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LBC:
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THE CURRENT FOREIGN EXCHANGE PROBLEM

1. The possible consequence of events. It appears to me that the position of the Gold Bloc is a highly unstable one. There has been no recovery, but rather deepening depression. In such circumstances political crises are likely to arise and every crisis will be attended by uncertainty regarding the maintenance of the gold standard, and a consequent flight of capital. The pound is likely to go down rather than up and every fall intensifies the difficulties of the Gold Bloc. The Gold Bloc individually or collectively may decide to prohibit the export of gold to us, or may devaluate to a new and much lower level. In either event, the pound will probably fall in relation to gold, and hence in relation to the dollar. Foreign money will leave England; she will lose some exports to the Gold Bloc, particularly Belgium; and her tourist expenditure on the Continent will increase. If the pound falls in terms of dollars, the yen will probably also fall.

2. How our interests will be affected. Such evidence as we possess seems to indicate that, from the point of view of relative price and income levels, the present relation of the dollar to other currencies is about right. The bulk of the gold we have been gaining can be attributed to an inflow of capital, rather than to a favorable balance of trade on goods account. There is a greater likelihood of our price and income levels rising more rapidly than those of other countries than contrarywise, and this would mean an unfavorable balance of payments. We could readily stand this if our income was

increasing rapidly. The real danger, however, is that our exchange position will be worsened before our income rises. This would be definitely deflationary, really and psychologically. If we do nothing and the events outlined in (1) occur, we may be confronted with a situation where the pound is at or below $4.00.

3. Alternative ~~courses~~ of action.

(a) Take no action until the Gold Bloc devalues and the pound falls below $4.50, and then attempt to peg it there. This would be a difficult thing to do. It would be exceedingly risky to build up large balances in London. The alternative would be to buy gold but the only gold that would be available would be newly-mined gold, which might not be sufficient. If we permitted gold exports, the England exchange fund and speculators could buy dollars with the assurance that the sterling rate would not go above the price at which we were buying sterling, and might go below. They could cover these by turning their dollar balances into gold. It would be advisable for us to prohibit the export of gold. If the United States and England engaged in a competitive bidding up of gold, the position of the Gold Bloc would again become worsened, and a renewed period of unsettlement would ensue. Moreover, we would again be confronted with the problems raised by getting more gold than we wanted and of having larger gold profits, which would be a source of danger in the future.

(b) It would appear to be in our interest to make some concessions now for the sake of avoiding the possible consequences outlined in (a). I should favor therefore the President making the following proposal _informally_ to the other countries concerned:

> If the Gold Bloc devalued by, say, 20-25% and England gave assurances that she would peg the pound for a period of a year at $4.50, we would acquiesce and take no action. If, however, foreign rates fell further than this, we would take action "to defend the dollar".

England is very reluctant to make any permanent commitments, both because of the deep-seated belief that the pound is at present overvalued, and because she fears further depreciation of the yen. She would not, however, relish a "currency war". Therefore she might be prepared to make a commitment for a period of, say, a year.

If we adopt alternative (b) we should not delay. Each day that sterling goes lower weakens our bargaining position, since it will appear that we are offering England no more than she has already attained.