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THE SECRETARY OF THE TREASURY
WASHINGTON

November 12, 1967

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MEMORANDUM FOR THE PRESIDENT

SUBJECT: Sterling Crisis

British Chancellor of the Exchequer Callaghan sent one of his principal aides, Sir Denis Rickett, along with a top official of the Bank of England, to see me yesterday on sterling.

> The message was that they were at the end of the line, unless they have assurance of substantial long-term credit soon. They may be forced to devalue -- perhaps within a week.

The British, as you well know, have come in for help before, but they have never previously indicated so clearly that, without help, they will be forced to take the plunge.

The austerity program imposed by the British last year brought sterling out of its summer crisis and very considerable gains were made in restoring British reserves and repaying short-term credits. This favorable picture prevailed through the fourth quarter of last year and into April of 1967. The British predicted a sizable balance of payments surplus for the year.

A sharp reversal took place in May, following poor April trade figures, accentuated by the Mid-East crisis. The British reserves suffered from some movement of Mid-East funds, accompanied by other speculative flight from sterling and, more fundamentally, due to closure of the Suez Canal and related aspects of the Mid-East crisis. In addition, the hoped-for resurgence in U. K. exports did not take place, due, in large part, to the stagnation in Germany and slow-downs elsewhere, including the U. S., in the early part of the year. Finally, interest arbitrage relationships were turned against the British, as interest rates in the United States rose.

The fact is that they are now scraping the bottom of the barrel. They have already used $2 billion in short-term credits, which mortgages nearly all their total reserves. They have left only $600 to $800 million in short-term credits, which could go in the attempt to defend the rate over the next few weeks. The market could go heavily against them next week, when they announce some very bad trade figures for October. Everyone expects these figures to be bad because of the dock strike, but, even so, the impact of the actual numbers is likely to be adverse.

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If they have to conclude that devaluation is inevitable, they would rather act now, while they still have some cash and credit left to defend a new parity rate.

It might seem tempting to settle this perennial problem now and let sterling go. The arguments for this policy are:

-- If the devaluation were modest (10 - 15 percent).

-- If everybody cooperated (the Common Market, Japan, Canada, and Australia held -- and few devalued).

-- If Wilson were able to hold his foreign commitments -- Germany and East of Suez.

-- If, and this is the big if, Wilson can maintain his Government and the movement were not wasted because of internal British pressures.

Then it might be desirable to relieve sterling's long agony and try to get the U. K. economy on a more solid basis.

But the risks for us are just too great to take this gamble if we can find another alternative.

-- While we believe the Common Market would hold, there is some evidence that France would try to follow the U. K. -- in an effort to attack the dollar and try to force a gold price increase. Japan, Australia, and Canada probably could be held, although Japan, itself, would face great pressures.

But even if all this worked out:

-- the dollar would come under attack;

-- the gold market would come under very great pressure -- and might explode;

-- the world might not believe a "modest" devaluation would be adequate and pressure on sterling could continue.

The British would prefer to hold the rate, for political and economic reasons. To do so, they tell us they need a $3 billion package of long-term help. I believe they hoped for a multi-governmental loan at long-term, but we told them that such an approach was not feasible -- at least now, with all governments having budget problems. Their other proposal was for a multi-governmental (U.S., Italy, Germany) agreement to hold guaranteed sterling. This avoids any fixed date of maturity. It would have no balance of payments or budgetary effect. They said that they had some favorable response from Germany on this proposal.

We suggested a package as follows:

-- $1.4 billion IMF credit, which technically they can get by drawing their full line;

-- $1 billion guaranteed sterling, <u>if Germany and Italy would take half</u>;

-- perhaps some private bank credits.

Central bank governors met at Basle this weekend -- their regular monthly meeting -- and came up with a different approach. They believe it would be the best course to have the IMF give the U. K. a $3 billion standby commitment and announce it. This would do two things:

-- announce to the world that the IMF thought the present parity was right;

-- provide -- on a standby basis -- a lot of money to underwrite the present parity.

These are the negative factors;

-- The U. K. would be drawing a lot more than its regular credit line. This can be done technically but may cause some problems. Neither Schweitzer nor the U. K. seem to favor this approach.

-- This would require use of almost all GAB resources and would make it difficult for the U. S. to make a big IMF drawing if we need to.

-- The operational and procedural matters will require five to six weeks to clear up before a firm announcement can be made.

Even with an IMF standby, there may be a short-term cash problem for the U. K., since the IMF package cannot be used until it is finally approved near the end of the year. It may be necessary for the U. K. to get some additional short-term credit soon, which could be liquidated when the IMF was drawn on. Should that need develop, I believe we should participate. This would involve no direct balance of payments or budget costs.

It is important to understand that even the IMF standby might not hold sterling. Our judgment is that it would give them a real chance for getting through the next two months, which are crucial for them, and gives some hope that they could hold on through 1968. We believe this is an important factor. And there is at least some prospect that, if they get through 1968, either they could hold longer or take the plunge under better circumstances.

If your schedule is manageable, I would like to go over this problem with you on Monday. We need to get your reactions to possible approaches. The Federal Reserve Open Market Committee meets on Tuesday and would want to consider the guaranteed sterling question then. The situation is developing rapidly. Fred Deming will be talking to Rickett by phone at noon to get the current U. K. feeling. Schweitzer is coming to lunch with me and Bill Martin today.

It would be useful to have Bill Martin (or Dewey Daane), Gene Rostow, Deming, Okun, Fried, and Walt there.

Henry H. Fowler
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