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August 9, 1971

MEMORANDUM FOR THE PRESIDENT

International monetary and financial developments have now become urgent and immediate policy problems. While the attached statement is long, I have attempted here to lay out the general nature of the problem, the objectives, and the considerations involved with each.

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For several reasons major changes are needed in this nation's international economic policies. In the short run we are seeing sustained leakages of dollars to other major centers which are giving us quite large deficits in our external payments. These holdings of dollars abroad are growing at an unsustainable rate, and they court the risk of a disorderly interlude of adjustment if we do not take the initiative.

Of more fundamental significance we have seen an erosion in our basic international economic position. After an improvement in merchandise trade payments in 1969 and a further improvement in the first half of 1970, we have seen a disappointing deterioration leading

U.S. Merchandise Trade
(Seasonally adjusted annual rate in billions)

Period	Exports	Imports	Export Surplus
1964	25.8	18.7	7.1
1965	26.8	21.4	5.3
1966	29.5	25.6	3.9
1967	31.0	26.9	4.1
1968	34.1	33.2	.8
1969	37.3	36.0	1.3
1970-1st half	42.3	39.2	3.1
1970-2nd half	43.2	40.7	2.5
1971-1st half	44.5	45.2	- .7

to three months (April, May and June) during which our merchandise trade exports have been less than imports. There are here, as is often the case, some extenuating circumstances. There is a dock strike on the West Coast, and such a strike often produces capriciousness in trade figures. Canada, Japan, and the United Kingdom have been in recessions of varying degrees of severity. Their slack economic demand has probably resulted in some shortfall of purchases from the United States, and these three economies are important international customers for this country. Indeed, these three nations normally account for approximately 40 percent of our total exports. At the same time the weakness in our trade position, even after the stern disinflationary policies here, must be taken seriously.

Moreover, there are disturbing indications for the future. Investment plans of American corporations more and more are taking the form of concentrating capital expenditures on facilities abroad. In 1970 14.2 percent of capital outlays by American companies will be spent on their foreign facilities, compared with 12.4 percent three years earlier. This increasing tendency to rely upon foreign facilities not only to service third markets but also to supply the American market is not an augury of growing strength for the United States in the world market.

We, therefore, face some underlying basic problems which could come to a head, as often happens, with specific and more immediate financial and currency problems. These current flows of funds to other centers, however, are more nearly the thermometer registering the problem rather than the furnace producing it. The basic problem has to do with these underlying evidences about our basic competitive position.

What we now face, therefore, is the importance of devising a coordinated economic policy that will accomplish some basic objectives. First, it must substantially improve the competitive position of the American economy in world markets. Second, it should put the United States in a position to reassert its leadership of international economic and trade policy. No nation with a weak currency and a weak competitive position can exercise strong international economic leadership. Indeed, history is quite clear that a country with a weak currency and a weak international economic position will find its capability for international political leadership also impeded. Third, it is essential to find some means for reversing the trend toward protectionism and restriction both here and abroad.

We can choose between two basic strategies. One is an assault on restrictions abroad based on the proposition that we confront unfair restrictions against us in other important markets. We support, for example, the political objectives of enlarging the European Community, but we do have to recognize that its external barriers may well become more inimical to our economic interests. We confront important barriers in Japan. The United States also bears a disproportionate share of the common free world burden for security, and this imbalance ought to be redressed. A posture based on the complaint that we are being treated unfairly is, however, defensive, it is apt to have limited practical results, and it is not the foundation for strong international leadership.

It would be better if we could go on the offensive and call upon the industrial world generally to eliminate all external barriers to trade. The rest of the world would then be on the defensive if they demurred about moving toward a fundamentally more liberal economic order. This affirmative economic strategy requires as a basic condition that the United States dollar and the United States position in the world economy be stronger. Without that improved strength such a call would be an empty gesture because our own present external payments position would seem to point toward the need for more barriers here, not less.

II

There are fundamentally two broad approaches for achieving that greater strength. First, we could impose on the United States a severe disinflation. If we could moderate sharply the price cost inflation here, we could expect a gradual further improvement in our international competitive position since inflationary trends remain strong abroad. Indeed, our price level performance during the last year has been slightly better than that in the industrial world generally. Moreover, if this better performance began to look like a persisting thing, we could expect a diminishing reluctance abroad about holding dollars even if the U.S. balance of payments had not completed its correction.

For several reasons it is doubtful if this is a viable alternative. We would need to improve rapidly and by a substantial amount our international competitive position.

Annual Percent Change in Export Price and Consumer Price Indexes During the Past Year

Country	Export Prices1/	Consumer Prices
U.S.	5.0%	4.5%
Canada	-2.5	2.4
Japan	5.7	6.6
Germany	2.9	4.9
France	6.5	5.0
U.K.	7.8	9.9
Italy	7.5	5.2

1/ Based on export prices expressed in U.S. dollars

Note. - This percent change is from early 1970 to early 1971, though the exact terminal month will vary slightly from country to country.

The severity of a disinflationary program required to achieve such a result would court the risk of further economic stagnation at home and higher unemployment. A stagnant domestic economy with sluggish markets and low investment is not apt to make substantial progress in improving its basic technological and competitive position.

This leads to a second fundamental approach which is an adjustment in the exchange rate of the dollar. If the dollar were cheaper in terms of other currencies, American merchandise in other markets would be correspondingly cheaper and foreign merchandise in the United States markets would tend to be correspondingly more expensive. It is probably only in this way that we can achieve the kind of prompt redress of imbalances between our costs and those abroad that are needed.

Within this second alternative there is a progression from the least to the greatest departure from the existing system. The smallest departure would involve a border tax on all imports with a corresponding credit for exports. If, for example, we imposed a border tax of 10 percent on imports we would be achieving a change in the exchange rate for the trade dollar -- leaving, however, the exchange rate in the formal sense unchanged. Such an action would have substantial political appeal, we would be strengthening our relative merchandise trade position, and we could maintain the same definition of the dollar as 1/35 of an ounce of gold.

The border-tax approach, however, has certain disadvantages. It leaves the "tourist dollar" exchange rate unchanged, and this is an important net drain on our balance of payments. It also leaves the "investment dollar" exchange rate unchanged, and this is exactly the opposite of what foreign nations would be most inclined to accept. In many of these nations there is growing concern about the rising American ownership of local companies. We might, therefore, find resentment abroad expressing itself in retaliatory measures against imports from the United States or our own foreign investment.

Second, we could go for an outright devaluation of the dollar, against other currencies generally, to a new and lower fixed rate. This would be the most clean cut. It would make foreign assets more expensive as well as foreign merchandise. It would also make foreign tourist travel in the United States cheaper and foreign travel on the part of our tourists more expensive, thereby leading to some closing of the tourist gap. A change of the same percentage magnitude would thus have a greater therapeutic effect on our overall balance of payments than the same percentage change through a border tax (which would affect merchandise trade only).

Cons of a devaluation

The problems here, however, are also formidable. The magnitude of the change to which other nations would now agree might well be less than what is really needed to correct the present disequilibrium. Moreover, the magnitude of the change in the dollar's exchange rate that would be desirable is not the same relative to all currencies. We need a smaller adjustment against the pound, for example, than against the yen. Finally, we cannot change the exchange rate of the dollar without legislation. If this took or seemed to be taking the form of an increase in the price of gold, some members of the Congress (e.g., Henry Ruess) could be expected to object strenuously. Indeed, this might substantially delay a congressional action where a prompt decision would be urgently desirable. (During the interlude exchange markets might be in enough turmoil to have a serious effect on trade, and U.S. tourists abroad might also be in trouble.) At the same time the United States ultimately ought to have domestic legislation that would enable it to adjust its own exchange rate relative to the field, just as is true for most other nations. Obviously, the United States, by virtue of its size and the international role of the dollar, is in a somewhat different position from other nations, but we should still have this perogative available to us. This we do not now have without congressional action.

If a change to a new fixed rate seems difficult operationally, there is a third strategy. This would allow the exchange rate of the U.S. dollar to float. We now maintain the fixed exchange rate by agreeing to buy or sell gold at $35 an ounce. If we were to close the gold window, the value of the dollar in the foreign exchange market would simply depend on what someone would pay for dollars in terms of another currency. The evidence strongly suggests that the exchange rate for the dollar in a free market would tend to decline but by how much is impossible to estimate. (Since for trade purposes other nations would resist an enormous change, it is reasonable to assume that no massive settling of the exchange rate would be involved.)

Floating also has its disadvantages. It would arouse a certain amount of resentment internationally. There would be an overhang of uncertainty that would have its inimical influence on world trade and on international financial markets. Probably these adverse effects would be less than we might fear, but we cannot be sure. Limited experience with floating does suggest that floating rates are not necessarily violently unstable exchange rates. Indeed the D-mark, the guilder and the Canadian dollar are now floating and movements have been reasonably orderly. At the same time we must recognize that this is an uncharted sea when we are talking about floating the world's most important currency.

This approach, however, does have certain advantages. The fact of floating, and the probability that this would not be warmly welcomed by other nations, would produce leverage for achieving a change in the exchange rate of the dollar somewhat larger than countries otherwise might be inclined to accept. After a period it might also be possible to wrap up a package of legislation with less paralysis in the foreign exchange market than if we started out to move from one fixed rate to another. If the free market tended to indicate clearly a new equilibrium level, this would be extremely useful information in selecting the new fixed rate.

III

These various approaches are not, of course, mutually exclusive. It is possible, for example, that a border tax would need to be considered in the near-term even if we were to have also a change in the exchange rate or a floating rate. The therapeutic effects on a nation's trade balance deriving from exchange rate adjustments take a substantial amount of time to emerge (one or two years). Actions to produce some effect in the interim might be in order.

Whatever the exchange rate strategy in the narrow sense, a program that would give greater assurance about American cost-price stability would be an urgently desirable element of the program. The cumulative evidence suggests that strong actions will be needed if we are to break the wage-price spiral, and this should be a part of any package. This, of course, is also desirable for domestic reasons in order that the expansion can take the form of more employment and output rather than higher prices and costs.

Without minimizing the flack that could be expected to occur from action here, in short, we should see this as a means of avoiding being forced into irrational domestic policies. That is the basic objection to the first broad approach of trying to regain needed international economic strength through disinflation. The magnitude of disinflation required and the adverse effects it would have on the domestic economy would make it, if we were to rely on this alone, almost socially unacceptable and possibly even perverse in its overall results. The results could be perverse, to repeat, because a weakened and stagnant domestic economy is not an economy which over the long run can be a strong contender for international economic leadership. Indeed, we should take these actions in order to establish the foundation for building a strong domestic economy at home, and the greater market strength for the U.S. dollar which is the indispensible condition for international economic and political leadership.