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INTERNATIONAL MONETARY PROBLEMS

We lose influence in world affairs whenever:

-- The dollar is weak in exchange markets;

-- There is a major outflow of gold; and/or

-- We are obliged to pressure countries into holding dollars or giving us payments assistance.

Small payments deficits permit us greater freedom to act. But our position can also be improved by action on the international monetary system itself to:

-- Decrease vulnerability to confidence crises;

-- Increase world monetary reserves (liquidity); and

-- Improve tools for adjusting payments surpluses and deficits.

Vulnerability to Confidence Crises

Gold is a basic problem. Whenever the price of gold in private markets rises significantly above $35 an ounce price there can be pressure on foreign central banks to replace dollars and sterling with gold. They worry that the United States will not be able to meet the demand for converting dollars into gold and either suspend conversion or revalue gold, thus penalizing those who hold a large part of their reserves in foreign exchange rather than gold.

With $33 billion of foreign dollar holdings ($16 billion in official hands) and only $10.7 billion of gold in the U.S. reserve, the risk is clear.

To contain these pressures our strategy is:

-- To isolate official from private gold markets by obtaining a pledge from central banks that they will neither buy nor sell gold except to each other;

-- To bring South Africa to sell its current production of gold in the private market, and thus keep the private price down.

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We have been substantially, but by no means completely successful. On March 17, 1968 the major central banks (except France) took the no buy/no sell pledge and set up the two-tier system. The no buy commitment was somewhat weaker than we would have wished--and some of the more conservative Continental banks (Switzerland and the Low Countries) have been trying to dilute it--but since that time no central bank except Portugal has bought or sold gold in the free market.

South Africa, however, has not yet agreed to sell its newly-mined gold in the free market. Indeed it has withheld gold since March 17 in the hope of driving up the private price and forcing a change in the official price.

On October 3 the major central banks offered South Africa the possibility of selling newly-mined gold to the IMF, should the free market price fall below $35 an ounce and on condition that normal South African sales to the private market resume. South Africa refused.

The game now is to see who can hold out longest. Although we do not hold all the cards--the interest of many European banks in getting a channel to new gold production is our soft point--South Africa cannot get on indefinitely without its main export (generally $1 billion a year). Meanwhile the overhang of speculative gold positions built up in the gold crisis last winter will help keep private gold prices moderate.

Currency speculation is a threat to the system, whether the target is a weak currency (sterling and the French franc) or a currency that might be revalued upwards (the deutsche mark). In addition a run on sterling can pose a direct threat to the dollar.

Our strategy here is:

-- To increase the short-term central bank credits in the system to offset hot money moves (the swap networks now total $10 billion), and

-- To make long-term credit available where needed, as in the $2 billion Basle safety net for sterling in September 1968.

Increasing Liquidity

Trade won't be able to grow, and the system will remain vulnerable to speculation unless there is regular growth in the international money supply.

Gold can't provide the needed increase: industrial and speculative demand is too high. U.S. payments deficits can't either: foreigners are unwilling to hold more dollars when we run large deficits and unable to increase net reserves by accumulating dollars when our deficits are small.

Our strategy is to supplement gold and dollars with a new international asset, Special Drawing Rights (SDRs).

Agreement on SDRs was reached at Stockholm in April 1968. By early 1969 we expect that the required 67 members with 80% of the votes in the IMF will have ratified the agreement.

Two hurdles will then remain. One is that 75% of the members must notify the Fund that they wish to become participants in the arrangement. The second is actual activation--which will require an 85% vote of participants.

Chances are good that the first SDRs will be created before the end of 1969--perhaps in an amount of $2 billion a year, of which $500 million would come to the United States.

As more and more SDRs are created over time--and official gold holdings fail to grow--they will gradually become a major element in the system. This is the long-term cure for the gold neurosis.

Improving the Adjustment Process

In the end the international monetary system can't be made crisis-free unless there is an effective mechanism for eliminating persistent surpluses and deficits. Excessive reliance on restrictions is too costly: we need a balance. While acting on our own deficit we have been pushing countries in persistent surplus (essentially Continental Western Europe) to take on their share of the burden of adjustment.

We have had some successes. German action to reduce border tax adjustments, German and other military offset agreements, OECD doctrine on adjustment, increasing awareness in surplus countries of the need to maintain high levels of expansion, and (albeit probably abortive) agreement by Western European countries this year to accelerate implementation of Kennedy Round tariff cuts, and European pressure for the 1968 U.S. tax surcharge all point in the right direction. But we are still well short of having an effective adjustment process.

Outlook

1. Despite the measures taken by France, Germany and Britain in November the threat of a new exchange crisis is very real.

2. We think the French program can work. But we may need to take further steps to help it work (more credit, hopefully a central bank agreement to recycle speculative capital flows). We will also need to be ready to take defensive action should France decide on an unwarranted devaluation of the franc.

3. German border tax adjustments will lessen their current surplus, but the basic problem (and with it the invitation to speculation) will probably remain. Kiesinger, Schiller and Strauss are locked into a no revaluation course, probably at least until elections in October 1969. But the Germans can--and may have to--take additional border tax adjustments and measures to stop speculative inflow before then.

4. British devaluation/deflation is working very slowly but it may at last be taking hold.

5. As the November crisis showed the two-tier gold system is a good cushion against gold speculation; but it is hardly foolproof.

6. Beyond the immediate exchange problems two questions will be on the agenda for 1969, although we are not yet at the action stage on either:

-- Can the adjustment process be made to work by coordination of monetary and fiscal policies in surplus and deficit countries, or do we need some modification of the present fixed exchange rate system? The two devices most often mentioned are: (1) wider bands (a broader spread between official buying and selling rates for currencies), and (2) the crawling peg (a small annual change in currency parities depending on supply and demand).

-- Do we need a formal mechanism to prevent disequilibrating shifts between dollars, sterling, gold and SDRs? The device most often mentioned is a conversion account in the IMF in which countries would deposit all or part of their reserves.

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