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RECORDS SECTION
AUG 31 1962

August 30, 1962.

To: Federal Open Market Committee

From: Ralph A. Young

Subject: Newspaper Article on U.S. Dollar

The attached article appeared (in German) last Sunday in the "Neue Zürcher Zeitung," probably the most influential newspaper of Continental Europe. Its author is the chief editor of the paper's economic section, and is generally considered to be an extremely acute observer of the world economic scene. The author took the unusual step of sending a pre-publication copy to Chairman Martin.

The article lacks originality but shows better understanding of the problems of U.S. domestic and international monetary policy than most other European discussions of the subject. Some of its observations and recommendations will not be acceptable to the U.S. side, and may indeed deserve refutation. But its generally optimistic tone may well have contributed this week to the firmer position of the dollar in European markets.

The translation, by the staff of the Board's Division of International Finance, has sacrificed stylistic beauty -- also noticeably absent from the original version -- for the sake of speed. It is distributed for the information of the Committee members.

Attachment.

Translation by: J. H. Furth
Mr. Ruckdeschel
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FOR FILES
J. Herbert Furth

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Neue Zürcher Zeitung, August 23, 1962

Is Dollar Pessimism Still Justified?

Like a "deus ex machina," President Kennedy's statement about the dollar at the end of last month brought the new attack against the American currency to a halt. The speculative wave had created capital flows, which brought to the Swiss Central Bank alone $270 million. Similar but smaller movements arose in other European finance centers. On the London gold market there was an increase in demand which raised the daily turnover to three and four times the normal market volume and caused a considerable drain on monetary reserves. The gold share boom in the midst of a general market decline reflected a confidence crisis of the dollar.

The American President only repeated what he had already emphatically declared at the beginning of 1961, namely, that he had decided under all circumstances to maintain the U.S. dollar at its present parity of $35 per gold ounce--and could only confirm what already was known about the latest development in the balance of payments. Nevertheless, the speculative wave has more or less ebbed for the moment; it disappeared just as it had arisen. For the Canadian currency crisis and the world-wide stock exchange decline originating in New York could in themselves not supply sufficient justification for a confidence crisis of the dollar.

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This proves that the newest pressure on the dollar can be interpreted only as a flare-up of a fire which had already been burning for some time under cover and which was kindled into an open flame by a slight breeze that could come from anywhere or everywhere. It also shows that the quiet which has returned will remain rather uncertain as long as those on whose judgment and behavior the stream of short-term funds on the international level chiefly depends, remain obsessed by strong skepticism about the dollar. That is, however, still the main mood to be found in many banking and economic circles, not only in Europe but partly also in America. As if hypnotized they look at the weekly published figures of the American gold outflow and of the remaining gold stocks, calculating that soon the $16 billion mark will be reached and that then, after substracting the gold reserves necessary for the legal cover for notes and deposits, only $4.2 billion remain as monetary stock, to cover the $19 to 20 billion of foreign liquid dollar assets. A further gold loss of a few billion--since the end of 1960 alone the loss has amounted to $1.6 billion--, it is often argued, and the United States will have to face a full-fledged confidence crisis, which will leave America no other choice than formally to devalue the dollar with respect to gold or, which would amount to the same thing, to suspend its convertibility into gold. One can speak of what amounts to hysteria, a nervous disease, in regard to the dollar. The suggestive power of the continually falling gold reserves and of the steadily increasing short-term dollar liabilities, a development from which there is apparently no escape, is for many so strong that they have lost their perspective of the total development of the dollar

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position. Because the amount of the American gold reserve is considered in many circles as the main standard of the dollar, each large gold loss brings with it the danger of creating further gold losses due to psychological reactions.

The hallucination that the dollar will not be able to avoid devaluation against gold if the American gold reserves further decline, is further strengthened by the widely dissominated fixed idea that a general rise in the price of gold is in any case necessary because of the constantly increasing discrepancy between the price of goods and the still unchanged gold price (in comparison to the price of gold before the war) and because of the resulting shortage of gold as an international means of payment. The combined effects of this international liquidity deficit and the continual reduction of the American gold reserves, so the general opinion goes, strengthens the probability of devaluation of the dollar against gold. True, a universal rise in the price of gold would not result in a devaluation of the dollar against other currencies. Speculation based on such an expectation could, therefore, only raise the price of gold instead of depressing the dollar exchange rate. In practice, however, things have worked out in a different manner. The strong increase in demand on the London gold market in 1960 and again this year induced the American Federal Reserve Bank to release considerable amounts of gold in order to control the rise in the gold price, and this in turn reduced American gold reserves. Also, many believe that a universal and simultaneous increase in the gold price would not rule out the possibility that the degree of devaluation of various currencies would be smaller than that of the dollar. The expectation of a general rise in the price of gold has therefore aggravated the confidence crisis of the dollar.

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Good Prospectives for the American Balance of Payments

Because these ideas are often treated like articles of faith, it is not easy to attack them with rational arguments. They can be refuted effectively only by the power of the facts, i.e., through the practical proof that the development need not run in the direction forecast; and that there are no grounds for the fatalistic interpretation according to which no other escape remains than a rise in the price of gold--which in any case would be no escape. In concrete terms: the talk about the fatal results for the dollar of a further drain on gold will stop only when the American balance of payments is brought quickly and permanently into equilibrium. And the international gold price discussion will be quieted only when proof is presented that international liquidity can be maintained through measures other than a rise in the gold price.

In the area of the American balance of payments one can now report encouraging progress in the recent past. Last year the total deficit in the balance was reduced from \$3.9 billion to \$2.5 billion; in the current year the deficit has further decreased so that on a yearly basis it has dropped to \$1 - 1.5 billion or almost to the normal level for the years 1950-57. The result for the year so far is to be ascribed in part to special factors such as considerable debt prepayments of European countries, capital repatriation from Canada, and smaller capital outflows. Decisive, however, is that there exist in various basic accounts of the balance of payments considerably improved long-term prospects: the current account balance, which last year had a favorable surplus of \$7 billion due to cyclical conditions, should fare not much worse in the immediate future. Cost and price relations have improved

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and the favor of the United States, in view of the greater wage and price stability, especially relative to Europe. The American measures to increase exports will soon begin to take effect, and the income from the continually increasing direct foreign investment clearly tends to rise. The importance of this last item in the American balance of payments is shown by the rise in income from private investments abroad from $2.9 billion in 1960 to an annual rate of $3.75 billion in the first quarter of 1962. It should be noted that this account is not affected by cost and price conditions in the United States. A prerequisite for the maintenance of a favorable trade balance is, however, that the relative stability in the price and wage sector continues, as it has in the recent past.

Favorable long-term prospects for the American balance of payments arise also from the thorough measures which the administration is presently undertaking in order to reduce the foreign exchange costs of defense aid and development aid, which now amount to $4 billion, first to 3 billion and after 1963 even further. This is being done in regard to military aid primarily through bilateral agreements for armament procurement by European countries in the United States and through savings in foreign exchange expenditures of American troops stationed abroad. In the area of development aid, the portion of tied aid which was previously two-thirds will be brought to about 80 per cent of the total development aid, so that only one-fifth will be a burden upon the balance of payments. But because the international development aid generally has the tendency to grow, the American authorities make

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great efforts to increase the particcipation of foreign countreis so as to avoid the need of futher raising the United States contribution. Taking into consideration these plans to save foreign exchange in the foreign aid sector--which, however, are not meant to reduce total aid--it is not too optimistic to conclude that the possibility of equilibrium in the American balance of payments is not too far distant.

Reservations

This, however, applies only with an important proviso: the domestic economic and business cycle policy in the future must be increasingly directed on the basis of balance of payments considerations. Whether the United States is capable of such a reorientation of economic policy--which is the core of the problem--will become clear when anti-recession policies will become necessary. While the Kennedy administration, in the interest of the balance of payments, had originally foreseen a balanced budget for the current fiscal year--after a deficit of $7 billion in 1961-62--, there is already budgeted a deficit of $5 billion, which could become considerably greater if general tax cuts and expansionary expenditures had to be initiated.

No one believes that the deficit could reach a level equivalent to that of fiscal year 1959 when it rose to $13 billion as a result of anticyclical policy. The economic upturn should be accomplished, when necessary, through a reduction in taxes and not through an increase in expenditures; it is expected that the resulting deficit will have no over-all inflationary effects, which would adversely affect the balance of payments. Avoiding damaging influences on the

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balance of payments of an eventually larger government deficit will depend on the form of government financing: Only if the deficit is financed through real savings, i.e., through savings available for long term investment, can inflationary danger be eliminated. Although this point of view in regard to the American problem is current abroad and in various international organizations (e.g. BIS and OECD), the American Government has failed unfortunately to voice a similar analysis.

This may in part be related to the still unclarified interest rate and credit policy goals of the Kennedy Administration. Previously the policy was to lower long-term interest rates to stimulate the ecoonomy, while the balance-of-payments situation was taken into consideration insofar as money-market rates were permitted to rise slightly. The hitherto minor balance-of-payments orientation of interest and credit policy resulted in interest differentials with respect to other countries which adversely affected the balance of payments because it increased the incentive for American capital investment abroad while it attracted foreign borrowers to the American capital market. Thanks to their increased liquidity, the American banks could furthermore increase their foreign advances. The level of American money market rates, despite American intervention on foreign-exchange markets abroad, was only sufficient to reduce interest arbitrage unfavorable to New York, but not to cause a larger flow of short-term credit into New York. In consequence, the private American capital export in 1961, as in the previous year, amounted to the large net figure of $4 billion (of which $2 billion were long and $2 billion were short-term). In the first half of 1962 there probably was a limited shrinkage not only of direct investment but also of New York flotations of foreign stocks and bonds and of bank loans, but its size is not yet known.

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In order to reduce capital exports, the American Government has proposed the removal of tax privileges on direct investment abroad. Secretary of the Treasury Dillon at the Rome meeting of the American Bank Association criticized the all too large burden caused by the export of capital. He called upon the European bankers present to use their own capital resources more fully and to rely less upon New York. His appeal would have been more effective if he had simultaneously announced a better adaptation of American credit and interest rate policy to the balance of payments situation. The view, widely held in America, that higher interest rates must hinder the growth of the American economy, should have been refuted by various European examples.

Today, American and European banking circles as well as international organizations (e.g. BIS and OECD) unanimously plead for a higher interest rate policy in America. This appeal should not be ignored in Washington. Whereas the actions taken in the sectors affecting the current-account, military, and economic aid accounts can only take effect after a relatively long time, much quicker and more substantial results on capital account could be obtained through an appropriate interest and credit policy.

The Importance of the Time Factor

The speed with which the American balance of payments can be brought back into equilibrium, has in our opinion far greater importance than is usually assumed in America. At the present level of gold reserves and short-term dollar liabilities, American gold losses have increasingly strong psychological effects. Naturally, no one could wish that the United States put into effect a "crash program" which, in order to insure

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an immediate readjustment of the payments deficit, would not hesitate to take the most drastic measures. But on the other hand, one should not assume too readily that the large United States reserves will provide enough time to wait for the long-term measures to take effect. At a time when each American gold loss creates unrest in the world--even a small dollar conversion by the Swiss National Bank of $25 million led a short time ago to nervous reactions--it should be high time for the United States to seize upon all measures compatible with a market economy that will reduce the payments deficit to a minimum. One should not permit liberal credit and interest policies to cause excessive capital exports, to create a considerable part of the payments deficit, if, on the other hand, one expects foreign countries fully to cooperate in helping to offset American speculative dollar outflows and to reduce American gold losses.

This contradiction in American policy has not prevented numerous foreign central banks and governments, including the Swiss, from placing at the disposal of American authorities their growing cooperation in defending the dollar and minimizing American gold losses. The central banks of the BIS member countries have declared themselves willing to aid in minimizing the pressure on the dollar, as felt on the gold market, by keeping out of the London gold market whenever this would assist in stabilizing gold prices, and by being ready to regulate the price of gold through a common pool for buying and selling gold; they have already contributed to this end. By their readiness to participate in swaps, and through the swaps already completed, numerous

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central banks--last but not least the Swiss--have in recent months placed with the American monetary authorities mutually covered foreign currencies; this has enabled the United States when necessary to support the dollar though sale of currencies and to compensate for temporary capital outflows from the United States through such transactions. The double agreement with the Swiss National Bank and the BIS has placed America in position to obtain from the Swiss central bank not less than $110 million of the $270 million which it had received in the course of the speculative wave, and thus to avoid further losses from the American gold reserve for the time being. A further $66 million has recently been invested in the New York money market by the Federation, likewise with the intention of avoiding major conversions of dollars into gold. Italy and France have also taken important action through their recent agreement to prepay earlier debts to the United States totaling $475 million, in order to balance off the unfavorable effects of their dollar surpluses on the American gold reserve. The French Minister of Finance went so far as to announce these goals at the end of July and to pledge that France had no intention of exchanging dollars for gold in the near future.

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Thanks to the combined exertions to save the U.S. gold reserves, the reduction in these reserves could be limited in spite of the strong tendency toward flight from the dollar, despite the French conversion of dollars into gold, and despite the continuation of the basic deficit in the U.S. balance of payments. In consequence, the U.S. gold stock dropped between the beginning of June and mid-August by only $286 million (from $16,434 million to $16,148 million). For seven weeks, between the beginning of June and mid-July, it even remained unchanged in spite of the decline on the stock exchanges and the pressure on the dollar. It is true that temporary repatriation of U.S. capital from Canada contributed to this result; still, it is a fact that international monetary cooperation succeeded in substantially limiting the monetary repercussions of the latest dollar crisis, which was much more serious than had become visible.

The multilateral agreement among 10 industrial members of the IMF regarding additional currency credits to the IMF totaling $6 billion in the event of major currency crises lacks only a few more ratifications. This agreement will create a further instrument, in addition to the existing bilateral measures, which will be designed in particular to make available to the IMF substantial amounts of non-dollar currencies for longer periods in the case of a major dollar crisis.

Foreigners have suggested to the U.S. authorities to grant a gold guarantee for short-term liabilities to foreign central banks and governments in order to create a further disincentive against hectic withdrawals of dollar balances, which would cause further U.S. reserve losses and could increase distrust in the dollar. The U.S. authorities

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have declined to give such guarantees whenever such suggestions have been made. The emphasis with which Secretary Dillon last week opposed renewed European suggestions of this kind in his appearance before the Congress, confirms that it would be impossible to count on such measures on part of the United States, although such measures would obviously have to be based on reciprocity and would certainly have a quieting effect on the holders of dollar balances. The refusal of such guarantees by the Washington authorities must, however, not be misinterpreted. In any case, it would be wrong to jump to the conclusion that the U.S. authorities did not treat the maintenance of the present dollar parity with utmost seriousness. Lack of sympathy for guarantees on the part of the U.S. Treasury and of the management of the Federal Reserve System might have the following reasons: The volume of the resulting obligations would be much greater for the U.S. than for other countries, despite reciprocity; if it became necessary to make good the guarantees, the result would be highly inflationary in the United States; and most importantly, such gold guarantees would have to be approved by the Congress, and the authorities wish to avoid the risk of a failure of Congress to pass such a bill, which would have a disastrous psychological impact.

While the U.S. monetary authorities oppose a gold guarantee as a general institution, they have lately made increasing efforts to give individual guarantees within the framework of the swap arrangements undertaken for the sake of the defense of the dollar, and to satisfy the demand for exchange guarantees for short-term dollar holdings by intervening in the forward exchange market. This shows that Washington

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and New York clearly understand the importance of an exchange guarantee. It should also be understood, however, that foreign central banks can not be expected to increase their dollar holdings in the long-run if they are persistently being refused guarantees of these holdings against devaluation.

The above-mentioned measures of an external defense of the dollar are necessary in order to avoid temporary disturbances and the threatening large losses of gold. Moreover, in the present phase of transition, in which measures to correct the underlying factors of the U.S. balance-of-payments deficit are only beginning to work and in which there is still a "basic deficit," these actions have in particular the interim function of anticipating the urgently needed reduction in the U.S. balance-of-payments deficit, so as to maintain the volume of U.S. gold holdings, which is being watched with concern by all parties. The measures of external defense must, however, never lead to delaying or weakening the internal defense of the dollar, on which the fate of the U.S. currency ultimately depends. On the contrary, foreign cooperation to avoid large U.S. gold losses should be an additional incentive for the United States to make all efforts to bring the U.S. balance of payments into permanent equilibrium as rapidly as possible. The consolidation of confidence in the dollar depends largely on the avoidance of any slackening in these efforts, even if anti-recession policies should become necessary in the United States.

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Long-term alternatives to an increase in the gold price

The wide-spread skepticism concerning the dollar is due not only to developments in the United States but also to a pessimistic evaluation of the long-term prospects of the gold exchange standard and to the idea that international liquidity will make a general rise in the price of gold inevitable. For this reason it is important to solve the problem of the future of the international payments system. It is not sufficient to state that the monetary authorities of the leading countries oppose both an increase in the price of gold and the creation of a super-national currency. It would be more important to know how they envisage the evolution and the expansion of the existing gold exchange standard into a permanent payments system, anticipating the period in which, equilibrium in the U.S. balance of payments having been achieved, the creation of additional short-term dollars will no longer feed international liquidity.

In the last decade the transfer of parts of the U.S. gold stock to other countries and the increase in their gold and dollar holdings have resulted in a better distribution of international liquidity. Agreements on compensatory transactions of central banks and Governments in case of major capital movements, and measures taken to reduce balance of payments disequilibria, have reduced the need to use currency reserves. The increase in the quotas of the IMF and the provision of additional means to combat major international currency crises have further strengthened the "second line of monetary defense," which should suffice for the next future.

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It remains uncertain, however, how things are going to develop in the long-run. Two months ago, the U.S. Administration indicated for the first time through Under Secretary Roosa how Washington thinks about the long-term evolution of the present payments system. Roosa's proposal was to "multilateralize" the gold exchange standard, which today is based on two reserve currencies (dollar and pound sterling), in such a way that in the future the individual countries will mutually keep their currencies as working balances and foreign exchange reserves. In this way, once there is no more dollar deficit and the U.S. has a surplus, new foreign exchange reserves can be created in non-dollar currencies, which together with newly produced gold could furnish the funds necessary to maintain international liquidity.

The accrual of reciprocal foreign-exchange holdings on occasion of disequilibria in the balance of payments would, according to the author of the plan, reduce the use of gold as a compensatory means of payments, and would free the United States of those gold losses that result today whenever dollar balances are transferred from one central bank to another which keeps its reserves in gold rather than in dollars. Roosa sees in such a system a possibility to satisfy the increasing liquidity needs of an expanding world economy in the long-run, without an increase in the price of gold and without the creation of a super-national monetary authority, which has been suggested, for instance, in the Triffin Plan.

The United States proposal, which so far has been only tentative, will certainly play an important role in international discussion, once governments and central banks concretely consider the long-term problems of the payments system. In this connection, however, the question of a

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gold guarantee will again arise. The expansion of foreign exchange reserves to include holdings of currencies other than the dollar and the pound, would probably be impossible without an exchange guarantee.

Conclusions

If we consider the latest developments regarding the U.S. balance of payments and the prospects for its most important items; if we consider the various measures for the internal and external defense of the dollar recently taken by the U.S. authorities in cooperation with foreign central banks and governments; and if we look at the efforts concerning the creation of a permanent payments system; we shall conclude that widely accepted pessimistic evaluation of the dollar has lost much of its justification. The statements of U.S. government experts, according to which the balance of payments problem has already been solved and according to which the restoration of equilibrium is only a matter of time, treat the situation much too optimistically. Much additional effort will be necessary to make sure that this goal will be reached in the near future, and the danger of reverses has not been eliminated. Nevertheless, the real prospects for a solution of the problem have so improved that there is no room for fatalism in regard to the dollar. The forecasts that the U.S. dollar will one day have to be devalued against gold, or that its gold convertibility will have to be suspended because there would be no other way to escape the run on U.S. gold holdings, have become much riskier for those who until recently put their money on them. But the speculation on a simultaneous universal

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increase in the price of gold for reasons of international liquidity, too, has become less certain since the prospects for a permanent currency reform by means of evolutionary developments have improved: and since the monetary authorities of the leading countries have become increasingly resolved to take measures that would avoid an increase in the price of gold and creation of a super-central bank. Instead of an unrealistic pessimism (the reality of which would only consist in its contribution to making things worse than they would have to be), we should and could be guided more and more by confidence in the dollar. In this way, we shall make the best contribution to a rapid solution of the fundamental problem on which, in the last analysis, the fate of the entire Western payments system depends.

Franz Aschinger