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THE SECRETARY OF THE TREASURY
WASHINGTON

March 27, 1965

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~~Pres~~ to LBJ

SANITIZED
Authority Treasury ltr 8/3/78
By ______, NARS, Date 9/1/78

MEMORANDUM FOR THE PRESIDENT

Subject: Final Report on the Balance of Payments

The week ending Wednesday showed another surplus, the fifth in a row in the rough weekly data we receive from the Federal Reserve Bank in New York. The latest surplus was considerably larger than earlier ones. These reports for the three weeks since March 3rd now show a cumulative surplus of $250 million. In addition, the week ending March 3rd showed an exceptionally large surplus of $270 million. However, since this week covered a portion of February there is no way of knowing, until we get the monthly figures for March later in April, how much of that surplus is attributable to March and how much may have already been included in the monthly figures for February. Since the final figures for February show a deficit of $475 million, somewhat larger than I had expected, my guess is that a good portion of the $270 million surplus for the week ending March 3rd will turn out to be March transactions and will add to the size of the surplus we seem to be running this month. While these weekly figures are crude and represent only a sample of the total, they are useful in projecting the general trend. In view of the steady nature of the surplus over the past five weeks, it is likely that banks not covered in the weekly sample survey are also recording surpluses. Therefore, the monthly figure for March could well turn out to be even more favorable than our weekly totals indicate.

These favorable weekly figures, the general strength of the dollar in foreign exchange markets and the rise in rates in the Eurodollar market all are clear evidence that our voluntary program is working as well or better than we could possibly have hoped. This is now generally recognized in financial circles both here and abroad.

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This improvement may, however, have come just in the nick of time. Sterling has been weak over the past couple of weeks as the impression has grown that the United Kingdom budget, which is now due to be presented on April 6, will turn out to be inadequate. This impression has been reinforced by the speech given last week by the official British representative at the International Monetary Conference of the American Bankers Association at Princeton. Should this prove to be the case, it is highly possible that, prior to the first of June, the European countries will join in forcing the British Government to choose between substantial further restrictive action, such as increased sales taxes on consumer items, or a devaluation of sterling. They have the capacity to do this simply by refusing to agree to renew the support which they gave sterling last November and which runs-out in May. It had been expected that the United Kingdom would make another drawing from the Monetary Fund in May for the purpose of paying off the bilateral support remaining from last winter's exercise. With an inadequate budget it is doubtful if the International Monetary Fund would, or could, agree to an additional drawing by the United Kingdom.

While it is impossible to render any final judgment on the above until the British budget has been submitted and reactions to it are available, a strong speculative attack was launched against sterling yesterday (Friday) by the French. Rumors that sterling would be devalued over the weekend were spread through Paris accompanied by substantial sales of sterling by French banks some of which may have been short sales. This attack forced the price of sterling below $2.79 for the first time since last November. The fear soon spread to other centers on the continent of Europe as well as to New York. The British were forced to support sterling heavily. I do not have the final figure for this support but apparently it amounted to about $75 million. The British tell us that they are prepared to continue such support at least until after their budget has been published and the reaction to it is available.

It is hard to understand the reasons for the French attack on sterling unless they figure that in this way they can indirectly attack the dollar. A devaluation of sterling would throw the foreign exchange markets of the world into a turmoil at least for a period. However, provided the devaluation is not too extreme, I feel confident that the dollar is now in a position to ride out the storm without too much difficulty. Prior to the immediate present, this would not have been the case and a sterling devaluation would have posed the gravest of difficulties for the dollar.

Should it appear in the coming weeks that a devaluation is inevitable, it is highly important for us and others that it not be too drastic. It is always a severe temptation to a devaluing country to go very far once the basic decision to devalue has been made. The general feeling in continental European circles is that an appropriate figure for a devalued pound sterling would be $2.50, as compared to the present rate of $2.80. This would be a devaluation of 10.7 percent. We agree that, if devaluation occurs, and we hope it won't, it should not go beyond the $2.50 level. Any greater devaluation would put heavy and possibly unbearable strains on the entire international monetary system. Should it appear that the British are seriously considering devaluation, it is important that we concert closely with them and, if necessary, intercede at the highest levels, including conversations between yourself and the Prime Minister, in order to hold any devaluation to the $2.50 level.

I am attaching a clipping from the Commercial and Financial Chronicle which is interesting in connection with this whole matter. It was written prior to Friday's attack on sterling. I do not know the author.

In the Cabinet meeting I said that, even if our balance of payments program was successful, we could look forward to the loss of $300 to $350 million more gold in the second quarter. $175 to $200 million of this can be expected in April. This is largely due to a one-time $80 million purchase by Italy. When the Italians were in trouble last year they were forced to sell $200 million of their gold. Beginning last summer they have been doing very well in their balance of payments and have built back their dollar holdings. They now feel it necessary to reconstitute their gold holdings to the total owned prior to last spring's sale. The Bank of Italy has apparently been able to find in their own commercial banking system all but $80 million of the amount needed to reconstitute their holdings.

The annual report of the Bank of Italy will be published in May and they wish to show their gold holdings up at that time. They intend to explain in this report that they have simply reconstituted their stock and will expressly disassociate themselves from French policy and express their faith and confidence in the dollar. Italy now holds about $1.7 billion of their reserves in dollars. Their gold ratio is about 55 percent, the lowest of any of the major European powers. The Italians have been very cooperative and cannot be criticized in any way for their forthcoming gold purchase.

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I have warned my colleagues here in the Treasury of the possibility that the French may well decide that their current working balances of $400 to $450 million are larger than they need and may therefore decide to purchase another $150 million in gold at any time. The present figure was given to me orally by the French Finance Minister with no one else present. Although the French have since publicly indicated that their objective was to limit their dollar holdings to the area of $1,050 million to $1,100 million, the working balance included in this figure is considerably larger than required and could easily be reduced by $150 million.

While it looks like we may be heading into a stormy period for the international monetary system in view of possible devaluation in the United Kingdom and the current French attitude, I feel confident that your program has given the dollar all the strength needed to weather the storm and more besides. However, should there be a British devaluation, there would undoubtedly be at least temporary repercussions on the dollar. In such circumstances and in order to indicate their determination to defend the dollar, I would not be at all surprised if the Federal Reserve Board were to increase their discount rate to 4-1/2 percent from the present 4 percent level. The wisdom or necessity for such action would depend on the force of the international reaction to a sterling devaluation. However, should a discount rate increase be necessary it would be better to have it come soon rather than late as was clearly indicated by the British experience last fall.

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In the event such an increase in the discount rate were to take place, it would be my feeling that it should be rescinded in a few months, once the exchange markets had settled down. I am not aware of any intention of the Federal Reserve Board in this connection, and I do not even know if they have discussed the matter. However, this would be such an obvious reaction to a sterling devaluation that I felt I should bring it to your attention before leaving.

I am attaching a table showing the breakdown of our first quarter gold losses. The Austrian purchases are the first portion of an eight month $100 million program. The Belgium purchases are in accord with their long-standing policy of keeping all their reserves in gold except for minimal working balances. The same applies to the Dutch and Swiss purchases, although the Swiss have allowed their dollar balances to increase considerably above what had previously been their normal practice. The Spanish purchase is the 2nd, 3rd and 4th installment of a $210 million program that will be completed in June. The United Kingdom purchases are to cover our share of the recent losses in the London gold pool. The Turkish purchase is partly the reversal of a temporary sale to us, but they have purchased about $10 million for reasons that are unexplained. The other small purchases, except for Salvador, were to make payments due to the International Monetary Fund. Except for the French figure, the general dimensions of which are public knowledge, these individual figures should be held in great confidence until their publication in June.

In view of the extreme sensitivity of the contents of this memorandum, no copies are being circulated outside of the Treasury.

Douglas Dillon

Douglas Dillon

Attachments

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