalization tax, tying of aid, etc.) must be phased out as rapidly as possible.

It was also agreed that an indispensable condition for restoration of equilibrium in the balance of payments is responsible financial policies which will halt our accelerating inflation.

The tax surcharge was a step in the right direction but expenditure reductions have not been effected to the full extent promised. Monetary expansion has been much too rapid despite much talk about restrictive monetary policies. [Here it might be said that high interest rates are a poor index of monetary stringency in an inflationary situation and figures of the growth of the stock of money, Federal Reserve credit, etc. be cited.]

Full employment and growth are, of course, major policy objectives and there was discussion how adversely employment and growth may be affected by disinflation. In particular, the question was raised whether temporarily somewhat higher unemployment may be required to obtain a better Phillips Curve. It was pointed out that a recession would have a disproportionate effect on Negro unemployment. Two other complications were mentioned -- the somewhat independent position of the Fed and the constraint placed on monetary policy by the ~~[illegible]~~ housing ~~[illegible]~~ket.

These topics need further discussion, but there was agreement that these problems should not be treated at length by the present group because they were the subject of another task force.

It was generally agreed that the continuation of gold convertibility of the dollar at $35.00 per ounce should not be listed as a basic, overriding objective, because it could severely limit attainment of other more important policy objectives.

Structure of the Report

The group has been asked to prepare a short policy report (20 pages about). It was felt that making just one proposal would unduly restrict the domain of the policy makers and make the report of little use, if that proposal was ruled out on political grounds.

On the other hand, a listing of all or very many policy possibilities withtheir pros and cons would be too cumbersome and inadvisable. It was felt that we should try to strike a balance between the two extremes by offering a limited number of choices.

The possibility of preparing two papers was discussed: a short one along the lines just mentioned and a longer back-up paper giving reasons why other policy possibilities have been rejected. /I think it would be better to stick to the target of one report, about 20 pages, but have a short summary of 2 or 3 pages. G.H./

It also seemed generally agreed that while we should work toward achieving as much genuine agreement as possible among ourselves, we should avoid being evasive on important issues on which agreement cannot be reached and name the various members favoring one or another proposal.

It was also felt that relevant legal along with economic aspects of policies should be mentioned, especially what seems to be permissible under the IMF Charter.

Assuming that disinflationary policies are initiated and successfully pursued (that the rate of inflation is sharply reduced) we may anticipate an improvement in the balance of payments position as well as a greater willingness on the part of surplus countries to add to their dollar balances. But we cannot be sure that lasting equilibrium will be achieved. Therefore, further policy choices have to be made.

The following alternatives were briefly discussed and should be further explored and possibly ranked:

(1) Devaluation.

(2) Terminate gold convertibility of the dollar leaving it to other countries to peg the rate of the dollar or to let it float down. This could be a temporary or permanent solution. It was generally agreed that if it were done, it should be done while we still had a large gold stock and not wait until a crisis forces our hands.

(2) The question of possible compensation for official dollar holders will have to be tackled.

(3) General increase in the price of gold as a second or third

best solution.

(4) A general import surcharge as a strictly temporary device.

(5) SDR's, gold pool, reserve settlement account, etc.
It was generally agreed that these liquidity problems will have to be briefly discussed, but that the adjustment problem is more important.