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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

REC'D IN RECORDS SECTION
JUN 1 ? 19??

June 17, 1963.

STRICTLY CONFIDENTIAL

TO: Federal Open Market Committee

FROM: Mr. Young

Attached for your information is a special memorandum prepared by Mr. Coombs on the present position of the dollar. It is being circulated for discussion at tomorrow's meeting of the Federal Open Market Committee at Chairman Martin's request.

Ralph A. Young
Ralph A. Young, Secretary,
Federal Open Market Committee.

Attachment

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June 12, 1963.

REC'D IN RECORDS SECTION
JUN 20 1963

To: Chairman Martin and President Hayes

From: C. A. Coombs

Subject: Present Position of the Dollar

Under the policy instructions of the U. S. Treasury and the Federal Open Market Committee, the Foreign Function of the Federal Reserve Bank of New York is charged with the operational responsibilities of (a) keeping watch over the foreign exchange and other international financial markets and (b) defending the dollar through exchange operations undertaken in consultation with foreign central banks. In so doing, our trading desk is in constant touch with developments in the European and New York markets. Each month at Basle, we confer with all of the major European central banks at the Bank for International Settlements. At these meetings in Basle and elsewhere, we have negotiated the London Gold Pool arrangements, the Federal Reserve swap network, and the placement of Treasury foreign currency bonds. Sizable operations in both spot and forward exchange in defense of the dollar have been carefully coordinated with the foreign central banks concerned through daily telephone communications.

From this vantage point of operational responsibility, we have been reporting with mounting apprehension that the continuing deficits in our balance of payments were progressively undermining the international strength of the dollar. In our judgment, we have now reached a critical phase. The dollar has become vulnerable to a break in confidence which might occur almost without warning and with devastating consequences.

Such a loss of faith in the dollar has been so far staved off, despite the ominous growth of our demand liabilities to foreigners and the deep erosion of our gold stock, by several repetitions of the President's

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pledge on gold; by the modestly improving trend in our payments balance in 1961 and 1962, and by the reinforcement of the international financial system in the form of increased IMF resources, our exchange operations under the Federal Reserve swap network and other cooperative arrangements, and U. S. Treasury issue of foreign currency bonds.

Full credence is still given to the President's pledge on gold. But the balance of payments program designed to fulfill the pledge now gives the impression of having become stalled while the deficit runs on at a dangerously high rate. This has ominous implications for the strength of our currency defenses. As originally conceived and agreed by all governments and central banks concerned, the international credit facilities available through the Federal Reserve swap network, the Treasury's foreign currency bond issues, and the Fund, are designed to finance payments deficits which can be reversed within a reasonable period of time. The central bank swap lines are intended to deal with essentially short-term flows of funds expected to prove reversible in no more than a year's time. The Treasury's foreign currency bond issues carry maturities so far of no more than two years. While drawings upon the IMF may run on from three to five years, repayments by borrowing countries have generally been effected in a much shorter span of time.

In the light of this general understanding of the nature and function of these international credit facilities, the European central banks would be prepared, either through an increase in swap lines or other arrangements, to provide almost unlimited credit facilities to cope with an emergency situation such as the Cuban crisis. Similarly, the European

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central banks and governments would probably be prepared to accept very sizable increases in our issues of foreign currency bonds or massive United States drawings upon the Fund if our payments deficit seemed attributable to a cyclical or similar problem likely to run its course within a year or two. But the European central banks and governments are not prepared to finance chronic deficits in the United States balance of payments over an indefinite period of time. This attitude has been made unmistakably clear to United States officials, and we are in fact already confronted with pressures by certain European financial officials to subject Federal Reserve swap drawings and Treasury issues of foreign currency bonds, so far conducted on a bilateral basis, to the multilateral surveillance and approval of all of our European creditors.

There is here involved, as there has been for some time past, a bargaining encounter between Europe as the creditor and the United States as the debtor, as to which should bear the brunt of the corrective adjustments required. Europe has placed a heavy stake on the integrity of the dollar, and a United States refusal to take corrective action might conceivably force Europe to take up a larger share of mutual defense costs and foreign aid or to extend other concessions. A more likely outcome, however, is that the European countries would finance our deficits for some time further, but with increasing reluctance, with stiffer terms, and with prejudice to United States prestige and influence abroad.

Moreover, by insisting upon such unwilling financing by Europe, the United States would simply dig still deeper the hole in which we are now stuck. Piling up further debt to finance further heavy deficits would only make the task of eventually restoring equilibrium correspondingly

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harder. Such debts, whether incurred under central bank swaps, Treasury foreign currency bonds, or Fund drawings, must sooner or later be repaid. This would require corrective action drastic enough to produce a surplus rather than just a balance in our payments accounts. Meanwhile, we should have dissipated during reasonably fair weather the credit resources we must have to survive the speculative storms. Perhaps most unfortunate of all, abuse of the present network of credit facilities would blight the highly promising prospect that such credit facilities may in good time contribute a large part to a permanent solution to the problem of international liquidity. It is no answer to these financing problems to suggest sweeping reforms of the international financial system based upon a United States gold guarantee of its dollar liabilities. Such schemes, cynically referred to abroad as "instant gold", are non negotiable not only in the short run but probably even in the longer run, and meanwhile serve only to cast discredit on the dollar. Comments by two European central bank governors on gold guarantee schemes may be cited:

> "If the United States should show any official interest in the Triffin, Maudling, or other gold guarantee schemes, we would conclude that your balance of payments was out of control.......
>
> "Resort to gold guarantees is the last resort of a poor debtor."

This impending crisis in financing United States payments deficits has so far gone largely unnoticed by the foreign exchange markets which have been impressed almost to the point of complacency by the success of central bank cooperation in beating back the speculative challenges of the German mark revaluation, the Berlin crisis, the Canadian devaluation,

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the world-wide stock market break, and the Cuban crisis. Such demonstrations of central bank cooperation, plus the massive piling up of official ammunition against speculation, have persuaded the exchange markets that for the time being speculation against any major currency parity would be a losing game.

But it would be foolhardy to imagine that we can long maintain this disparity between the surface calm of the exchange markets and the turbulent undercurrents being generated by a continuation of heavy United States payments deficits which Europe is reluctant to finance. And it would be even more foolhardy to assume that market expectations will adjust only gradually to the underlying deterioration in our balance of payments position and thereby leave us ample time to make the policy adjustments required. Experience rather suggests that market expectations will shift abruptly, perhaps explosively, and confront us with the necessity of far more drastic action than the moderate corrective measures which would now suffice.

The nature of a speculative run on the dollar would partly depend on the event which triggered the break in confidence. While we are in a sense at the mercy of any massive conversion of dollars into gold by the Bank of France, the Bundesbank, the Bank of Italy, or other European central banks, we would feel reasonably confident that none of these central banks will take action along these lines either from hostility or from panic. More likely is the prospect of stiffer resistance by these banks to our requests for credit accommodation plus the initiation or stepping up of gold purchases on a regular but moderate scale. More dangerous is the risk that the smaller countries of Europe, Latin America,

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Africa, and Asia would be panicked, as they were in the closing months of 1960, into gold purchases aggregating a very sizable amount. Even more dangerous, private demand for gold on the London gold market might abruptly snowball to such proportions as to overwhelm the $300 million in gold available to the Gold Pool. You will recall that the Pool lost $45 million in only two days following the Cuban crisis. Perhaps most dangerous of all is the risk that the Russians--and possibly even some of our allies who favor a higher gold price--might through various maneuvers try to push us over the cliff of a dollar devaluation. Whether through technical naivete or an excess of caution, the Russians have so far not only failed to exert pressure on the dollar during periods of strain but have, with almost uncanny timing, made heavy sales of gold just when we needed it most. But it would be imprudent to assume the Russians will continue to be so cooperative in the international financial arena.

There is very little new to be said about the policy decisions required to bring about an approximate balance in our payments accounts. Reviewing the main factors governing our trade and current account surplus, we are inclined to think that we must work very hard indeed even to maintain our present surplus, and that it would be imprudent to count upon a substantial growth of this surplus to finance our heavy burdens of foreign investment, foreign aid, and military spending abroad. The solution therefore lies primarily in cutting back such payments on investment, foreign aid, and military account, and in encouraging the repatriation of short-term capital that has moved abroad in large volume in recent years.

We obviously can make no effective judgment as to where economies can safely be effected in either military spending or foreign aid. But we

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can and do make the judgment that the full burden of the adjustment cannot be forced on the private capital sector alone.

On capital account, the outflow since 1959 may be broken down into the following major categories:

U. S. Capital Outflow - 1959-62
(in billions of dollars)

	1959	1960	1961	1962
A. Long term				
1. Direct	- 1.4	- 1.7	- 1.5	- 1.4
2. Portfolio	- 0.6	- 0.7	- 0.8	- 1.0
3. Other	- 0.3	- 0.2	- 0.3	- 0.2
	- 2.3	- 2.6	- 2.6	- 2.6
B. Short term				
1. Bank lending	+ 0.1	- 0.7	- 1.0	- 0.3
2. Other	- 0.2	- 0.7	- 0.5	- 0.2
	- 0.1	- 1.4	- 1.5	- 0.5
C. Errors and omissions	+ 0.4	- 0.6	- 0.6	- 1.0
B. plus C.	+ 0.3	- 2.0	- 2.1	- 1.5

With respect to direct investment by United States industry in plant and equipment abroad, such investment in long-term foreign assets will eventually bring a heavy return flow of dividend and other earnings. Meanwhile, however, so heavy a buildup of long-term corporate investment abroad is straining our international liquidity position. Among the various policy measures which might be employed to slow down the pace of such direct investment, there may be some room for officially urging United States corporations investing abroad to rely more heavily upon foreign sources of

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financing rather than channeling capital funds from the head office to the foreign subsidiary. Less easy credit conditions in the United States might also induce some shift of the burden of financing such direct investment to foreign financial markets. But any effort to impose direct governmental controls upon direct investment abroad would have a shattering effect upon business confidence both here and abroad, while the problem of managing such controls would be an administrative nightmare.

With respect to portfolio investment abroad, the outflow of $1 billion registered in 1962 may well move up to a considerably higher figure in 1963. The heavy volume of such foreign issues in this market reflects not only the comparatively low level of long rates here but probably even more importantly the limited availability of long-term capital funds in other markets. While some moderate reduction of such foreign long-term borrowing in our market might be accomplished by a moderate rise of long-term rates, a major curtailment in this type of capital outflow through credit restraint would probably require rate increases so drastic as to seriously threaten domestic economic expansion. Moreover, much depends upon the nature and purpose of such foreign flotations in our capital market. In the case of most Western European borrowers, such flotations have further enriched their central bank's dollar surplus position and thereby presented us with the absurd contingency that the U. S. Treasury might have to finance such foreign borrowing by transfers of gold. Secretary Dillon's Rome speech in May 1962 served to discourage European borrowing in this market and the Secretary's recent suggestion that United States underwriters should actively encourage foreign subscription to new foreign issues in this market also seems likely to have a useful effect. On the other hand, the recent heavy issues in this market by Canadian governmental and corporate entities may

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hardly more than suffice to finance Canada's current account deficit with the United States. Even if such borrowing should result in increases in the Bank of Canada's reserves, there is relatively little risk that these reserve increases will be converted into gold. Some United States officials have urged that official controls over such foreign security issues would be preferable to other alternatives, such as cuts in military and economic aid spending abroad. In our judgment, however, introduction of controls would involve a highly dangerous gamble with foreign confidence in the dollar. A somewhat less risky approach, if action to restrain foreign security issues in this market should be deemed essential, would be to encourage early reporting of foreign governmental issues in this market. At the present moment, we become informed of prospective foreign government borrowing operations in this market only after our underwriters have entered into negotiations with the foreign government concerned and, on numerous occasions, only after the deal has pretty well jelled. Such delayed reporting has on occasion handicapped our efforts to avoid an undue bunching up of such issues.

While possibilities of effectively reducing long-term capital outflows may thus be fairly closely limited, the chances of effecting sizeable reductions in short-term outflows or encouraging inflows are much more promising. From 1960 through 1962 total short-term outflows (including here in this category for rough-estimate purposes the "errors and omissions" item although some part of this item is attributable to other causes) have amounted to \$5.6 billion. In 1962 recorded short-term outflows, plus the errors and omissions item, amounted to \$1.5 billion. This total represented a significant decline from the 1961 total of \$2.1 billion and probably partly reflects the two-way squeeze of some declines in short rates abroad and

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some modest rise in short rates in this market. In our judgment, it is unlikely that we shall see during 1963 any further declines of short rates in the major financial centers abroad; in fact, we already see evidence of a renewed firming of these rates as foreign central banks struggle to control an inflationary trend of prices and wages.

In the absence of a shift of Federal Reserve credit policy towards lesser ease, the combination of greater liquidity and low rates relatively in the United States as compared with foreign financial centers will probably continue to generate sizeable outflows of short-term funds in the form of bank lending, acceptance financing, and short-term investment. Even more serious, there are ominous indications that United States corporate treasurers are becoming increasingly aware of investment opportunities in the so-called "Euro-dollar market" where 90-day rates have been fluctuating around the 3-3/4 per cent level, as compared with our Treasury bill rate of roughly 3 per cent. During the past three years, U. S. corporations have steadily increased their U. S. dollar time deposits with Canadian banks operating in the Euro-dollar market with the latest reported total approaching $500 million, while unreported placements with other foreign banks might well amount to several hundred million dollars more. So long as a sizeable differential between rates in the United States and the Euro-dollar market remains, there is a great risk that U. S. corporate placements in the Euro-dollar market will continue to grow rapidly and, in the process, shift dollars into the hands of foreigners and thereby enlarge the deficit. Any weakening of confidence in the dollar would result in heavy additional outflows in the form of speculative "leads and lags" in commercial and other payments.

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The disparity between credit conditions in New York and foreign financial centers has adversely affected not only our balance of payments accounts but also the willingness of foreign commercial banks and other foreign private holders of dollars to leave their money in New York. Foreign commercial banks and other private holders of dollars have open to them a range of alternative uses for such dollar funds as they may acquire and if, in the process of shifting these funds out of New York, the dollars involved are sold to foreign central banks, the United States becomes exposed to the risk of central bank conversions of such dollars into gold. Action has already been taken to provide an inducement to foreign central banks to hold dollars on deposit in New York by exempting such central bank time deposits from the Regulation Q ceiling. Foreign central bank decisions whether or not to convert dollars into gold are relatively insensitive to interest rate considerations, however, while foreign commercial banks and other private lenders are acutely sensitive to relative interest rate levels here and abroad in allocating funds to one market rather than another. At the present moment, neither the U. S. Treasury bill rate nor the maximum of 2-1/2 per cent allowable on 90-day time deposit placements under Regulation Q permit the New York financial community to keep a solid grip on foreign private balances. So far this year there has been a substantial rise in foreign private dollar holdings, but this appears to be mainly the result of an increase in the liabilities of American banks to their branches abroad, probably reflecting Euro-dollar market activity. Foreign private holdings of time deposits and U. S. Government securities, on the other hand, have not risen at all. Even a slight tightening of credit markets abroad tends to bring about sizeable repatriations of dollar

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short-term investments, with the effect of further increasing the dollar reserves of the foreign central bank concerned.

In our judgment, a moderate tightening of credit policy involving an increase in the Federal Reserve discount rate to 3-1/2 per cent, a contraction of free reserves sufficient to push the Treasury bill rate up close to the 3-1/2 per cent level, and an adjustment upward of the Regulation Q ceiling on 90-day deposits to at least 3-1/2 per cent, would have a major effect on the short-term capital balance. We believe that New York commercial banks tend to give preference to domestic as compared with foreign customers, and that the tightening of bank liquidity positions would have a stronger restraining effect upon foreign than upon domestic lending. A rise of Treasury bill and time deposit rates to a 3-1/2 per cent level probably would not be fully matched by a sympathetic rise in the Euro-dollar rate, with consequent restraint upon United States corporate deposits in that market. Moreover, the level of the Euro-dollar rate is heavily dependent upon policy decisions of several foreign central banks which have in the past alternately encouraged and discouraged borrowing by their commercial banks in the Euro-dollar market. We have some hope that these foreign central banks might be willing, at least temporarily, to restrain borrowing activities by their commercial banks in the Euro-dollar market with consequent lessening of any upward pressures on the rate.

A tightening of credit policy would not only have a restraining effect upon the outflow of short-term capital, but might well enable us to exploit a favorable technical position. The heavy outflow of short-term funds in recent years has had as its counterpart the emergence of a sizeable short position in dollars on the exchange markets. A contraction in the

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availability of short-term credit from United States lenders or investors should therefore generate a sizeable, and perhaps very substantial, demand for dollars, with consequent beneficial effects on the rate of the dollar against most European currencies. Such buying pressure on the dollar would, after a certain point, induce the European central banks to feed dollars into the market from their exchange reserves or, in the case of high gold ratio countries, to resell gold to the United States. Most Continental European central banks would welcome such a running down in their dollar holdings and even in their gold holdings. Finally, action of the type suggested above would have a most salutary effect upon foreign confidence in the dollar and might bring about further sizeable return flows of funds to this country as the "leads and lags" reversed themselves.

Such credit policy action by the Federal Reserve would, of course, be largely frustrated if the Continental European central banks were to make corresponding and competitive adjustments in their own policies. We have strong reason to believe, however, that the Continental European banks, who have long urged such a tightening of credit policy by the Federal Reserve, would not do so. On the other hand, even a moderate tightening of credit policy in the United States might put some pressure on the British and Canadian markets, and the Bank of England and the Bank of Canada might find themselves compelled to take action in line with ours. If so, this would represent a much needed strengthening of the international financial position of all three countries vis-a-vis the Continent and would help to restore a generally improved balance in the international financial markets.