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THE SECRETARY OF THE TREASURY
WASHINGTON

~~CONFIDENTIAL~~ - LIMDIS

June 23, 1969

MEMORANDUM FOR THE PRESIDENT

I am transmitting herewith a memorandum (Annex I) prepared by an interagency group under the chairmanship of Under Secretary Volcker, setting forth your basic options in international monetary affairs. The complexity of the issue will require some extended discussion. It may be useful to highlight a few points on which early guidance will be particularly useful.

The document suggests three major alternatives, which are discussed in paragraphs 25 to 50, and summarized in Attachment A.

The principal question for decision arising here is whether we should conclusively rule out any option at this stage.

Assuming that for the present Option I (a series of multilateral negotiations pointing toward a fundamental, but evolutionary change in the existing system) is to be pursued, these negotiating issues either will or may be faced in days or weeks:

(a) The SDR question: negotiations are beginning on June 27, and we should reach a decision on the amounts that we should propose to be activated for the first five-year period.

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(b) The question of adjustment of exchange rates may be precipitated at any time by a French move; we need guidance on the extent to which we might bring political pressure on one party or another to achieve the desired result.

(c) A speculative crisis may at any time require additional credit support for the pound, to prevent a further depreciation; Europeans are very reluctant to go further, and additional extension of Federal Reserve short-term credit may ultimately require Congressional funding. What is our attitude?

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DECLASSIFIED
E.O. 12958, Sect. 3.6

By TM NARA, Date 6/19/98

What should our public posture be on proposals for limited exchange rate flexibility and how is it to be timed and handled?

These issues are discussed in paragraphs 51 to 65 of the attached memorandum.

Also, paragraphs 62 to 65 allude to the fact that payments of gold to the IMF in 1969-71, partly in connection with quota increases, and "nibbling" gold sales to central banks could possibly reduce our gold reserves as low as $8 billion. It is important for negotiating purposes to know whether this prospect is acceptable.

While I hope you will be able to read the memorandum to get the full flavor, I thought it would be useful if we started the meeting on Thursday by having Under Secretary Volcker review the main points orally, with the assistance of some charts, before proceeding with the general discussion.

I know you are aware of the sensitivity of some of the material included here, and we have safeguarded copies accordingly. Subject to your approval, I believe that the attendance should be kept very limited. The following are now expected to attend:

The Secretary of State
Federal Reserve Chairman Martin
Dr. Arthur Burns
Dr. Henry Kissinger
Dr. Paul McCracken
Budget Director Mayo

David M. Kennedy

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June 23, 1969

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Summary

ATTACHMENT A

SUMMARY OF BASIC OPTIONS

[Paragraph notations refer to the basic document (ANNEX I)]

I. Paragraphs 30 to 32. A series of multilateral negotiations pointing toward a fundamental, but evolutionary, change in the existing system. This would include:

(a) Early activation of Special Drawing Rights in a substantial amount. The U.S. asking figure would be \$4 to \$4-1/2 billion, as against a possible European starting point of around \$2 billion a year, for 5 years.

(b) Realignment of exchange rates, with emphasis on a substantial appreciation of the Deutschemark (and other strong currencies if possible). We would acquiesce in a moderate French depreciation, which may be inevitable and perhaps imminent.

(c) After SDR activation, an active and sympathetic exploration of various forms of limited exchange rate flexibility designed for the longer term.

(d) Negotiations to expand IMF quotas in 1970.

(e) At some stage, possible exploration of the feasibility and desirability of "reserve settlement account" proposals designed to consolidate dollar balances and gold in a common reserve pool.

(f) Continued and strong efforts to remove structural impediments to our trade and to achieve better offset arrangements on military expenditures.

This approach, if successful, should restore considerable flexibility for U.S. policies and preserve a united world monetary structure. The main disadvantage is that the cautious pace of multilateral agreement may fail to move rapidly enough to achieve the objective and relieve the present strain.

II. Paragraphs 33 to 39. Suspension of the present gold convertibility at the request of foreigners. This might be forced upon us by reserve losses, or considered necessary because of insufficient results under Option I. It could take various forms

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ranging from continuing some convertibility on a negotiated basis, using gold, IMF drawings or other assets, to an entirely passive role that would make all foreign dollar holdings inconvertible. If successful, this move to a "dollar standard" would reduce gold losses, stimulate favorable currency realignment, and retrieve flexibility in financing U.S. deficits and influencing the international monetary system. Disadvantages would be the possible acceleration of divisive tendencies leading towards a dollar bloc and a European gold bloc, a general European reaction against financial cooperation, the possibility of foreign controls to limit dollar receipts from U.S. investment, and undesirable special exchange arrangements.

III. Paragraphs 40 to 50. A small or large increase in the official gold price. This would require formal Congressional approval, against probable strong resistance from important Congressional quarters in both parties.

The purpose of a small change would be to facilitate limited exchange realignment, but this would be achieved only with serious international political problems and at the risk of a run on our gold stock in anticipation of further changes.

A massive increase would be designed to strengthen our reserve position and flood the world with liquidity, thus potentially "buying time" for financing future deficits. On the other hand, such a change would add to the current worldwide inflationary potential and present extremely serious problems of equity for Japan, Canada and other dollar-holding countries. Progress toward the more basic monetary reforms under Option I would be shelved indefinitely, and any added financing flexibility could be short-lived. For these reasons, this option had no support in the "Volcker Group."

TREASURY DEPARTMENT

June 23, 1969

TO: Secretary of State Rogers
Director of the Budget Mayo
Chairman McCracken
Chairman Martin
Dr. Arthur Burns
Dr. Kissinger

Secretary Kennedy has requested that the existence and contents of the attached memorandum on "Basic Options in International Monetary Affairs" be limited to recipients of this memorandum, in view of the sensitivity of this subject.

Accordingly, it is requested that all earlier drafts of this paper should be destroyed or returned to Under Secretary Volcker, Room 3312, Main Treasury Building.

Paul A Volcker

CC: Mr. Houthakker, Council of Economic Advisors
Governor Daane, Federal Reserve Board
Mr. Thomas O. Enders, Deputy Assistant Secretary of State for Monetary Affairs
Mr. C. Fred Bergsten, National Security Council

ANNEX I

~~CONFIDENTIAL~~ - LIMDIS June 23, 1969

BASIC OPTIONS IN INTERNATIONAL MONETARY AFFAIRS

Introduction

1. Basic policy decisions in the international monetary area are urgent for the following reasons:

(1) The international monetary system itself is under strain, with a consequent threat to world economic development and the progressive reduction of restrictions on flows of trade and investment.

(2) U.S. policy in this area will have an important bearing on the United States balance of payments problem, including our ability both to achieve and maintain equilibrium and to finance deficits as they appear, consistent with essential domestic economic or foreign policy goals.

(3) These decisions are related, more peripherally but significantly, to the nature of the basic political alignments within the Western World, including incentives to create regional blocs.

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2. While changes in monetary and financial arrangements should, over time, provide an environment in which our balance of payments problem can be more readily solved, they cannot be expected in and of themselves to provide a near term answer to our present difficulties. Indeed, the chances of full success for any of the options presented in this paper are closely related to the effectiveness of our shorter-run policies for dealing with the serious current payments problem. Specifically, we do not contemplate that the courses of action proposed in the monetary area will permit early abolition of restrictions on foreign investment and other elements in the balance of payments, even though elimination of these controls is a fundamental objective of the choices discussed.

3. A review of balance of payments programs will be a logical complement to the choices made in the monetary area. Moreover, it must be emphasized that two other factors will have a fundamental bearing on our ability to negotiate orderly changes in the financial system and the effectiveness of those changes, namely, the success of our efforts to contain domestic inflation, and to de-escalate the Vietnam conflict.

Characteristics of the Present System

4. The present international monetary system (variously termed the gold-dollar system or the Bretton Woods system) has the following major elements:

(a) Fixed Exchange Rates Among Leading Countries. Parity adjustments have been made only in response to continuing large payments imbalances, usually after controls have been resorted to for an extended period. Because of economic and political "shock" effects, the decisions have been typically forced by a crisis and depleted reserves. Although adjustments can in principle be made in both directions, these pressures have tended to bias the system toward depreciation rather than appreciation.

(b) Extensive official facilities for providing short- or medium-term credits to meet speculative attacks and to gain time for balance of payments adjustments by means other than exchange rate changes. These facilities run the gamut from the formalized procedures of the International Monetary Fund to ad hoc bilateral borrowing arrangements. While they cannot be quantified in total, IMF quotas of more than $21 billion and U.S. bilateral swap lines of over $10 billion are major components. These facilities economize on the use of reserves for financing balance of payments deficits but are not a full substitute for "cash" reserves.

(c) A presumption that adjustments of imbalances in national payments will be made over time by restraining inflationary pressures in deficit countries and by encouraging expansion of incomes in surplus countries. Fiscal and monetary policies favoring adjustment do not always coincide with domestic economic circumstances and objectives, and in such cases there is likely to be a tendency to apply selective policies, including stimulus to capital outflow in surplus countries or restraint on capital exports in deficit countries.

(d) A pivotal role for the U.S. dollar as the leading "reserve" and "vehicle" currency. Convertibility of the dollar into gold is maintained for foreign monetary authorities at the fixed $35 price, but convertibility is now circumscribed de facto by common recognition that attempts at large scale conversion would be frustrated by a lack of adequate gold in U.S. reserves (now about $11.2 billion of which about $1 billion is required to cover commitments to the International Monetary Fund).

Other countries state and defend their exchange rates in terms of dollars; and to widely varying degrees, hold dollars in their reserves. Foreign official short- and medium-term dollar holdings ($16.1 billion) and foreign private dollar holdings ($23.4 billion at the end of 1968) are serviced by a complex and highly developed set of banking, investment, and trading facilities both in the U.S. and Europe.

(e) A substantial, but diminishing role for gold in national reserves. Monetary gold stocks in national reserves of about $38.9 billion (the U.S. still has more than one-fourth) were about 51 percent of total international reserves at the end of 1968, as against 63 percent in 1960. Barring a price rise, there is little chance that the gold component can increase appreciably either absolutely or relatively. At present, reserve growth is thus dependent either on U.S. deficit financing or the creation of "reserve credits" through crisis financing -- neither of which is generally regarded as a satisfactory base for long-run reserve growth of the required proportions.

5. Viewed broadly, this system has supported a rapid and steady growth in international trade and investment, and has been consistent with unparalleled world prosperity. By past standards, substantial freedom in trade and payments has been achieved and sustained, although one of the implications of current strains is to place that achievement in jeopardy. The inhibition on changes in exchange rates has helped avoid spreading depreciations such as were characteristic of the 1930's. The "discipline" in the system has probably tended to moderate inflationary pressures in deficit countries, although fixed rates may also have contributed to inflation in surplus countries.

6. Viewed more narrowly, and from the standpoint of U.S. interests, the present system has permitted financing some 70 percent of our cumulative balance of payments deficits (on the liquidity basis) of $24 billion over the past decade with increased foreign official and private liquid dollar holdings -- the amount of $17 billion in ten years is substantially larger than our entire remaining gold stock. Gold losses, while large in absolute size at $10 billion, were called upon to finance only about 40% of the deficit. During 1960-68, the rise in liquid and non-liquid official dollar holdings was $8.0 billion, and financed 58 percent of the cumulative official settlements deficits.

The available financing for our deficits has permitted the United States to carry out heavy overseas military expenditures and to undertake other foreign commitments, and to retain substantial flexibility in domestic economic policy. Politically, the system has been consistent with, and encouraged, a fully multilateral trading and payments order. It has facilitated a role for U.S. leadership and influence more or less commensurate with our relative size and economic power, but at the cost of substantial borrowing at short term in the form of liquid dollar liabilities.

7. In more recent years, growing difficulties and strains have appeared that clearly threaten these achievements. Pressures toward restrictionism, particularly on capital movements, have emerged in the U.S. and elsewhere. Repeated speculative crises involving several major currencies and the gold market, while coped with successfully, have left a residue of growing uncertainty. Balance of payments disequilibria of major countries have persisted for years. These tendencies have led to a maldistribution of reserves and have heavily taxed official credit facilities. There

is a risk of a breakdown in the basic minimum of confidence in currencies and monetary arrangements necessary for a smoothly operating financial system. This could affect in an important way our capacity to make foreign commitments and to exert international leadership in international economic, ~~and~~ financial & political matters.

Underlying Issues

8. We are poised at a rather critical juncture in the evolution of the international monetary system. It is questionable whether the present monetary system has the capacity to provide financing for continuing large United States deficits. At the same time, the attenuation of confidence in the dollar and in our ability or intention to control our deficits actively encourages our trading partners to seek additional means of limiting our ability to finance deficits, which they regard as a transmission belt for passing our inflation on to others and as threatening a monetary system under which they have so long prospered. The uneasy feeling abroad that United States deficits are in danger of becoming uncontrolled erodes our bargaining position, not only with respect to improvements in the international monetary system, but in other aspects of our international economic and political objectives. One way

of viewing the current controversy over monetary arrangements is to recognize it as a struggle over who should assume the main burden for eliminating or adjusting to the excessive U.S. deficits, and the form the adjustment should take. The outcome will have implications for the constraints that may be applied to our own foreign and domestic policies; as compared to the substantial degree of freedom that we have enjoyed during most of the postwar period.

9. The growing strain on present international monetary arrangements can also be viewed in large part as a reflection of inadequate national economic policies. The strong inflationary pressure in the United States over the past four years, which has been a major factor in the elimination of our formerly strong trade surplus and in undermining confidence in the dollar, is a leading case in point. Among other deficit countries, the internal strains and labor difficulties of the United Kingdom have been notable. Among surplus countries, Italy has failed to push internal expansion, Japan remains highly protectionistic, and the cumulative German trade surplus can be traced in part to an earlier recession.

10. National economic policies have been inadequate to eliminate the strains of persistent deficits and surpluses partly because internal objectives differ among countries. In Germany, for example, all elements of the community

place an extremely high priority on resisting inflation and holding the upward trend of prices within limits that are markedly lower than most other industrial countries, because of their traumatic experience with hyper-inflation in the past. A decision as to monetary arrangements (including especially the degree of exchange rate flexibility desired) rests partly on whether these differences among objectives are thought to be desirable, or whether we encourage greater consistency among objectives in a framework of fixed exchange rates.

11. There is another conflict in economic objectives that lies beneath the present difficulties of the international monetary system. The world wants to take full advantage of the gains in productivity and welfare inherent in the free movement of goods, investment, and people internationally. At the same time, the sovereign claims of the nation-state to control its own economic destiny continue to be pressed strongly. The basic dilemma between international economic integration and national self-determination has been sharpened and aggravated by the rapid growth of the international corporation, which is on the one hand a powerful vehicle for encouraging productivity and rationalizing worldwide production patterns,

while on the other hand contributing to speculative flows and undermining purely national objectives. Any monetary arrangements must seek a viable compromise between these basic objectives, but they cannot be fully reconciled.

12. It is also clear that there are inadequacies and internal dilemmas within the monetary system itself that can and should be corrected. These include:

(a) The absence of adequate provision for growth in reserves. In a context of growing trade and economic activity, most countries desire to build up reserves over time by aiming for balance of payments surpluses. In practice, this process tends to perpetuate U.S. deficits. Our deficits, in turn, attentuate our ability to maintain convertibility, with the associated risk of a loss of confidence in the stability of the key currency in the system.

(b) The absence of balanced incentives or mechanisms to promote effective balance of payments adjustments. Surplus countries can pile up reserves for long periods without revaluation or other adjustment; deficit countries (apart from the U.S.) are eventually forced to devalue, tending to bias the system in favor of devaluations against the dollar, further damaging our competitive position.

(c) In many situations, potential rewards for destabilizing speculation are high, without commensurate risk of loss.

Basic Objectives

13. As a starting point it must be recognized that no international monetary arrangement can permit the United States (or any country) to escape "external" constraints entirely or indefinitely. A tendency to spend or invest more abroad than other countries want to invest or spend (or leave on deposit) in the U.S. will, sooner or later, need to be corrected. The differences among alternative monetary practices lie in the speed and nature of the adjustments required, including the extent to which adjustments are achieved through the price mechanism (including changes in the exchange rate), through changes in domestic inflation or employment, or through controls.

14. Against this background, our planning for further evolution in the international monetary system involves a balancing of priorities among the following economic and political considerations:

(a) Retention of substantial flexibility for the U.S. both in terms of domestic economic policy and foreign spending (including military and aid outlays). This implies, for example, some satisfactory way of financing even large cyclical and temporary U.S. deficits on the official settlements basis.

(b) Encouragement of a free flow of goods, services, and investment internationally, and a healthy non-inflationary growth in the world economy, both by assuring relatively stable monetary arrangements and by minimizing pressures for administrative controls on either trade or capital.

(c) Safeguards against speculative or other disturbances that threaten a breakdown of the basic framework of the system.

(d) Politically, a substantial element of U.S. control, in order to safeguard the legitimate U.S. interest in (a) or (b) above. However, in the interest of facilitating international harmony, the appearance of U.S. hegemony should not be sought. In more concrete terms, this tends to point to the desirability of working in a context of multilateral consultation and cooperation, so long as this does not, by reducing progress to the lowest common denominator, frustrate needed change.

The Present Setting

15. The current tensions in the international financial area both point to the urgent need for constructive change and severely constrict our freedom of choice in what changes we can seek. At the same time, certain potential crises could be

seized upon for encouraging constructive change. The most serious imbalances outside the U.S. in terms of the likelihood and imminence of their precipitating another foreign exchange crisis are in Europe.

(a) The French franc is in a weak position, and the French are steadily losing reserves at a heavy rate. A French decision to depreciate the franc moderately could come at any time, though the general expectation is that the French might prefer to couple this with a simultaneous German revaluation, waiting until after the German election in the hope of doing so if their reserves and credit lines hold out. Such a devaluation, particularly if unilateral, could add to the pressure on sterling and other currencies and might induce other devaluations. Such depreciations could adversely affect the United States trade position, add to pressures on the dollar, and thus further undermine the stability of the system. This would tend to force one of the more drastic solutions on our part (discussed below), but at the same time reduce the prospects for the most desirable results.

(b) The German mark is undervalued, and is a strong focus for speculation. Revaluation of the mark and of any other currencies of surplus countries would assist our own competitive position, and, more importantly, reduce or eliminate prospects for a French (or U.K.) devaluation spreading. Consequently, a German revaluation, joined if possible by other strong currencies, remains a highly desirable goal. The more or less imminent prospect of a French devaluation could be the catalyst for such a multilateral realignment, but the scope for the U.S. to influence the outcome is limited by the strong internal political repercussions of exchange rate changes.

(c) The pound sterling has withstood fairly well the speculation in the German mark in recent months, and losses of reserves have not been excessive. However, the U.K. position remains very weak, with very large emergency credits to be repaid or refunded in the next few years, and with only very slender reserves available. A reserve loss of several hundred million dollars could force the British to devalue, adopt a floating rate, or impose import restrictions. While at the moment they are less likely to precipitate an exchange crisis than the French, there is a real danger that sterling might not survive a unilateral French devaluation, not accompanied by a German upward adjustment.

U.S. Balance of Payments

16. Despite continued serious imbalances in U.S. international accounts, the dollar has been relatively strong on the exchange markets in recent months. However, this strength is accounted for mainly by unsustainably large short-term capital inflows induced by increasingly tight money in this country.

17. For the time being, these inflows, generated primarily through U.S. banks' branches abroad, have kept dollars out of foreign official hands, and have thus greatly improved our official settlements balance. In fact, the increase of some $7 billion in the takings of Euro-dollars by U.S. banks in the first half of this year has pulled a sizeable amount of dollars out of existing foreign official reserves, with the result that we have a surplus of more than $2 billion on the official settlements basis.

18. At the same time, we are headed for a record deficit measured on the liquidity basis, which counts as liabilities dollars in foreign private hands (including foreign branches of U.S. banks). This deficit, paradoxically, is also exaggerated by tight money, since a large volume of U.S. funds has apparently been shifted to the Euro-dollar market to take advantage of very high interest rates there. In addition, large outflows of corporate money were stimulated

by the recent mark crisis, with the result that the liquidity deficit is already nearly $5 billion, larger than the previous record deficit for an entire year ($4 billion).

19. While one can adduce various explanations for the bizarre behavior of our international accounts in recent months, there is little doubt that the size of our liquidity deficit will come as a shock to the markets and foreign officials. If one could argue that current results were entirely an aberration from an otherwise strong U.S. balance of payments performance, the difficulties would be minimized. Unfortunately, this is not the case. Our trade balance has deteriorated sharply from its traditional sizeable surplus into deficit. Longer term capital outflows (particularly direct investment), which were depressed in 1968 by the "once-for-all" first-year impact of the mandatory control program, will be much higher this year. Gross military spending of $4.5 billion overseas remains a heavy drain, as does net tourist spending overseas of $1.8 billion. Capital inflows, particularly into U.S. stocks, have been tapering off in recent months, and the upward trend in earnings on our overseas investments will not offset these drains.

20. Our trade balance should improve as the overheating of the domestic economy ends, but this favorable influence is likely to be both slow and limited. Moreover, an easing of

money in the U.S. will tend to expose the underlying weakness in our balance of payments structure.

21. Looking further into the future, the rising competitive power of Japan, Germany, and Italy, our deteriorating trade position with Canada, and the structure of our imports and exports, suggest great difficulty in rebuilding a large trade surplus - say more than $1-$2 billion - over the next 3 to 5 years. An ending of the Vietnam conflict would provide important psychological relief, but direct foreign exchange costs (running more than $1-1/2 billion per year) could not be expected to decline rapidly. Growth in our earnings on foreign investments should provide some relief, but not enough to achieve a large and sustained current account surplus. Thus, on present prospects, even if we succeed in reducing appreciably the rate of inflation, our payments position will be dependent upon a much more balanced position on capital accounts than in the past. While such a balanced position was achieved last year, this was unusual, and probably not sustainable or desirable in terms of the U.S. savings potential, capital markets, and wealth.

22. All this means that until appropriate changes can be made in commercial policy, world trading rules, and/or monetary arrangements, our balance of payments position will continue to require the protection of capital controls.

More generally, our relatively weak competitive position (reflected in the absence of a trade surplus) tends to undermine the financial leadership of the U.S. and limits our ability to shape the monetary system in the most constructive manner. Thus, our balance of payments outlook both increases the urgency of change and limits our options.

23. For both the period immediately ahead and the medium-term future, the dominant factor affecting the evolution of the international monetary system (and our success in guiding that evolution) will be our ability to contain domestic inflationary forces. The symptoms of inflationary psychology apparent in domestic financial markets -- skyrocketing interest rates, heavy strains on financial institutions that operate within the framework of fixed-interest obligations, increasing insistence on equity "kickers" by lenders, and the tendency of borrowers to anticipate needs -- have parallels in international markets. These strains have been tolerable, and they should remain so as long as the business and financial community -- and responsible foreign financial officials -- have reason to believe that they are short-run costs of restoring reasonable price stability. Should that belief be undermined, the risks of a major confidence crisis will be greatly increased. (A failure to maintain the surcharge would be a signal of our inability to control inflation in many foreign eyes.)

24. Lack of confidence in relative U.S. price stability (and thus in the future value of the dollar internationally) would for all practical purposes make it impossible to negotiate toward our objectives in deliberate evolutionary steps. Instead, we would be faced with the prospect of (1) taking one of the more "radical" options in an environment that maximizes uncertainty and unfavorable repercussions, or (2) in an effort to avoid these options and preserve the stability of the system, accepting strict limitations on our ability to finance future deficits in our balance of payments with dollar liabilities. The latter restrictions might be associated with some foreign acquiescence in consolidating our extended foreign financial position, but the clear implication would be heavy reliance on controls to avoid an unsustainably large loss of gold.

Major options in the longer-term evolution of the monetary system

25. One approach toward the monetary system would be to attempt to preserve the present arrangements more or less intact, perhaps supplemented in time by a modest activation of Special Drawing Rights. Provided money remains relatively tight in the U.S. and there are clear signs of progress toward dealing with domestic inflation, this passive approach might be sustainable for a considerable period, barring spreading devaluations abroad and assuming a willingness on the part of the U.S. to incur substantially more external debt through the

IMF or direct bilateral borrowing. It would, however, offer no basis for confidence that, under pressure from foreign creditors, we could escape in coming years from continuing and probably more intensive use of selective balance of payments measures. These might include not only controls on capital, but also strong restrictions on government overseas spending, a series of ad hoc incentives to exporters and barriers to imports. One possibility along this line would be a general tax on imports, perhaps accompanied by corresponding payments to exporters.

26. The ultimate success of such an approach in terms of the basic objectives cited earlier, would be dependent on a combination of an exceptionally favorable performance at home in controlling inflation and stronger tendencies abroad toward inflation and a deteriorating competitive position. This is not impossible: e.g., France turned quickly from a persistent surplus to a deficit country. However, the likelihood of success is too small to recommend this course of action, and it implies substantial risks in terms of a breakdown of the system.

27. Consideration may be given to three alternative broad courses of action: (a) a series of multilateral negotiations pointing toward a fundamental, but "evolutionary" change in the existing system; (b) suspension of the present

United States policy of providing for the conversion of dollars held by foreign monetary authorities at their discretion;[1/] and (c) a change, large or small, in the official price of gold.

28. These courses of action are not necessarily mutually exclusive in all aspects. For example, even the existing inhibitions on convertibility affect attitudes toward (a) above, and the prospect of (b) is a factor in foreign calculations. However, these courses do represent three quite different basic concepts and focuses for action, each with different problems and advantages.

29. The paragraphs that follow describe these options briefly and suggest the strengths and weaknesses of each.

Negotiated multilateral evolution

30. In the months since this Administration has taken office, our efforts in the international monetary area have, in good part, been directed toward probing intensively prospects for progress toward negotiating evolutionary reform in the international monetary system. The major elements in carrying forward this approach would be:

1/ It has been pointed out that there is already a substantial amount of de facto inhibition on gold conversions by foreign monetary authorities, and that a formal understanding not to convert exists in the case of Germany -- hence this course is not, strictly speaking, clearly "non-evolutionary" in all respects.

(a) Early and sizeable activation of the Special Drawing Rights scheme. This would provide needed assurance that international reserves could be provided on a sufficient scale in coming years by constituted multilateral procedures to importantly relieve developing strains and tensions on the monetary system. Although its usefulness in directly financing our deficits will be limited, activation on a sufficient scale will facilitate balance of payments adjustment by surplus countries and will therefore relieve some of the pressures within the system that tend to perpetuate U.S. deficits. Activation should have a distinctly favorable effect on confidence, and it will be an important step toward confirming the diminishing role for gold in the system and in relieving pressures for an increase in the gold price. To achieve these objectives fully, activation would need to be on a scale substantially larger than the $2 billion per year figure now in the minds of many Europeans for the first five years; amounts of $4 billion a year would be desirable, but probably unobtainable.

(b) Some realignment of existing exchange rate parities now biased against the U.S. This is discussed fully in paragraphs 57 and 58.

(c) Activation of Special Drawing Rights would be followed by active and sympathetic exploration of the various techniques for introducing a greater degree of exchange rate flexibility into the monetary system. No international consensus now exists in this area, and a long period of consideration, running to two or more years, could be expected before any negotiated agreement is reached. However, there is a distinct possibility that one or possibly more countries (e.g., Germany) could be encouraged to introduce some form of limited flexibility upon their own initiative without awaiting a fully multilateral consensus, and it is possible that such limited steps could be distinctly useful, both in themselves and in gaining experience. Important problems would arise in making sure that any new exchange rate practices are not biased in the direction of depreciations vis-a-vis the U.S. dollar (on the contrary, they should be aimed at relieving pressures on our own trading position), will not provoke speculative tendencies, and would not so damage the reserve currency role of the dollar as to unduly limit our own financing flexibility.

(d) Expansion of IMF quotas. The quinquennial review is due in 1970. Because of the complex and time-consuming nature of quota negotiations, we hope to defer serious consideration of quotas until after SDR activation. In 1970 we may wish to enlarge the U.S. quota to retain our strategic voting position and to enlarge our credit facilities at the Fund, but this is not of crucial importance to us as it is to certain other countries.

(e) At some stage we may wish to explore the feasibility and desirability of so-called "reserve settlement accounts". This approach would be designed to consolidate the different types of international reserves (gold, dollars, and SDR's) in one more or less homogeneous asset, thus adding to the stability of the system and further circumscribing the role of gold. However, while such arrangements would tend to consolidate existing dollar balances, there would be an effort to put restrictions on the further growth of the dollar element in reserves, thus restricting our flexibility in financing deficits. Both the United States and other participants would lose control of substantial parts of their gold reserves to an international pool of reserves. Consequently, this element in monetary reform would need to be approached with definite caution, and probably will be by other countries. It would be beneficial only if sufficient flexibility was to be achieved in other directions.

(f) Continued and strong efforts toward removing structural impediments to U.S. trade and reducing the balance of payments costs of our defense efforts. This would require an aggressive negotiating posture aimed at reaching a new modus vivendi with respect to border taxes that would help eliminate the present bias against the U.S. We would also seek to diminish other non-tariff barriers where the case is strong (Japan is a case in point), recognizing this is a complex and time-consuming area in which the U.S. is not free of criticism. Better and more permanent offset agreements would also be sought.

31. <u>If successful, this negotiated evolutionary approach would offer substantial advantages</u>.

(a) From the standpoint of the United States, success in negotiations over a protracted period would require control of inflation and continued emphasis on strenghtening our balance of payments, but in the end we should restore a considerable flexibility for domestic economic policy and for meeting our shifting security requirements while completing the phasing out of present controls. Given the present setting and pressures, this would represent a real accomplishment.

(b) Politically, while definitely implying a gradually increasing participation and responsibility for other countries in the mangement of the international monetary system commensurate with their growing economic power, it would retain for an indefinite period a major role for the dollar and monetary leadership of the United States.

(c) Economically, it would preserve a unified monetary structure for the free world, with clearly defined rules of the game. It would be a counter-force to pressures toward blocs and divisive forces. It would be fully consistent with and tend to support a multilateral framework of rules to promote liberal trade and investment policies worldwide.

(d) This course involves no sudden and disturbing changes in the international monetary system as it has evolved from Bretton Woods. It is fully consistent with the general effort to promote international cooperation and collaboration in other areas among major countries.

32. Against these advantages, there are apparent difficulties in this approach.

(a) The necessity of moving ahead by consensus among the major European countries and in the IMF ties us to a negotiating framework in which progress can proceed at a sluggish pace, governed by the least common denominator. These negotiating difficulties can be intensified by such political roadblocks as the intransigent attitude taken by the French in recent years. We would need to cope continuously with the conservative bias of many European officials. At the least, this course might imply personal intervention at the head of state level from time to time to get over specific hurdles.

(b) The apparently deliberate pace of international monetary negotiations may not bring change soon enough to forestall the breakdown of the system, particularly if our own inflation is not brought under visible control and we are unsuccessful in turning the trend of our trade balance.

(c) Commitment to this course would entail negotiating some limitations on our own future freedom of action, and these limitations would tend to become embedded in the structure of the IMF and other international organizations. To some degree, this process has been started in the course of the negotiation of the SDR scheme, where European agreement was purchased only at the expense of increasing their relative power position within the IMF. This potential loss of flexibility will be more theoretical than real, if the basic American trade position remains relatively weak, but could be restricting at some future time when the relative strength of the U.S. economy and our competitive position are stronger.

Suspension of Gold Convertibility

33. At the present time, the United States maintains the formal posture of converting dollars into gold at the discretion of foreign monetary authorities. However, conversions have in fact been relatively small since the flurry following the establishment of the two-tier gold system.1/ The German authorities have stated in a letter that they do not intend to present dollars for gold, though this intention could be changed under different conditions. Informally, Japan, the United Kingdom and a number of other countries have been generally discouraged from acquiring gold. (Only in the case of Japan has the question been raised with this Administration, and then only tentatively.)

34. Outright suspension of the gold convertibility of the dollar for foreign monetary authorities could either be forced upon us by events or could be taken as a deliberate considered action. In either case, such suspension represents a departure from the negotiated multilateral settlement approach and, unless clearly forced upon us by a crisis, would tend to be considered by foreign countries as a U.S. power play. However accomplished, it would contain the seeds of political divisiveness, although the degree of risk would differ, depending on the particular approach and procedures adopted.

1/ Gross sales of gold were about $600 million in the period April 1, 1968, to June 20, 1969. From July 1, 1968, to June 30, 1969, the corresponding figure was about $300 million.

35. Two broad substantive approaches might be considered:

(a) While suspending formal gold convertibility, we would retain the option, at our discretion, to convert dollars from time to time in a given situation when it suited our own objectives, through a combination of gold sales, IMF drawings, or other devices. At least initially, it could be maintained that such practices are consistent with the basic structure and rules of the IMF.

(b) At the other extreme, we could simply announce the suspension of any obligation to convert foreign-held dollars and adopt an essentially passive role vis-a-vis foreign dollar holders. This would more clearly appear inconsistent with current IMF principles and rules.

36. Particularly in the latter case, the result would be to require other countries to face directly the question as to whether they (a) wish to maintain their exchange rates by accumulating dollars, (b) wish to let their currencies appreciate to hold dollar accumulations down, or (c) apply, at their own initiative, some form of controls on the inflow of dollars (most likely on U.S. investment), and/or stimulate the outflow of capital. The Continental European countries might attempt, despite difficult obstacles, to form a monetary block of their own. In any case, the degree to which they would permit their currencies to appreciate, rather than introducing controls, designed to limit dollar accruals,

is highly problematical. On the other hand, it seems likely that a large number of our close trading partners and less developed countries would prefer alternative (a), so long as the United States retained reasonable price stability and our basic competitive position did not deteriorate markedly. The result would be an informal "dollar bloc" in which countries heavily dependent on trade and/or financial relations with the United States would "tie" their currencies to the dollar. We could encourage this development by certain preferences.

37. The uncertainties and potentially divisive risks of suspension could be ameliorated by choosing the first of the sub-options cited, i.e., a measure of convertibility but with a substantial degree of discretion in converting foreign dollar holdings, using various reserve assets to do so. Moreover, the political repercussions would also be limited if such a step were taken only in response to crisis, rather than under conditions suggesting that it was a deliberate act of U.S. policy. However, this approach would be sustainable only in a situation in which our own basic balance of payments and competitive position tended to strengthen. Otherwise, it might buy only a limited period of time, since it would probably imply relatively heavy use of gold and other assets in settling balances, and extensive use of foreign borrowings.

38. The major objective and potential advantage of suspension, either on a limited or comprehensive basis, would be to strengthen the real, and also the negotiating position of the U.S. by (a) eliminating or reducing the possibility of a run on our gold stock and (b) by increasing the pressures on surplus countries to adjust by presenting them with essentially unpalatable alternatives. The successful outcome rests in part on the proposition that most foreign countries, and particularly the leading powers of Europe, would have much more to lose from a move away from cooperation and orderly development in the international monetary system than the United States. Consequently, they would have strong incentives to make responses relatively favorable to us -- i.e., passively hold dollars or permit a gradual appreciation of their currencies. If successfully carried off, the United States would retrieve for itself a very substantial degree of flexibility in financing future balance of payments deficits and would remain in an extremely strong position for guiding future changes in the international monetary system.

39. On the other hand, this course involves some major economic and political risks. The economic risks grow out of the inherent uncertainties of this course; there is no assurance, for example, that major countries would accept the choice between accumulating dollars and appreciating, but

rather would resort to controls, probably aimed at reducing capital imports. Moreover, the fact that the United States may be less harmfully affected than other countries by the additional strain on international monetary cooperation does not, in itself, make this a happy prospect. These risks could be minimized only if the United States were successful in its anti-inflationary efforts at home and in improving the structure of its balance of payments. Consequently, the theoretical flexibility afforded by this approach could not safely be fully utilized, at least in the short run. Politically, this potentially divisive act could affect cooperation with foreign governments in other spheres. In the meantime, the possibility that the United States might follow this course may serve as a sort of lever to get action in other areas.

The Gold Options

40. Two variants of a change in the price of gold may be considered:

(a) A small increase of 10 percent to 20 percent to promote multilateral realignment of exchange rates in which the dollar would be devalued relative to a number of other major currencies.

(b) A large increase (to a range of $70 to $100) in an attempt to reestablish a strong U.S. reserve position and to saturate both foreign official and private demands for gold, thus providing a base for maintaining gold convertibility and fixed exchange rates.

41. A compromise approach of changing the price by an intermediate amount (say, 30 percent to 70 percent) carries the disadvantages inherent in a larger change, while practically eliminating any chance of reducing the balance of payments constraints on the U.S. It therefore can be rejected outright, <u>although this is likely to be the preferred alternative of some Continental European monetary officials if the gold price question should be seriously opened</u>.

42. Any proposal to change the gold price must take account of the legal and political obstacles. Legally, Congressional sanction would need to be obtained, and a Republican Administration would be forced to seek approval from an opposition Congress with liberal economic leadership strongly against a gold-price change. Republican Banking and Currency Committee leadership (e.g., Widnall) shares this view. Extended emotional debate -- even if finally won on the basis of ratifying a "fait accompli" -- would at the least magnify the market uncertainties and tend to exacerbate the intuitive association of devaluation by the man in the street with inflation, broken promises, and monetary instability.

43. A change in the price of gold does not per se imply any change in exchange rates of foreign currencies against the dollar. However, it has been argued that a small devaluation of the dollar in terms of gold would facilitate appreciation of other currencies relative to the dollar, and thus achieve an improvement in our international competitive position. In

certain negotiating situations, this is possible. For example, the Germans and Swiss might well be willing to "stand still" if the U. S. devalued by no more than 10 percent (or to move only part way if the devaluation were larger). However, for the foreseeable future, nearly all other countries -- including all the large ones -- would be expected to follow the dollar, or to devalue by even more.

44. In addition to facilitating a limited realignment (which might still be achieved so far as the key countries of Germany and Switzerland are concerned without the gold price change), a small increase in the gold price would modestly increase world liquidity and increase the profitability of gold mining. At the same time, it has been argued that so small a change might be achieved consistent with other reforms, and without inequitably rewarding present gold holders.

45. These limited advantages would be offset by substantial disadvantages:

(a) A small change would in itself create strong expectations of still further changes, and thus strongly reinforce central bankers' preferences for gold as a reserve asset. This would create forces weakening the dollar and greatly accelerating demands on our gold stock. Since our reserve position would not be significantly strenghtened, the suspension option (or a much higher gold price) would be forced in unfavorable circumstances.

(b) Politically, the direct benefits, while limited in amount, would still be inequitably distributed, favoring a small group of European gold holders at the expense of those who have cooperated by holding dollars in the past (e.g., Japan, which has repeatedly expressed the view that a change in the gold price would be politically intolerable for the present government).

(c) In exchange for a limited rate realignment, a signal that the gold price is negotiable is likely to strengthen resistance to other reforms, such as SDR's and rate flexibility, by those skeptical of such reforms.

46. As a result, the approach of accepting a small gold price change simply to achieve realignment is untenable. The further question has been raised as to including such a change in a much larger package containing substantially all the other elements set forth earlier as part of the "multilateral approach". Our considered judgment is that this could not practicably be negotiated. Indeed, any evidence that the gold price is "negotiable" as part of the "multilateral approach" would tend to weaken our hand and jeopardize success by encouraging some Europeans to force a "gold solution" at the expense of other reforms.

47. This leaves only the option for a massive increase in the gold price. The "Rueffian" version of this approach favored by some Europeans (including particularly Mr. Debre in France) can be ruled out as undesirable from the U. S. standpoint. This would contemplate that the large increase in the gold price be accompanied by elimination of existing holdings of dollars from world reserves and a foreswearing by other countries of adding to dollar holdings in the future. Gold would again resume a central and unique role as an international reserve asset. The U.S. would be expected to utilize the revaluation profits on its own gold stock to repurchase outstanding dollar liabilities or to compensate other countries with relatively little gold for their failure to participate proportionately in these profits. The net result (and the basic objective) would thus be to impose discipline on the U.S., to restore the rigidity of exchange rates, and eliminate flexibility in handling balance of payments deficits in the future.

48. A massive increase in the price of gold might be considered without the accompanying "Rueffian" constraints, but rather on the presumption of continued foreign dollar holdings. The objective would be to obtain a strengthening of our reserve position, greatly enhance world liquidity, satisfy both central bank and private demands for gold, and thus increase our financing flexibility. As in the case of a moderate gold revaluation, Germany and Switzerland might

permit some appreciation in their currencies, and the massive increase in liquidity would help provide better assurance of the ability of most countries to maintain their exchange parities.

49. On the other hand, there are definite weaknesses in this approach.

(a) Countries holding substantial amounts of dollars in their reserves on the basis of earlier U.S. assurances of a stable official gold price would be seriously embarrassed (the Japanese say the government would fall), and would end up with a much smaller share of global reserves than at present. European gold-holders, and the USSR and South Africa, as major producers, would be major beneficiaries; Canada, Japan, Scandinavia and the developing countries would be major losers.

(b) The plain inequities involved in a massive gold price increase would lead to strong demands that the U.S. provide compensation to the "losers" out of its own devaluation "profit". These competing claims would be a continuing sore point in international relationships, and to the extent the U.S. decided to provide compensation, the desired strengthening of our reserve position would be undermined.

(c) To assure success by eliminating expectations of further increases, there would be a strong incentive to increase the price by more than doubling it, making the inequities worse in the process. The abrupt addition of $40-$80 billion to world reserves (presently totaling $76 billion) would have a plain inflationary potential. Despite efforts to sterilize the excess liquidity, this would only exacerbate the virtually world-wide problem of coping with inflation and inflationary psychology.

(d) Past experience with sterling devaluation in the 1930's suggests many countries would want to exchange their dollar reserves (apart from limited working balances) for gold following a large price change. Moreover, the United States might be expected to finance more of any future deficit in gold rather than dollars, the argument being made that the United States could now afford to do so. The result is that available financing for continuing balance of payments deficits (and thus our ability to lift controls on foreign investment and on governmental outlays) would probably be improved only briefly, and then only by a few billion dollars. A recurrence of the present problem could be anticipated within relatively few years.

(e) We would lose options in dealing with this future problem because a massive gold price increase would shelve indefinitely prospects for agreed monetary reforms along the lines outlined under the first option. Instead, the role of gold in the system would be reinforced for a generation.

(f) In a sense, this would reverse the broad historical trend of monetary evolution away from a dominant role of metal to control by men.

50. The conclusion on the massive gold price option is that the positive results in terms of relieving the immediate financial pressures would be limited and likely to be short lived, while the political and economic disadvantages are weighty and fundamental. It does not seem to offer a way out.

Current Issues

51. The United States in recent months has been engaged in probing the prospects for negotiating orderly multilateral evolution, particularly through activation of SDR's and, subsequently, some form of limited exchange flexibility. This approach does not rule out a shift, to another option, should (a) United States reserve losses become excessive, or (b) there be convincing evidence that progress in negotiations is clearly short of what is essential.

52. There are three issues on which the United States must now take a firm negotiating posture. These are: (a) the amount of Special Drawing Rights to be activated, (b) our attitude on currency realignment, and (c) our support for

sterling through additional credit. In addition, our public posture on proposals for limited exchange flexibility needs to be considered.

53. We should also have a reasonably firm idea of how far we are prepared to see our gold reserves decline during the next year or two, and how our attitude toward gold losses will be affected by allocations of Special Drawing Rights.

54. Finally, some preliminary indications as to the way in which we would proceed, if we felt it necessary to move into the second option, would be useful.

Activation of Special Drawing Rights

55. It is suggested that the United States should, during the negotiations within the Group of Ten at the end of June and in July, take the position that economic logic points toward an annual amount of SDR's of $4 to $4-1/2 billion over the next five years. The United States share would then be about $1 to $1-1/4 billion a year, roughly the maximum permitted under present U.S. legislation.

56. This figure is approximately double the figure of $2 billion a year regarded as a maximum illustrative figure in 1968 -- a figure many Europeans now accept as a minimum. The higher $4 to $4.5 billion figure is fully defensible in terms of past trends in reserve growth, and the need to strengthen the reserve positions of the United States, the United Kingdom, and France. Nevertheless, we anticipate strong resistance from a half dozen of the conservative

European countries, and we would clearly have to be prepared to compromise. The crucial question is how small a figure the United States might eventually be willing to accept. It is believed that the earlier maximum figure of $2 billion a year is too small. Failure to achieve agreement on a larger amount would be one of the important factors pointing toward a shift to the second option of suspension. On the other hand, reversion to a smaller figure of $2 - $2-1/2 billion following larger initial amounts for, say two years, could provide a basis for agreement.

Realignment of Exchange Rates and the Defense of Sterling

57. The prospects for a French devaluation have increased in the past month, and a decision may be forced by continuing reserve losses within a matter of weeks. Such a devaluation, unless of small size and accompanied by at least as large (and preferably larger) German revaluation, would be a serious setback to the position of the dollar since it would encourage still more devaluations. Thus, the key to a successful outcome remains in the hands of the Germans. Moreover, there would be decided advantages if German revaluation were to be accompanied by appreciation of the Swiss franc and currencies of other countries with strong German trade ties, such as the Netherlands and Austria. While a strong economic case can be made for appreciation of the Italian lira or Japanese yen, there appears no reasonable hope for such action.

58. We share the view of the British Government that there should be no change in the present rate of the pound sterling. However, we must recognize that sterling could come under heavy speculation during the next six months. Maintenance of the rate in these circumstances would undoubtedly require substantial additional credit assistance. Europeans are extremely reluctant to provide such assistance, and our own ability to assist is limited due to already heavy exposure totaling more than $3-1/2 billion. The capacity of the Treasury to provide further assistance without Congressional sanction is exhausted. The Federal Reserve could further extend its $2 billion short-term swap facility (of which $1,140 million is now utilized), but would find this difficult to justify without adequate funding arrangements. Specifically, we may be faced with the need to fund existing and new credits by asking for Congressional authority.

59. In this situation, it seems appropriate for the United States to indicate to the Germans our serious doubts that, in the event of a French devaluation, it would be possible to restore stability to the world's monetary system unless the Deutschemark is substantially revalued (this should preferably be 10% or more, but, practically, 8% or so may be the feasible limit). Similarly, the French should be informed that any devaluation should be limited to less than 10%, and coordinated with German action. This might call at an appropriate time for a direct communication from the President to the head of the German and French

states. The pattern of events might compel some form of ministerial conference, despite disillusionment with the November 1968 meeting of Ministers in Bonn, and if so we would prefer a Washington locale under IMF auspices.

Limited Exchange Flexibility

60. Proposals for a "wider band" of exchange rates around fixed parities, or for "moving parities" have only recently begun to be examined within governments and central banks. Another possibility, favored by IMF leadership, is more flexible use of existing procedures for discrete changes in parities within the IMF framework. The United States has been actively prodding other major countries to examine these proposals at a technical level, with a view to ascertaining whether there is sufficient official interest to pursue more serious multilateral discussion of these techniques. European monetary officials tend to resist, but some German, Italian and Dutch officials have shown interest in one version or another. One German view of a crawl only in an upward direction vis-a-vis the dollar, at the discretion of individual countries, could be a promising approach from our point of view.

61. While these proposals deal directly with one of the basic problems of the international financial system, the process of identifying the specific U.S. interest in the several variants and the realistic negotiating possibilities is not complete. Moreover, open discussion of this subject is sensitive, for it adds to the uncertainties in exchange markets, and we do not

want to divert attention from currency realignment or SDR activation. As a practical matter, active negotiations could not in any event begin until after the September IMF meeting; that meeting provides a logical forum for stating openly the U.S. interest and establishing the negotiating framework. Meanwhile, the process of private, bilateral discussion at a policy level should be encouraged as a means of signifying our interest and to identify negotiating prospects.

Gold and Reserve Losses, 1969-71

62. The United States faces the prospect of substantial payments of gold to the International Monetary Fund over the next two years.

(a) A repayment of a Fund demand claim of $800 million covering a loan of Fund gold to the United States in the late 1950's, the special justification for which is now gone.

(b) Gold payments required as part of any 1970-71 enlargement of Fund quotas, amounting to

(i) approximately $400-$500 million to meet our obligation to pay one quarter of a rise in the U.S. quota; a quota increase of $1-1/2 to $2 billion may be needed to retain a strategic 20 percent vote in the Fund;

(ii) about $700-$800 million of sales to Japan and a number of small countries to cover their general and selective quota increases.

63. In addition, unless we decide to suspend gold convertibility, we must expect that our gold reserves would be drawn down further by occasional sales to other monetary authorities, including the potential for a rebuilding of French reserves following a devaluation.

64. Potentially, the anticipated decline in our gold reserves in 1969-71 could be largely offset by other reserve gains: specifically these will include our first two allocations of Special Drawing Rights (a potential of $1.5 to $2.0 billion) and the automatic gold tranche drawing right acquired with a U.S. quota increase ($400-$500 million).

65. The question remains as to how far we are prepared to see our gold stock decline. If we are to embark on the route of negotiated multilateral reform, we should be prepared to see the gold stock dip as low as $8 billion. Something in this magnitude might be needed, largely because of the present state of public psychology here and abroad. A willingness to accept that gold loss (wholly or partially offset by other gold guaranteed assets) would in turn enhance the prospects for negotiating success. However, a willingness to accept so large a decline in our gold should be dependent on those losses mainly reflecting the special IMF transactions cited above, the absence of a "run", and clear signs of negotiating progress.

Recommended Course of Action, 1969-70

66. Success in any approach depends heavily upon the progress made in restraining inflation. A reduction in the burden of expenditures on the war in Vietnam would be a major plus, not only because of its relation to inflation but because of its direct balance of payments consequences. Assuming reasonable progress toward price stability, it is suggested that the United States proceed with the negotiated multilateral evolutionary approach. We would work toward:

(a) Activation of Special Drawing Rights in a substantial amount;

(b) appreciation of the German exchange rate accompanied by as many smaller countries as possible, accepting a small French devaluation as a necessary cost and "trigger";

(c) after the question of activation of Special Drawing Rights has been decided, active and sympathetic exploration of the various forms of limited exchange rate flexibility, weighted on the side of gradual appreciation of strong currencies.

67. We must, however, recognize that either external developments or a negotiating impasse may at some time, and perhaps soon, justify use of the "suspension" option. If this is to be the case, there is no reason to believe that we will have lost anything by moving forward along the lines of multilateral evolution, assuming we avoid any new commitments to the contrary in the negotiating process.

68. A basic aim of changes in the monetary system is to provide a framework for improving the U.S. balance of payments without reliance on controls, to free domestic economic and foreign policy from constraints imposed by weaknesses in the financial system, and to restore financing flexibility. Our success in negotiating these longer-term objectives would, however, be gravely jeopardized by the suspicion or reality that we fail to recognize present balance of payments "disciplines". To assure consistency, a decision in this area thus should be followed by a complementary analysis of our current balance of payments effort.