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This paper examines the options open to the United States in dealing with what may be an emerging international monetary crisis.

Nature of Problem

The U.S. balance of payments deficit was very large in 1970 and even larger in early 1971, and foreign central banks are piling up dollars at an extremely rapid rate. Although much of the deficit reflects short-term capital outflow, which cannot go on forever, there has also been a deterioration of the U.S. trade balance at a time when it was expected to improve because of the sluggishness of the domestic economy. Meanwhile inflation goes on, even if at a slower pace than abroad.

In these circumstances, a crisis of confidence in the dollar could begin at any time; that is, both foreigners and Americans could begin to shift financial assets out of dollars into foreign currencies and gold in order to profit from an expected change in the value of the dollar. Such a run on the dollar would seriously disrupt U.S. financial markets and would require intensive negotiations with foreign monetary authorities. But, even if such a crisis does not occur, it appears increasingly likely that the U.S. balance of payments cannot be restored to health without some fundamental policy changes in the United States or abroad. Three broad strategies, and the various options under those strategies, are outlined in the next section.

The pros and cons of the options open to the United States are examined in greater detail later.

Three Possible U.S. Strategies

The possible strategies are: (A) to try to preserve the status quo by taking various actions to hasten the restoration of price stability and to reduce the balance of payments deficit; (B) to initiate action designed to achieve a realignment of exchange rates between the dollar and the major foreign currencies; and, (C) to do nothing but to wait for other countries to initiate action or for the crisis to develop.

Strategy A (Preserving status quo)--What would be involved here would be a package of measures to be taken by the U.S. Government for the specific and announced purpose of improving the balance of payments and protecting the dollar without interfering with the recovery of the domestic economy. Such a package of measures might include:

--further steps toward an incomes policy;

--support from the Administration for further fiscal actions--tax reductions--as a way of shifting some of the burden of generating economic expansion from monetary to fiscal policy and therefore achieving recovery with somewhat higher short-term interest rates than would exist in the absence of such fiscal actions;

--a tightening of existing controls on U.S. capital outflows to developed countries. This would include a tightening of the OFDI program and the VFCR, and an increase in the Interest Equalization Tax;

--adoption by the U.S. Government of additional measures to discourage repayment of liabilities by U.S. banks to their branches or to absorb such funds so as to keep them out of foreign hands.

This stragegy might be adopted for a number of reasons:

--uncertainty as to how serious the fundamental problem is and hope that, as inflation proceeds in Europe, the U.S. balance of payments will improve;

--a belief that adoption of this stragety will strengthen the U.S. international negotiating position for achieving a more fundamental correction of the imbalance in U.S. accounts;

--a belief that a satisfactory solution of the fundamental problem is not achievable now and that a holding action is both necessary and feasible as a way of preventing the development of a crisis.

The pros and cons of this strategy are presented below (pages 7-11).

Strategy B (Action initiated by U.S. designed to achieve exchange-rate realignment)--What is considered here is specific U.S. action (as distinguished from attempts to persuade other countries to act, which is covered in Strategy C) that will begin the process of realigning exchange rates so that the dollar will depreciate relative to a significant number of other major currencies (these currencies will appreciate relative to the dollar).

The process could begin with a decision that the Federal Reserve would not cover further foreign dollar accruals with drawings on the swap lines. This decision might in turn lead to a decision by the U.S. Government to suspend gold payments and purchases as well as use of SDRs and other reserve assets.

The pros and cons of this strategy are presented below (pages 11-13).

Once the gauntlet had been thrown down, a period of intensive negotiations with foreign monetary authorities would begin, at their initiative if not that of the United States. The possible outcomes under this strategy may be classified as follows:

--the United States does nothing further, adopting a purely passive policy towards its balance of payments position and leaving it to other countries whether to maintain their existing exchange rates against the dollar (which would require that their central banks purchase large amounts of dollars) or let their exchange rates appreciate. For the indefinite future, the United States would neither accumulate nor sell reserve assets. The Articles of Agreement of the IMF would either lapse altogether or be radically altered. This outcome could be described as a complete dollar standard;

--after other major countries revalue their currencies vis-à-vis the dollar and agreement is reached on other matters, including concessions by the United States to other countries, the convertibility of the dollar into gold at $35 per ounce is restored;

--convertibility of the dollar into gold is restored but at a price higher than $35 as part of a package agreement with other countries. The realignment of exchange rates under this outcome could come about as the result of some appreciation of other currencies relative to gold while the dollar depreciates in terms of gold or it could come about purely from a depreciation of the dollar while other major currencies stand still. Conceivably it could involve a depreciation of all currencies in terms of gold but a larger depreciation of the dollar.

In combination with some of these outcomes, related agreements with other countries would be necessary or desirable. These might involve the amount of SDRs to be created, future policy regarding exchange rates, limitations on future increases in the dollar component of foreign official reserves, movement toward phasing out the use of gold as a reserve asset, movement toward the consolidation of all reserve assets into a single asset in the form of a claim on the International Monetary Fund. It is possible that the restoration of the convertibility of the dollar would be into other reserve assets but not into gold.

Strategy C (No action by the U.S.)--Under this strategy, the United States would for the time being initiate no specific action of its own. Even so, there are at least two quite different options under this strategy:

--the United States, through negotiation and persuasion, could try to engineer a revaluation of other major currencies prior to a crisis and as a way of forestalling a crisis. Insofar as this outcome requires some quid pro quos from the United States, it shades into Strategy B, above;

--the United States does nothing. If the crisis developes, the United States pays out reserves for a while but at some point ceases to draw on swap lines with other countries and then suspends gold payments and purchases.

The possible outcomes are similar to those listed under Strategy B.

The pros and cons of Strategy C are presented below (pages 13-14).

Strategy A--Pros and Cons

This strategy involves U.S. action to defend the dollar by reducing the balance-of-payments deficit.

Pros--1. Perhaps the strongest argument for such action is that it might strengthen the U.S. negotiating position in achieving more fundamental changes, which require cooperative action by other countries. Many officials, and others, in Europe and Japan believe that the United States has in the past year or so simply ignored its balance of payments and the effects of its large deficit on the rest of the world. Rightly or wrongly, these officials will be strongly motivated, in negotiations about the future of the international monetary system, to impose constraints on the U.S. payments position. This motivation could show up in various ways:

--an unwillingness to revalue their currencies because this action seems to take the United States off the hook;

--an insistence on strengthening the role of gold in the system on the grounds that it is only the threat of gold losses that induces the United States to do something about its balance of payments;

--an unwillingness to agree to adequate creation of SDRs on the grounds that more discipline is needed;

--an unwillingness to contemplate greater flexibility of exchange rates in the future.

2. Another argument in favor of Strategy A is that it may be the only way to prevent a crisis. If the Government wishes at all costs to avoid a crisis, if it is judged that the United States is unable to persuade other countries to revalue their currencies (as under Strategy C), if the United States does not wish to initiate action on its own to engineer a realignment of exchange rates (as under Strategy B), and if it is judged that doing nothing will bring

on a crisis, the Government then has no other alternative to trying to maintain the status quo with a strengthened balance-of-payments program.

3. A related argument for Strategy A would run as follows: the major European countries are experiencing inflation and are quite uncertain about the future value of their currencies. This makes them unwilling (except for Germany and Japan) to revalue. Revaluation by these two currencies alone would help the U.S. trade balance, and thus probably the whole balance of payments, only a little. Thus it is necessary to hold the fort for a while until other countries are willing to revalue. To prevent the onset of massive private speculation in the interim, a strengthened U.S. balance-of-payments program is desirable.

Cons--1. To tighten the balance-of-payments programs--particularly on direct foreign investment by U.S. corporations--would run counter to Administration philosophy and policy and thus have high political costs, even if a crisis were successfully avoided.

2. There is a significant risk that a crisis will occur even if a new program is attempted. Announcement of a major new package could conceivably trigger the speculative movements that would lead to a crisis. There might be additional political costs to the Administration if a new program were tried and then fails.

3. It is at least possible that the costs associated with trying to avoid a crisis would be excessive when viewed in the light of benefits that might be realized if a crisis occurred and were resolved well and quickly. Hence it should not be too readily concluded that distasteful measures should be adopted to avoid a crisis.

4. If the new balance-of-payments program were successful enough in improving the U.S. payments position to prevent a crisis, it would relieve the pressure on other countries (Germany and Japan as well as other surplus countries) to revalue their currencies. Thus we might be in the position of continuing a distasteful program, while putting off into the future still further a more desirable solution to the persisting U.S. payments imbalance.

5. To adopt a new program in order to strengthen the U.S. negotiating position is to pander to European misconceptions about the United States and about the workings of the monetary system. Europeans fail to understand that the United States does not need a balance-of-payments constraint in order to resist inflation. This is a fundamental difference between European countries and the United States. The sooner the Europeans understand this, the better will be our relations with them. Similarly, the Europeans and the Japanese are still too reluctant to recognize that changes in relative exchange rates are a preferable means of dealing with large, persistent payments imbalances and that a change in the exchange rates of the dollar vis-à-vis other currencies can, under present institutional arrangements, only be smoothly accomplished by revaluations of other currencies. The sooner the Europeans

and the Japanese begin serious negotiations with us on changing present institutional arrangements, the better off all of us will be.

Strategy B--Pros and Cons on Seizing the Initiative--Under this strategy, the United States would seize the initiative by taking action designed to realign exchange rates before a crisis developed. Such action could itself precipitate a crisis.

Pros--1. A case can be made that, for the restoration of international balance, exchange-rate realignment is going to be needed in any event and it is better from the U.S. viewpoint not to wait until we are overtaken by events (in the form of a speculative run on the dollar).

2. If we seize the initiative, we will catch other countries, especially the EEC countries, before they have been able to work out a coordinated position for dealing with a crisis and we will be more likely to prevail in the ensuing negotiations.

3. It may be possible to initiate this strategy with quiet negotiations that do not reveal to markets that an exchange-rate realignment is imminent. In this way we may be able to secure exchange-rate realignment without a crisis that would disrupt markets and hinder economic recovery. Such negotiations could be carried out at a Group of Ten meeting called under the cover of

another issue or, if a crisis has not yet begun by then at the time of the annual Fund and Bank meetings in September, when all leading officials will be in Washington anyway.

Cons--1. It will be impossible to conduct quiet negotiations and once it has leaked out that the United States has suspended gold convertibility, an enormous flight from the dollar will begin. This will disrupt financial markets in the United States and set back the fragile recovery that is under way. It will also flood foreign central banks with dollars, undermining further their monetary policies.

2. If the United States adopts the view that exchange-rate realignment must come about from other countries revaluing against the dollar, it makes more political sense to be passive rather than to precipitate matters with a suspension. Our throwing down the gauntlet would surely provoke much greater hostility, and hence hostility to the crisis resolutions favored by the United States, compared with a situation in which a crisis had materialized as a result of other countries' failure to act.

3. Related to this point just made, it may be argued that suspension of gold-convertibility, like the nuclear deterrent, is better unused than used--better a bargaining threat than an actuality.

A discussion of the options under Strategy B (the possible outcomes) is presented below.

Strategy C--Pros and Cons on Taking No Action-- Under this strategy the United States would continue with present policies--domestic and international.

Pros--1. There is little that other countries can rationally ask of the United States so long as we continue to strive to stop inflation and to promote a moderate rate of economic expansion. A few countries, like Belgium, Holland, and Switzerland will take gold from us but these amounts are small relative to our total reserves. Moreover, it is quite sensible to buy time by drawing down, as necessary, the present reserves of gold, SDRs, and Fund position.

2. In time other countries will realize that they must revalue if they want to cut down on dollar accumulations. We can, in private discussions, encourage them to do this.

3. Continuation of present policies keeps all our options open and does not set us on a course that is irreversible. In contrast, if we initiate a suspension in the absence of a crisis, an increase in the gold price may become unavoidable even though a judgment may be made that such a outcome is highly undesirable (the pros and cons on this option are outlined below--(pages 21-28).

Cons--1. The dollar outflow is so large that a crisis may be almost unavoidable if no action--à la Strategy A or Strategy B--is taken.

2. Even if we can count on foreign central banks to continue to be moderate in asking for conversion of dollars into gold, SDRs and Fund positions, the private markets are likely to decide soon that the situation is untenable and a massive speculative flight from the dollar is likely to begin.

3. When that happens we will eventually be forced to Strategy A and/or Strategy B anyway.

Realignment of Exchange Rates--General Considerations

Whichever of the above strategies is adopted, we may find ourselves in a situation in which we are negotiating actively with major foreign countries over exchange-rate realignment. As noted above, the alternatives can be classified as: (a) a revaluation of other currencies against the dollar, which maintains its present value in terms of gold; (b) a devaluation of the dollar in terms of gold, while other major currencies maintain their present gold parities; (c) a combination of these two alternatives; and (d) a devaluation of all currencies in terms of gold but a larger devaluation of the dollar than of other currencies.

Before examining the benefits and costs of these alternative approaches to exchange-rate realignment, we may first take note of the difficulties in the way of bringing about a change in the exchange rate between the dollar and other currencies.

(1) The determination of the exchange-market value of the dollar takes place in a unique way. Most other countries maintain the value of their currencies in relation to the dollar by having their central banks stand ready to buy or sell dollars. The United States does not do this and the exchange value of the dollar in relation to each other currency is determined by the market intervention practices of other countries. That this is the state of affairs is illustrated by the fact that if one asks what is "the" exchange rate of the dollar, one cannot give any answer at all unless one specifies which other currency one has in mind. But if one asks what is "the" exchange rate of the pound or franc or mark, it is common practice to answer in terms of the dollar value of these currencies.

(2) The only way that the United States can unilaterally act to try to change the exchange rate between the dollar and other currencies is to change the dollar price of gold while other countries (or those willing to let their exchange rates be altered) maintain the existing value of their currencies in terms of gold. Those countries willing to let their exchange rates be altered would have to change the prices, in terms of dollars, at which their central banks intervene in the exchange market.

Since an exchange rate is the price of one currency in terms of another and its determination depends on both countries, it is true that no country can change its exchange rate if other countries are unwilling to see their exchange rates altered. But the United States may be different, at least in degree, from other countries in the difficulties it would encounter in changing its exchange rate, especially in a downward direction. One reason for this difference has already been noted--countries think of their exchange rates in terms of the dollar value of their currencies. They may find such a change more difficult to accept than a change in the sterling or franc or peso value of their currencies. The second reason is that the United States plays such a large role in the trade of many countries that, quite apart from technical monetary considerations, they are unwilling to see their currencies appreciate in relation to the dollar.

It has always been assumed, and there is little reason to doubt it now, that if the United States tried to devalue the dollar (by raising the price of gold), all Latin American countries and many other less-developed countries would also devalue, so as to keep the dollar value of their currencies unchanged, and therefore to keep from weakening their competitive positions in the U.S. market.

It is a useful exercise to list those countries that might potentially be willing to stand still for a devaluation of the dollar relative to their currencies. The EEC countries can probably be listed (though question may be raised as to how long France would hold its revalued rate); also Switzerland, Japan, Austria. Canada has already appreciated and seems unlikely to appreciate further relative to the U.S. dollar. The United Kingdom is unlikely to let the pound appreciate and this in turn raises doubts about Australia, New Zealand, South Africa and the rest of the sterling area. Spain and Portugal are also uncertain.

The Scandinavian countries cannot be firmly counted on not to follow the dollar. What we might be left with in practice is a handful of countries: perhaps no more than Germany, Italy, France, Belgium, Netherlands, Switzerland, Austria and Japan.

Thus, whatever means are used to bring it about, an exchange-rate realignment will probably involve a change in the value of the dollar against no more than 8 or 10 major countries and possibly a few small countries (former French colonies, for example).

Whether the method chosen for bringing about exchange-rate realignment affects significantly the number of countries willing to countenance an appreciation of their exchange rates relative to the dollar is discussed further in the next section.

(3) If exchange-rate realignment, by whatever means it is achieved, arouses expectations of early additional changes in exchange rates in the same direction, considerable instability is likely to be generated, since capital would tend to move out of the currency expected to devalue again.

While this is a problem for any currency, it is particularly important for the United States because of the special role of the dollar in the monetary system. Official and private holdings of dollars by foreigners are extremely large. An expectation of even one discrete change in the exchange rate between the dollar and other currencies could bring on a massive shift of funds out of dollars into other currencies. If, after an exchange-rate adjustment, there is a general belief that one or a series of further adjustments are likely, there could be a steady shift out of dollars into other currencies, with consequent pressure on U.S. reserves as the central banks of the recipient countries convert their dollar accruals into other reserve assets. In other words, the willingness of private holders of dollars to retain their holdings would be weakened if there is an expectation of a series of devaluations of the dollar or a series of revaluations of a particular foreign currency. (This point will be referred to again below, where the alternative techniques of bringing about exchange-rate realignment are discussed.)

(4) A change in the exchange rates of the dollar vis-à-vis the countries listed above, would be designed mainly to bring about an improvement in the U.S. trade balance. The effects on other components of the balance of payments--service transactions, remittances of earnings, capital flows--are less certain and probably of smaller relative magnitude. Thus the improvement in the overall U.S. position would come mainly (although not entirely) from an increase in earnings on trade, which would offset a greater portion of our net payments abroad on capital account.

The decision of other countries to permit a change in the exchange rate between the dollar and their currencies (and as brought out above, it will be a joint decision whatever means are employed to bring it about) will depend in large part on how large a reduction in their trade balances they are willing to tolerate.

We must recognize the possibility that the other major countries of the world have objectives for their trade balances that are inconsistent with our objective. For example, if the United States wishes to abolish its restraints on capital outflow when a change in exchange rates is brought about, the change in exchange rates must be large enough to make possible a sizable U.S.

trade surplus. If we are to achieve a sizable trade surplus, it must be at the expense mainly of the other industrial countries. Query: are the European countries and Japan willing to accept a sizable reduction in their trade balances? If not, they will not permit a sizable depreciation of the dollar relative to their currencies. If this is so, it may have significant implications for the method we choose to effectuate a change in exchange rates, since it will be likely that the initial exchange rate adjustment will not be sufficient to restore equilibrium and another adjustment will be needed before long.

We turn now to the alternatives for bringing about an adjustment of exchange rates between the dollar and other major currencies.

Realignment of Exchange Rates--Increase in the Official Price of Gold

As noted earlier, the United States cannot change "its" exchange rate. All it can do, apart from using various forms of leverage to persuade other countries to change their exchange rates, is to change the dollar price of gold and, to the extent that other countries either stand still or devalue less in terms of gold than we do, this action can bring about a change in the exchange rate between the dollar and the currencies of those countries.

The pros and cons of adopting this approach are as follows:

Pros--1. An increase in the price of gold, while adopted for the purpose of bringing about an adjustment of exchange rates, may also raise the dollar value of U.S. gold reserves and therefore give the United States greater scope for financing future deficits.

2. Carrying this point further, one may argue that if we raise the price of gold by a large amount, we may provide assurance that the price will remain stable for many years (almost two generations have elapsed since 1934). This in turn will strengthen the willingness of other countries to hold dollars in their reserves, which would also give the United States scope for financing its balance of payments in the future.

3. If the United States agrees to raise the price of gold, other countries will be willing to stand still for a larger change in exchange rates (appreciation of their currencies relative to the dollar) than if we refuse to act and insist that the entire exchange-rate realignment must come from a revaluation of other currencies relative to the dollar with no change in the dollar price of gold. The reasons for this difference may be largely political, but that makes them no less real.

4. It may be argued by some (notably by Milton Gilbert) that the SDR is not an adequate substitute for gold and that unless gold reserves rise steadily, other countries will adopt policies that force a balance of payments deficit on the United States. An increase in the official price of gold would not only increase the value of existing reserves, it would call forth a greater annual supply (in volume and price) of gold for additions to reserves.

5. The free market price of gold is likely to rise in the future as industrial and artistic demands increase against a supply from new production that will not rise much at the present price. As the free market price rises significantly above the official price, instability will be generated as monetary authorities and private dollar holders grow increasingly apprehensive that, despite the two-tier system and the SDRs, the official price will have to rise too.

Cons--1. The United States has firmly maintained, from one Administration to another, that the official price of gold will not be raised. Many foreign governments accept this as a commitment and base their reserve management (willingness to hold dollars) on it. There would therefore be political effects, at home and abroad, from an apparent reversal of a long-standing U.S. policy.

2. The United States has led the rest of the world toward the SDR system and away from heavy reliance on gold. U.S. agreement to increase the official price of gold would add to the prestige of gold as a reserve asset and turn the clock backwards on the evolution away from dependence on gold and towards a multilaterally-managed international monetary system based on SDRs. What many regard as a noble development of the 1960's would be discarded unless the increase in the official price of gold were combined with agreement on other measures that clearly accelerated the process of phasing-out gold as a reserve asset.

3. An increase in the dollar price of gold would result in a pattern of capital gains and losses that does not further the political or economic interests of the United States. Russia and South Africa would be major gainers. So would the gold bugs and the many elements in Europe, the Middle East and elsewhere that have bet against a rational monetary order and even against the United States over the years by investing in gold and in gold-mining shares. Countries that have been least cooperative with the United States in monetary matters and have insisted on keeping a very high proportion of their reserves in gold would have the largest relative gains (Belgium, Holland, and Switzerland). While it is true that countries that have held large shares of their reserves in dollars have earned interest over the years, this fact in itself does not justify giving a greater

capital gain now to countries that have not held dollars; presumably the U.S. interest calls for continuing to see to it that dollar-holding countries feel that they have been net-gainers over time.

4. A related point is that those countries whose monetary authorities have kept strict limits on their dollar holdings will finally be vindicated and this will have a demonstration effect on the behavior of other countries in the future. (It will be no coincidence that the central bankers most vociferous in urging the United States to raise the price of gold will be those that have the highest ratios of gold to foreign exchange in their reserves. They will be motivated not so much by a wish for capital gains as for a demonstration to their own fellow citizens that their policies over the years have been wise.)

5. An increase in the official price of gold will not increase U.S. reserves (see point 1. under Pros above), to the extent that it leads countries to change their reserve management policies and convert either outstanding dollars or new dollar accruals into gold and other reserve assets. Such a change in the willingness to hold dollars in official reserves could come about for a variety of reasons: the EEC countries are more than likely to adopt a uniform policy of strictly-limited dollar accumulations on the grounds that this is the only way to impose balance-of-payments discipline on the United States and prevent a repetition of what has happened in the last 10 or 15 years. Many countries whose dollar holdings were large at the time of the increase in the gold price would be under political pressure to

prevent a repetition of such a capital loss (or failure to gain). The Netherlands reacted this way when sterling went off gold in 1931.

6. If a large increase in the gold price is sought (for the reasons set forth under point 2. in the Pros' section above), the net exchange rate advantage to the United States will still be limited by how much of such an advantage other countries are willing to give us. In other words other countries will raise the price of gold in terms of their currencies by enough to limit the extent by which their currencies appreciate relative to the dollar. Thus if, as is likely, the dollar depreciation relative to other currencies is no more than 10 per cent (plus and minus, say, 5 percentage points), there is no assurance that even a large increase in the price of gold will not be repeated soon, since there is no assurance that the United States will have a healthy balance of payments. In this case, the scope for future financing of U.S. payments deficits will not be large, for two reasons: other countries will convert existing dollar balances into gold and other reserve assets; other countries will be reluctant to add to their dollar holdings.

7. To argue that an increase in the price of gold will enable the United States to achieve a larger depreciation of the dollar relative to other countries is to say that we must bribe other countries, by giving them a capital gain or by accepting a politically and economically distasteful step, to agree to an exchange-rate realignment that is in their interest as much as ours. This would be an unfortunate basis on which to begin a new era in international monetary relations. Could we ever again expect other countries to revalue when in surplus if we accept the notion now that they must be "bribed" with a U.S. devaluation?

8. If the United States takes the initiative by changing the official gold price, the Government will at the same time wish, and be required by political pressures, to abolish the existing restrictions on the outflow of U.S. capital. While this is clearly desirable for many reasons, this step will make it appear less likely to the world that the new exchange rate between the dollar and other currencies can be maintained for a long period of time. Yet, other countries may not be willing to stand still for a large enough depreciation of the dollar to make possible a trade surplus large enough to cover an unrestricted outflow of private capital from the United States. In this event, the advantages attributed to an increase in the price of gold under Pros above would not materialize.

9. The international monetary system does not require an increase in the official price of gold either for the purpose of increasing reserves or preventing instability as the free market price rises over time relative to the official price. Reserve expansion can occur via SDRs and countries can be expected, as time goes on, to treat SDRs as a full substitute for gold. Furthermore, in these circumstances, the two-tier system can continue to function well. The only leakage that is likely is that some countries may decide to sell gold reserves in the free-market in order to take advantage of the higher price there. The monetary system can easily adapt to such events. In fact such sales by central banks could, in turn, be undertaken as a concerted policy.

Realignment of Exchange Rates--Revaluation of other Currencies

Judgments on the arguments for and against this approach are closely related to the judgments about an increase in the official price of gold. The only way to achieve an exchange-rate realignment in the absence of an increase in the official price of gold is via a unilateral revaluation by a group of other countries.

Many of the arguments for and against an increase in the official price of gold are also arguments against and for revaluation of other currencies at an unchanged dollar price of gold. These arguments will not be repeated in this section.

There is one argument favoring revaluation of other countries' that is not brought out or implied in the analysis of the gold price issue. A major problem in any change of the exchange rate between the dollar and other currencies is to avoid generating expectations of further changes in the same direction. If the dollar is devalued, via an increase in the price of gold, and there is an expectation that further devaluations may be necessary, private and official entities can act to protect themselves by buying gold.

If on the other hand, other currencies are revalued and there is an expectation that further moves in this direction may be ahead, buying gold will not be an attractive hedge. Furthermore, there will be no certainty regarding which foreign currencies may be revalued in the future. Thus a revaluation of other currencies provides less scope for destabilizing future speculation than a move by the dollar against gold.

A major consideration in the minds of Europeans is that if they agree to revalue their currencies in order to reduce present imbalances in international payments, the United States will be able to relieve its balance of payments problem too easily. In their view, U.S. policy in the future would continue to ignore the balance of payments, since we would always be able to count on other countries to revalue.

While this view may be based in large part on a misconception regarding what motivates U.S. policy makers (as noted earlier), it is not easy to persuade Europeans that it is completely without foundation.

It seems likely that, at a minimum, the United States would have to make certain commitments to the rest of the world in return for an agreement by other major countries to revalue. These commitments would involve the future of the U.S. balance of payments and in particular the future rate of growth of official dollar holdings.

In this connection, however, it must be remembered that, even if the U.S. agreed to raise the price of gold, European countries would be determined to prevent a repetition of the U.S. payments imbalances of the past decade. Thus even if they did not extract commitments from us, they would probably act to impose balance of payments discipline on us by insisting much more than in the past on conversion of dollar accumulations into gold and other reserve assets.

Among the demands that Europeans might put to us as <u>quid pro quos</u> for revaluation of their currencies are the following:

1. A willingness by the United States to adapt the mix of its fiscal and monetary policies so as to avoid large monetary impacts on them (as happened in one direction in 1968-69 and in the other direction in 1970-71).

2. A willingness of the United States to restrict long-term capital outflows when necessary to prevent too large a deficit in our balance of payments.

3. A willingness to use, more actively than in the past, selective devices to try to regulate short-term capital inflows and outflows.

4. A willingness to reform the international monetary system in a way that changes the role of the dollar and its relation to gold so that, in the future, the United States could be expected to devalue the dollar if our balance of payments is in persistent deficit.

The extent to which the United States should be willing to accommodate to such demands is a matter for debate. But, as noted above, we may be forced in any event to greater efforts to control our balance of payments in the future.

Finally, it should be pointed out that the trump card in U.S. hands is the ability to suspend gold sales and purchases. Such a suspension could trigger a crisis or it could come after a crisis has begun. In either event, it leaves it up to other countries whether and how much to revalue in order to restore order and balance in international payments. Use of this trump card without accompanying concessions by the United States--concessions that would provide some assurance to other countries that there will not be a repetition of the developments that led to the crisis--would create strong resentments abroad and in turn would probably lead to various policy actions inimical to the United States. These actions could include:

1. A turning inward by the EEC in an effort to insulate itself and its satellites from the United States in trade and investment.

2. The erection by European countries of barriers to U.S. investment and capital flows generally. These measures could go well beyond the effects of existing U.S. restraints on capital outflows, which affect mainly the locus of financing of direct investment and bank lending. European restrictions could act directly on the real activities of U.S. corporations and banks in Europe.

3. Adoption of exchange controls in Europe combined with a dual rate of exchange--one for current transactions and one for capital transactions. This could lead the world back toward the restrictive climate of the 1930's.

It seems a safe conclusion that there is no simple way to restore order in the international monetary system. While the Europeans and the other major industrial countries may be to some degree irrational in their attitude toward the United States, we must realize that they regard themselves as being "in a boat with an elephant" and some of their demands for protection are justified. The great need is to design a policy for dealing with them that will preserve as much freedom in international transactions as is consistent with harmonious relations while avoiding either policies or market reactions that will hamper non-inflationary growth here and abroad.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 22, 1971

To Board of Governors

Subject:

From J. R. Coyne

The article below was transmitted on the Reuters News Service wire early this morning. It was provided to us by the Federal Reserve Bank of New York at our request.

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United States willing to hold up short-term interest rates, says Bundsbank head

Frankfurt, April 22--The United States is willing to hold up short-term interest rates at the higher level seen in recent weeks in the interests of international monetary cooperation, the President of the West German Federal Bank, Karl Klasen, said.

He told newsmen that United States Federal Reserve Board Chairman Arthur S. Burns told Central Bankers in Basle last week that the United States would attempt to hold up short-term rates even though it would probably find it easier or more desirable to allow them to decline for domestic economic reasons.

Klasen added that Burns showed "understanding" of the aims of international cooperation in the monetary field and that the United States monetary authorities are not indifferent to the problems of the United States balance of payments deficit.

prime rate not index of ~~[illegible]~~ [illegible]
only on business
loans &

May 4, 1971

TO: Chairman Burns

FROM: J. Dewey Daane

SUBJECT: Notes on Conversation with Emminger

~~CONFIDENTIAL~~

At Volcker's suggestion, and with your approval, I called Otmar Emminger, Deputy Governor of the Bundesbank, this morning to find out how they viewed the most recent developments. Emminger's comments ran as follows.

(1) Dollars had been piling up in the last few days because of a lot of rumors that the German authorities were going to take actions to stop or reduce such inflows. Into this explosive situation several reports had been introduced, the most important being that of the Five Institutes who advised that the only way the German government could stop the inflows and insure internal stability was to resort to a temporary float. As Emminger put it, this was "phrased in an unfortunate way, suggesting that it could only lead to an up valuation of the Deutschmark."

(2) The whole discussion, unfortunately, was now taking place in the public arena due to the fact that there had been leaks following the meeting in Hamburg a week ago of the Finance Ministers of the EEC countries. It was reported in the press that in an after dinner debate in a closed session of the Ministers chaired by Schiller, the latter had asked whether the EEC countries would be prepared to take part in joint action (a) under current circumstances and (b) in the exchange rate discussions in the Fund. When this had leaked, Schiller as the chairman of the conference confirmed to the press that this discussion had ended "in total disagreement." In turn, this set the whole rumor machinery into action since the market then concluded that, absent agreement among the six, the only possibility was unilateral action by the Germans. This market view was further reinforced at that point by a report by the Organization for the Protection of German Savers (representing all major banking and insurance companies), making an urgent appeal for a temporary float.

~~CONFIDENTIAL~~

(3) Emminger took note of the very large inflows both forward and spot, and particularly the inflows beginning yesterday and leading to today's inflows which he labelled "the largest for some time." He further noted that, to the best of his knowledge, Schiller had only made a "noncommittal" statement regarding their position; however, the front page of the London Financial Times had carried a full excerpt of the Institute's views and indicated that Schiller's preference was for a common position of the six.

(4) Emminger then said that, frankly, the political situation was an extremely difficult one. They had a full discussion of this with Pierre-Paul Schweitzer of the IMF last Friday night and Schweitzer had "all the inside knowledge of their tactical and political difficulties." The government and the Bundesbank currently were under tremendous pressure to do something to break the inflationary cycle. The most recent data indicated that the inflationary pressures were stronger then before and there was a general public call for immediate action to do something. There would be a meeting of the Bundesbank central bank Council tomorrow, but the Council members had divided views:

(a) some members were in favor of a temporary float leading up to a modest revaluation;

(b) others favored capital import controls despite the fact that they might not solve the problem and could undermine their restrictive domestic policy.

All of this was against the background of widespread talk of devaluation of the dollar which had been the major subject behind the scenes at the recent meeting of the International Chamber of Commerce, aggravated perhaps by a major speech there by Mr. Gaines, Senior Vice President of the Manufacturers Hanover Trust Company.

(5) I asked Emminger whether there was any way we could be helpful in the current atmosphere and he responded that the problem was entirely inside Germany and that they would have to sort it out themselves. He had made his

own preference clear, namely in favor of the temporary float to be followed by a modest revaluation. He then spoke to me as follows: "May I ask you on an intimate basis what your personal view would be if the decision was to move in the direction of the float and revaluation?" I responded that we did not have a consensus judgment on this point but in the spirit of his question I would say that looking at it only with my own personal eyes I could perhaps answer no depending on whether this were done in such a way as to avoid a protracted period of public discussion and uncertainty that could only aggravate the flows across the exchanges. Emminger concluded by saying he thought stopping the flows could only be helpful to the system and we should all try to do what we could.

May 4, 1971

STATEMENT IN RESPONSE TO PRESS INQUIRIES

Taking note of the large speculative movements of funds into Germany today, Secretary of the Treasury John B. Connally re-emphasized the view of the United States that no change in the present structure of exchange parities is necessary or anticipated. The United States will continue its established policy of cooperation with other countries in maintaining the stability of the international monetary system. As necessary, the United States is prepared to raise additional funds in the Eurodollar market and to assist with appropriate investment outlets for foreign central banks. In pursuing our policies of orderly, noninflationary expansion, the various tools of economic policy will be used in a flexible manner, with due regard for external as well as internal needs. Measures to improve the balance of payments will remain of high priority.

These measures are fully compatible with our objectives at home.

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May 4, 1971

INTERNATIONAL MONETARY SITUATION AND OPTIONS

Massive speculative flows into Germany and, to a lesser extent, into other Continental centers have recurred. This consequence is clearly related to policy discussions within the German Government -- much of it apparent to the press and other observers -- concerning a possible "float" of the German mark as a means of shutting off capital inflow and establishing a basis for a more restrictive domestic credit policy.

The German Government coalition feels politically vulnerable. Its recent fortunes in regional elections have been poor, and it is being vigorously attacked on grounds of inflation. It is desperately searching for remedies and seems to be seizing on exchange rate action as the most feasible course, having rejected new taxes, a stronger incomes policy, and capital controls as practicable options. There is a serious question, with speculative forces active, whether this momentum can be turned.

This approach, on a coordinated basis with other EC countries, was broached and rejected at a meeting of EC finance ministers last week. The proposed German action will be a serious divisive force in the EC (although it could eventually force unity at a more rapid pace). Unilateral German action will release extremely heavy pressures on other currencies (e.g., the Dutch, Belgians, Swiss, and Japanese). These currencies and others will probably be forced to float. They will be in a position to -- but may not -- force a confrontation with the United States on our policy of converting dollars into gold.

In this situation, we have three options:

(1) To try to head off any exchange rate changes. This will require an immediate direct appeal to the Germans on the basis that it is in the best interests of the international monetary system. We will have to be prepared to provide:

1. Higher rate, longer term dollar denominated issues in which to invest a portion of their reserves.

This presents no great problem.

2. Foreign currency denominated bonds, to protect Germany against a dollar devaluation or float. This presents larger problems, primarily because it would be widely generalized and presents financial risks.

3. Reassurance on monetary and fiscal policy (e.g., any further stimulation by fiscal rather than monetary policy, resistance to any short-term rate declines).

4. More U. S. borrowings, in dollars, in the Euro-dollar market to sop up dollars flowing into their reserves.

5. More generally, reassurance that our own balance of payments is a matter of high policy attention.

Whether such an approach could be successful must be considered doubtful at this stage. On the other hand, it is not clear there is much to lose.

(2) A relatively passive position, limited to attempting to guide responses away from the more destructive alternatives toward the constructive.

(3) Suspension of U. S. dollar convertibility into gold, followed by a general regime of floating exchange rates. Negotiations could be promptly undertaken to re-establish the rules of a new monetary order, including the role of gold and limited flexibility of exchange rates.

GERALD R. FORD LIBRARY

This form marks the file location of item number 2 as listed on the pink form (GSA Form 7122, Withdrawal Sheet) at the front of the folder.

STRICTLY CONFIDENTIAL (FR)

To: Chairman Burns

From: R. Bradshaw and R.W. Smith

Subject: Foreign exchange markets--noon conditions.

Conditions are essentially unchanged from those reported earlier in the day.

No further official statements by German or other central bank officials.

Mark and Swiss franc somewhat firmer (1.4% and 2.7% above upper limit, respectively). Dutch guilder somewhat easier.

Italian officials indicated that there will be consultations among the EEC countries and Switzerland; no time or place yet determined.

FRBNY officer said that the Bundesbank official he spoke with expects the mark to be floated for the time being (e.g., beyond this weekend).

(See attached for exchange rates.)

Attachment.

RB:nss

11:55 A.M.

FR 9.A (Rev. 3/70)

WED.

STRICTLY CONFIDENTIAL (FR)

Notes from 9:30 Call

Date: 5/5/71

EURO DOLLAR BID RATES:

O/N	Call	1	3	6	12

GOLD: London: 1st fixing 39.66 2nd fixing 40.10

intervention amounts	RATES:	old upper limits ~~Europe (spot)~~	New York (sp)	spot premium over old upper limits ~~New York (fwd)~~
>50	Sterling	242.00	241.97	
	Can.$	—	99.25	
+1040	DM	27.548	27.925	+1.4 %
+600	SF	23.283	23.90 bid	+2.7
+250	Guilder	27.836	27.95	+0.4
+120	FF	18.141	18.140	
+2	Lira	quiet .16120	.16098	
+100	BF	2.0151	2.0200	+0.2

ARBITRAGE: ________ points in favor of ________ over ________.

COMMENTS:

German cabinet meeting Friday.

from Italians – there will be consultation among EEC countries & Switzerland

no big meetings announced, however,

one B.B. official ~~thought~~ Germans would float

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date May 5, 1971

To Chairman Burns

From Ralph Smith & Paul Kelty

Subject: 2:00-2:15 Report on Foreign Exchange and Domestic Securities Markets

Foreign Exchange Markets

As of 2:00 P.M., there was no change in foreign exchange rates from those given in the previous reports.

The National Bank of Belgium has requested the System to draw $65 million on the swap line. This will bring outstandings to $500 million -- the full amount of the facility.

Domestic Securities Markets

Short- and intermediate-term Treasury securities have weakened further. Issues due within 10-years are now 1 to 13/32 lower. Long-term bonds continue to show gains. The when-issued 15-month note is now quoted at 99.31--100.02. The new 3-1/2-year note is quoted 99.18--.20. In both cases the notes are bid 1/32 below issue price.

Treasury investment accounts have now purchased $230 million of Government securities, including $20 million of bills.

Other Market Quotations

Federal funds	4-7/8 per cent trading
3-mo. Treasury bill	3.92--3.84 per cent
Stocks (DJ industrials)	down 2.39

DRAFT 4   5/6/71

Secretary of the Treasury John B. Connally, after meeting with the President, said that the Administration was carefully following the speculative exchange market crisis in Europe. No immediate action by the U. S. is necessary or planned, but the United States remains prepared to cooperate fully with others to assist in stabilizing the situation. The Secretary emphasized the United States contemplates no change in its own gold and foreign exchange policies.

Secretary Connally again expressed the view of the United States that maintenance of current parities would provide a basis for reopening the markets in various European centers. The Treasury is prepared to assist those few central banks receiving large amounts of dollars in recent weeks in the orderly investment of a portion of these funds, through special Treasury securities.

The Secretary pointed out that consistent with orderly economic expansion, the U. S. was now making visibly more progress against inflation than its major trading partners overseas. This is the fundamental basis for continued confidence in the dollar at home and abroad.

Monetary authorities of other countries are aware of these views in reaching their decisions with respect to exchange rates and other policies.

Conversation with Dr. Klasen -- May 5, 1971

Germany had to close foreign exchanges. Inflow was so big in the first 15 minutes; over a billion dollars came in during this period.

The critical question is what to do. Schiller favors a "small floating." The majority in the government favor a line that would not permit business to take up loans outside Germany.

Statement by Connally was clear and very significant to the Bank. It was not so clear to other government officials. If we are worried about the trend of events in Germany we should inform Schiller and clarify our position or perhaps we should speak with the Chancellor. Klasen is very much opposed to the floating rate. If we too are not in favor of a floating rate, we should inform German officials promptly. The government must decide the day after tomorrow.

In answer to my question as to what the German government is most likely to do, Klasen replied: "Float the mark, keep the premium from exceeding 5%." As to the duration of the float, it might be six months.

Conversation with Sir Leslie O'Brien - May 5, 1971

Bank took in 65 million dollars. Money market has been quiet. Price of gold reached $40.10.

The U.K. is not a candidate for a revaluation of its currency.

In view of the outflow of dollars, something had to be done. The most likely outcome for the immediate future is a floating rate of the mark and some other currencies. The French and Italians will not go along and this will put great strain on the Common Market.

Conversation with President Wormser - May 6, 1971

The Bank of France did not intervene at all today in the exchange market -- it neither bought nor sold dollars. There was only a slight fluctuation in the value of the dollar. Yesterday the book took in $120 million.

Interest rates not very well below the Euro-Dollar market; this is deliberate, to avoid inflow of dollars.

Price of gold slightly lower than yesterday. This is unlike the London market.

Talked to Germans yesterday at a memorial meeting for Blessing. The Germans are very hesitant. Most of them seem to feel that there is no economic or monetary reason to revalue the mark, but they want to permit the mark to float temporarily within margins. Some others feel that control of German firms would be preferable.

At a meeting of experts at Brussels, controls were advised.

What are the prospects? If the Germans revalue, the Swiss will follow. Maybe Belgium and the Netherlands as well. France will definitely not float.

Conversation with Sir Leslie O'Brien - May 6, 1971

Markets had a quiet day. Bank took in no spot dollars. Gold reached $40.30 in a thin market. Dollar weakened until lunch-time then strengthened. The 3 month Euro-Dollar rate reached 8%, then moved back to 7 1/4%.

Converaation with Dr. Zijlstra - May 6, 1971

At this moment markets are closed. Important question is what will happen on Monday. We must wait until the Ministerial Council on the European Community meets on Saturday morning. The Germans have agreed to postpone their decision until after this meeting.

Thinks that the Germans will float the mark. Does not know whether there will be any restriction onthe degree of the float.

European Community is opposed to floating. At least two countries, France and Italy, will not follow Germany. Disruption of theCommunity may be the result.

Does not know what the Netherlands or Belgium will do. But if the Germans and the Swiss revalue, Netherlands will probably be forced to do the same. Belgium is likely to follow the Netherlands.

Mr. Gill, Bank of England - May 6, 1971

He called in response to my inquiry of O'Brien as to whether Wormser and Klasen would go to Basle. Both intend to go but they may be subject to call by their Finance Ministers. They would certainly hope to be there Sunday anyhow. But there could be no absolute assurance.

Telephone Call from Dr. Karl Klasen, President, Bundesbank - 5/10/71

I wanted to inform you of my personal feelings. We have accepted on the Common Market Community that we have only the permission to float for a short certain time. We are obliged to return back to the old parity that that is very much ___________. That is a definite understanding and our government has taken the responsibility to fulfill this obligation and all the other members are very much interested. It is quite natural that this way will not be very easy because in the meantime the Swiss and the Austrians have re-valued. But I think these countries are not so important that they can prevent us.

Today I had a visit from the Governor of the Bank of Japan. He said that Japan has not the slightest intention of changing its rate. Therefore, I think it is no reason for us to change our parity. I think we will have a floating rate during 3 months, 4 or 5 months and during this time we have to work with the United States to find all the arrangements to stop the money inflow to us as you proposed it.

In the meantime, the Governors of the Central Banks of the Common Market have to organize the new system to prevent a big inflow of speculative money. I think it was good for you to be informed because in the public it is not so clear that we are obliged to go back to our parity.

It is not very easy to do this but we are obligated -- we are partners and cannot get a new parity without consent.

Dr. Burns asked if they were placing any limit?

Dr. Klasen said it would not go more than 5% -- this is not being made public. Then he said something about 3.525. . . . . . less than the normal rate -- would amount to a little more than a revaluation of 4%. It is not so much we cannot go back. We have not the intention in the next days to set our dollars to a lower rate than 3.63 because we think all the people who have speculative engagements will be in need of dollars -- therefore we have intention of not to sell. It would be very good if at this time you could also keep as much dollars back as possible. It would be good that speculators get nervous.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

May 6, 1971 - 71/54

NOTE: The following aide memoire by the Managing Director will be discussed at an Informal Session to be held at 11.00 a.m., Friday, May 7.

Aide Memoire

In my statement to the Board yesterday I tried to outline some general principles to guide us in finding a way out of the present grave difficulties of the world exchange rate system. The principles I mentioned in that connection were:

(1) Primary emphasis on the preservation of the par value system;

(2) Recognition of the possibility that some additional flexibility may be required with respect to margins, at least until the present uncertainties have been dissipated.

Concrete solutions for these difficulties are, of course, being discussed in many places at this moment, both within governments and internationally. The Fund will contribute all it can towards a solution that should at least be tolerable for the short-run, as well as being constructive for the longer-run.

Any solution that will at the same time preserve the essential features of the par value system and provide sufficient flexibility for the difficulties and uncertainties of the moment, will obviously have to be a compromise solution. It will have to be made in the light of all available evidence. The specific suggestions that I am putting forward now should, therefore, clearly be understood as tentative. They represent my best estimate at this moment of what would both meet the needs of the situation and preserve the essential features of the system.

I would judge that the chance of any new parities being introduced between now and Monday is not high, although as I said yesterday I would in no way be against this. If my guess on this is right this would mean that markets would be reopened, at least nominally, on the basis of existing parities. It would probably be unrealistic to expect that this could be done within the 1 per cent margins. Many people have drawn the conclusion from this that the alternative would be for a large number of currencies to float. To my mind a preferable solution--from the point of view of the preservation of the system--would be the avoidance of floating rates, finding the flexibility needed by widening the margins even if this widening might have to be rather substantial for a short period. I would not, in present circumstances, preclude upward margins of 5 per cent or 6 per cent from par in relation to the dollar. Perhaps the downward margin of 1 per cent could be maintained as a useful reminder of the permanent margins in the system, given the fact that flexibility in that direction does not seem to required now.

- over -

Any arrangements of this nature should have a clear time limit of a few months at most. This should give enough time to test what, if any, parity changes were needed. At the end of the short period one might either envisage returning to the 1 per cent margins (on existing or new parities) or maintaining for a substantially longer period margins of say 2 per cent or 3 per cent, and then presumably on both sides of par.

If this were approximately the regime one aimed for--and it might of course be further refined--there are, as I mentioned yesterday, two ways in which it could be approached under the Articles.

First, under Article XVI the Fund can suspend the margin provisions and at the same time set as a condition that members that do not observe the 1 per cent margins would be required to observe specified wider margins. This regime, which takes unanimity on the part of Directors for its introduction, can be continued for a period of up to 1 year.

Alternatively, the Fund could call on members to collaborate, under the provisions of Article IV, Section 4(a), to observe the same specified wider margins in those cases where they felt unable to observe the 1 per cent margins.

Whatever arrangements might be adopted should include provision for close consultation with the Fund on all their aspects, including intervention policies.

I have limited my observations in this memorandum to the exchange rate aspects of the present situation, and have not dealt again with the broader issues mentioned in paragraphs 3 and 4 of my statement of yesterday.

FOR IMMEDIATE RELEASE   MAY 6, 1971

OFFICE OF THE WHITE HOUSE PRESS SECRETARY

THE WHITE HOUSE

PRESS CONFERENCE

OF

HON. JOHN B. CONNALLY, JR.
SECRETARY OF THE TREASURY

International remarks begin on page 7

12:30 P.M. EDT

MR. ZIEGLER: President Nixon has just completed a meeting with Secretary Connally. The Secretary is here this morning to make an announcement and also to take your questions on the subject, if you would like.

Mr. Secretary.

SECRETARY CONNALLY: Thank you, Ron.

With the President's obvious priority and explicit approval, I am here today to announce that the President is going to send to Congress a request for legislation to enable the Government to provide $250 million in loan guarantees for the Lockheed Aircraft Corporation.

This is a matter that we have had under review, as you know, for some time, since Rolls Royce went into receivership. We have looked at it very carefully and looked at it in terms of the impact on this economy, the number of people that are employed. We have considered the ripple effect that, frankly, the bankruptcy of Lockheed would have. And in my judgment, after studying this situation, that is precisely what would happen if the Government does not provide a guarantee.

I think there are certain essential facts that I should make to you. The first is that the L-1011 with a Rolls Royce engine is going to be a very excellent airplane; that the RB-211 by Rolls Royce will probably be the most advanced engine of its type produced in the world.

Secondly, I feel it is important to point out that far from bailing out Rolls Royce or the British Government, so to speak, the British are going to put in approximately $288 million of additional monies in order to provide the necessary funds for the research and development that still needs to be done on the engine.

In addition to that, they anticipate that they will suffer some losses in the full production of the engines themselves when they get into the production runs.

From strictly the domestic standpoint we should point out that there is presently invested by different parties in this country approximately $1.4 billion in the L-1011 program; $400 million of that by various banks throughout the country; about $350 million of that by Lockheed suppliers; a lot of it, obviously, by the shareholders of Lockheed itself. There is $240 million of that figure that has been advanced in progress payments by the airlines themselves.

MORE

I think there are other significant factors that lead to the conclusion that the President has reached to seek this type of authorization from the Congress, and that is simply that Lockheed is not only a very important airframe manufacturer in this country, it is the nation's largest defense contractor. It has, overall in its corporation work, 35,000 subcontracting companies -- not people, but companies -- throughout the country. Seventy percent of those, or 25,000 of them, fall in the category of small businesses with less than 500 employees each.

The impact on this economy in the event of the bankruptcy of Lockheed would be enormous in my judgment.

In February when the L-1011 program was still going, there were over 17,000 people employed by Lockheed in this one program alone, the L-1011 program; approximately 7,000 of them have already been released. There are over 10,000 presently employed by Lockheed. There is an additional 14,000 employed by their principal suppliers solely dedicated to this particular project, the L-1011 So that the economic impact in terms of jobs, of employment, would be enormous and is enormous.

There is, of course, the additional factor that in the event Lockheed should not survive, the Treasury, frankly, would be affected. This $1.4 billion will be written off as best it can be by the various entities involved. I would not now today want to put a dollar figure on the losses to the Treasury in terms of revenues, but it would be very, very substantial, beyond any question, when you consider not only the write off of the $1.4 billion invested but also the loss of salaries and revenues. The salaries that Lockheed pays to its present employees or to the 17,000 employees under L-1011 program alone was $5 million a week -- just that one payroll for their own employees not counting their subcontractors.

So all things considered -- and we have, as I said, looked at it over a period of weeks in as great a depth as we possibly could, after talking with all of the parties involved, the airlines, banks, Lockheed and others, every agency of the Government, almost, who has some expertise in this field -- I did recommend to the President that this course be followed. He has made that decision and we are now announcing it today.

Q What Committees are you going to ask to act on this, and what chances do you think you are going to have up there?

SECRETARY CONNALLY: I think the chances are quite good. I would anticipate in the given nature of the bill and the legislation that it will undoubtedly go to the Banking and Currency Committees in the House and Senate.

Q Have you taken soundings in Congress, and what have you found?

SECRETARY CONNALLY: To some extent we have taken soundings, yes, and I might say I have been very encouraged.

MORE

Q About the $288 million British contribution to the Rolls Royce engine, is that contingent on the $250 million legislation being passed?

SECRETARY CONNALLY: I would say it is contingent upon their belief in the survivability of Lockheed.

Q No more directly than that?

SECRETARY CONNALLY: Well, I am not sure I can answer for them, but I think their position is that they don't believe Lockheed can survive without the $250 million loan guarantee. That is my position. I don't believe they can survive and I will be perfectly candid about it.

Q What terms are you putting on the loan, repayment, et cetera?

SECRETARY CONNALLY: The bill is not finally drafted. Hopefully it will go forward about Tuesday of next week, I hope.

Q Would you object to Congress broadening this to include any aerospace company?

SECRETARY CONNALLY: That will be a matter for Congress to decide. At this moment we are limiting the request to an amount that would only be sufficient to cover Lockheed.

Q Mr. Secretary, some people in Congress have expressed concern that by helping Lockheed now you are setting a precedent for helping every big company that might get into trouble.

SECRETARY CONNALLY: I think that will be raised. I don't assume that this will be a precedent. I don't think it should be viewed as a precedent. I think perhaps in more normal times the answer might have been even different in this particular case, but at a time when we are coming out of a slack economy period, at a time when we have a rate of six percent unemployment in this country, and at a time we are seeking economic expansion and vitality, we feel that the impact that the demise of this company would have would be of such proportions that it ought not to be permitted in the interest of the economic revival of this nation.

Q Mr. Secretary, whether or not it should be viewed as a precedent, is it in fact a precedent? Has the Government done this before?

SECRETARY CONNALLY: Sure the Government has done it before. They do it almost every day. They did it in the days of RFC, in defense contracts now, in 1967 a $75 million V loan was made available to Douglas Aircraft prior to its merger with McDonnell. We do it through export-import loans, through the FDIC, we guarantee bank deposits and savings and loan deposits. We are now guaranteeing investment in the market. We guarantee a lot of things.

MORE

Q Mr. Secretary, why is this loan necessary? What is wrong with Government policy that lead to Lockheed's trouble?

SECRETARY CONNALLY: I didn't understand your question.

Q Why do they need the money?

SECRETARY CONNALLY: To keep from going broke. (Laughter.)

Q Why are they in danger of going broke? Is it the C5A?

SECRETARY CONNALLY: Part of it stems from two things: First, there is not any question but as a result of the C5A, the Cheyenne, SRAM, and the shipbuilding program which they took on here several years ago, the Defense Department, obviously has as late as I believe January of this year in effect made the Lockheed Corporation eat about $500 million in losses. Even though there is no question about that they had the costs and there is no question but what under prior times perhaps through change orders or one thing or another they might have not had to suffer this much of a corporate loss. Nevertheless they did agree to these losses.

They did so because they were under pressure to get on with their business and they were totally unaware that anything such as the Rolls Royce debacle would occur and within 48 hours after they made their agreements with the Defense Department to absorb approximately $500 million in losses on these various programs, Rolls Royce collapsed. They had no knowledge of it, they had no control of it, and it put them in such a bind that, frankly, they cannot now extricate themselves without some help.

Q Has the British Government, in your view, done all it can in this situation? Would you welcome a BEA order for this plane?

SECRETARY CONNALLY: I would certainly hope that Lockheed might get a BEA order. To answer your question, I would not say that I would want to issue a proclamation that Rolls Royce and the British Government were Simon pure with respect to this but, nevertheless, I think they have performed admirably under the circumstances. They have recognized a liability. There was not a Government liability. Rolls Royce was not a Government-owned company. The Government, to their credit, has undertaken to fulfill the commitment to produce these engines and has agreed to put up, as I have already said, hundreds of millions of dollars to assure the production of these engines.

MORE

Now in the process they have insisted that the price of the engines be increased and they have insisted on some other things which differ from the original contract that Rolls Royce made with Lockheed. So in the re-negotiation they have put greater pressure on Lockheed and on Lockheed's purchasers and customers than was true under the old deal. But I think in balance you would have to say the British Government has performed admirably well under the circumstances.

Q Why do the banks require a Federal guarantee before putting up $250 million?

SECRETARY CONNALLY: Simply because the banks now have $400 million in it. They had $350 million. They were told by me, in addition to others, that they were going to have to put additional money into the project to be sure that Lockheed did survive during the time that these decisions were being made and during the time that Congress had to act. So they have $400 million in it. This is not going to be guaranteed in any sense. The guarantee applies only to the additional $250 million which will be advanced and has no relationship and no bearing to the existing indebtedness.

Q How much of a collateral do they get for that additional $50 million, sir?

SECRETARY CONNALLY: I don't know. You will have to ask either the banks or Lockheed. I can't answer that.

Q What collateral does the Government get?

SECRETARY CONNALLY: We will have the collateral first in many forms. I believe we are going to be able to save one of the large contractors in this country. We are going to be able to ensure the continuity of jobs and a rehiring of a great many people to carry forward this project. We will have the collateral of the continuity of an additional airframe manufacturer in this country and the competition that that provides. We are going to have the collateral of the conservation and utilization of the technological talent that is a part of Lockheed's operation. We are going to have the additional collateral of getting our money out first before anybody else does, and in my judgment we don't run any risk in connection with this. I think we will have all of our money back before anybody else gets anything.

Q Do you think the $250 million loan will be paid before?

SECRETARY CONNALLY: That is part of the bill. Our money will be out first.

Q The President indicated in San Clemente that if we go along with this program that it might be necessary to change management at Lockheed. Mismanagement at Lockheed, of course, has been a big problem here. Do you have any plans for this?

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SECRETARY CONNALLY: I don't want to pass judgment on the management of Lockheed at this point, other than to say that the management of Lockheed, so far as I know, is infinitely more interested in Lockheed and its performance than it is in the preservation of their own jobs. If that is a factor, I don't think it will be a problem.

Q Have you rejected an American solution to the problem?

SECRETARY CONNALLY: I don't think there is an American solution to the problem, if I understand what you are getting at. I don't know that there is an American solution. Specifically, what do you refer to?

Q The General Electric proposals that have been reported in the press.

SECRETARY CONNALLY: Well, I don't think it is a solution for a number of reasons. First, and I am not an aeronautical engineer but everybody knows that every successful airplane that was ever built has been designed around the specific engine, and the L-1011 has been no exception; it has been designed around the Rolls Royce engine. To use the GE engine would require a redesign of the airframe itself that would add on enormous cost. So far as we have been able to tell, the engines to the customer would be much more expensive than is true of the RB-211 engines, even under the re-negotiated price.

In addition to that, you have the time factor. In addition to that, you have a question to whether or not the L-1011, as altered and changed with all of the attendant difficulties that occur, whether or not it can compete with the DC-10 in the time-frame that we are talking about.

In addition to that, the customers would be unimpressed, I think, by a completely new airplane and a completely new engine and a completely new design, as opposed to the existing situation, because, very frankly, they have some favorable financing arrangements with respect to the RB-211 engines with the British. And, more than that, they have an investment tax credit with respect to this particular airplane built around this particular engine.

Q There are reports that a number of airlines are still unhappy with this program, even given the fact that you are now attempting to get a Government guarantee on this program. Are you confident that the airlines will now go along with this package, particularly Delta and Air Canada?

SECRETARY CONNALLY: The airlines will have to speak for themselves. If they are unhappy, I don't know why they should be. If this program proceeds as I think it will they are going to have the assurances of the British Government that the engines will be produced and they are going to have the assurances of the Congress of the United States that $250 million additional money will be made available to Lockheed so they can survive and produce the planes. And very few outfits that I know of in this country, regardless of what you buy, has the assurances of two Governments that they are going to get a product.

Q Aren't you putting yourself in a position of supporting Lockheed over the Douglas plane?

SECRETARY CONNALLY: No, that has nothing to do with it.

Q They are in very bitter competition in this.

SECRETARY CONNALLY: It has nothing to do with it. If it was purely a matter of a toss of the coin as to whether or not it was the Douglas DC-10 -- they make a great product. I am sure it is a great airplane. It is a well run company. Jim McDonnell, I think, is one of the outstanding industrial leaders of this nation. I have no argument about the DC-10. I am trying to point out some of the things that are affected.

But primarily the President's decision was based on the impact that this is going to have on the economic recovery of this country and the maintenance of jobs. We are spending billions of dollars to try to provide training and re-training, manpower training, in this country. We are trying to build jobs. You have bill after bill being introduced in Congress almost daily with respect to creation of public service jobs.

Here we have jobs. We have jobs of a highly technical nature. And, all things considered, which I don't want to repeat, the President felt that it was in the best interest of this nation and it was on that basis and that basis alone that he made this decision.

Q When Penn Central went bust a year ago they didn't lay off everybody in sight and most people think that if Lockheed went through a Chapter 10, why you would maintain the SAMS works, the "Spook" works, and Marietta and everything else.

SECRETARY CONNALLY: Beyond any question, the military projects would be carried on. Anyone who assumes that a company of this character can go through bankruptcy and maintain the degree of efficiency and economy and that you will come out with the same costs, frankly, has not had any familiarity with bankrupt companies.

Q May I change the subject to the dollar in European markets? How deeply concerned are you about that?

SECRETARY CONNALLY: We are concerned about it, obviously. I have issued a statement which you have seen. I have nothing basically new to add to that.

Any time you have a closing of the central banks in Europe, as we have had the last few days, of course, we are concerned. We are studying it. We are watching it every hour of the day. We regret that the circumstances have occurred. We think much of it certainly cannot be attributed to any actions of the United States, nor to even the weakness of the dollar. I think it would be a mistake to assume that.

We have problems. We obviously have problems in the balance of payments. Our basic balances have been off approximately $2-1/2 to $3 billion a year for several years. This concerns our friends around the world. Germany, however, has very, very difficult problems of their own. They are trying to fight a high rate of inflation at home and at the same time conduct their affairs to where they can protect their overseas markets and their exports, and this is a difficult thing to do.

So this all started with a short-term outflow of capital into Germany because of the disparity of rates that existed here and what prevailed there. But this Administration, rightfully, was not willing to in any sense completely sacrifice the stability and the recovery of our own economy in order to just try to narrow the gap between the rates prevailing here and prevailing over there; just as they are making decisions, I think, that tends to solve their problems without sole regard to other people.

I don't think there is any question but what these kind of problems are going to continue. We have tried to make clear to everyone, and will continue to do so, that we are going to be as cooperative as we know how to be. We don't like to see speculators in the market and that is what it has been in the last few days. There is no question about it, speculators were in the market.

Q Mr. Secretary, would you be distressed if a number of European currencies were to rise against the dollar as has been discussed?

SECRETARY CONNALLY: That is a matter for them to decide as to whether or not they want to revalue. We are going to try to make it abundantly clear in every way that we can that we recognize what we do here has an impact on countries around the world. We are going to try to make it clear that we are going to be cooperative and as helpful in every way that we possibly can. This includes issuing special issues in order to sop up Euro-dollars, if necessary.

We are going to make it abundantly clear that we are going to try to conduct our affairs here in such a way that the stability of the international currency will be obtained.

The problem always comes in this sense: We think we are making more progress against inflation in this country than they are making over there. But the cycles don't always occur at the same time and in the same way.

Q On the question of inflation, you had the Wholesale Price Index go up. There has been an increase in the price of steel. How do you assess these in your fight on inflation?

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SECRETARY CONNALLY: I assess them in two entirely different ways, of course. I hated to see the Wholesale Price Index go up, but I don't think we ought to pay too much attention to it. It is one of the things that you see. There are going to be other things, I think, that reflect even more favorable news than that. If you will look at the average, though, the Wholesale Price Index is about the average of the first quarter of this year. It is above what it was in March, yes. I wish it had not been, but it was and we are going to see some other things probably jump up and down because you don't have that type of a managed economy.

But on the whole I am very pleased. Retail sales are up, housing starts in March were up, as you well know. The Consumer Price Index has held extremely well. The rate of inflation has decreased, I think, to a very significant degree. So I just don't think we ought to pay that much attention to that one single factor.

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Q Now, the steel thing.

SECRETARY CONNALLY: I have a different reaction to it. I am disappointed that U. S. Steel found it necessary to raise the price on some of their products. This was, I must say in fairness to them, in keeping with a previously announced policy that on the anniversary date of last year that they were going to have to raise prices on some of their commodities.

But the thing that we have to keep in mind, the thing that management and labor, steel and the labor unions that work in those steel mills have to keep in mind, is whether or not by pricing and by labor demands and by wages they are pricing themselves out of the world markets.

This Nation is a free-trading nation and we want to remain so; and we are going to remain so. But it is significant to me, as the President said to you in San Clemente last weekend, that 20 years ago the United States had precisely 47 percent of the steel production of the world and today we have 20 percent, and it is estimated that Japan is going to pass us in the next two years.

It is fine to talk about increased prices and increased wages, but the thing that everybody in this country has to understand -- it doesn't only apply to steel -- but management and labor is going to have to understand that what they are dealing with is not their own personal problems of the moment, but they are dealing with the standard of living in this Nation and the basic security of this Nation from the standpoint of being able to compete in world markets.

One of the biggest users of steel, as you well know, is automobiles. It is significant to me that 18 percent of all the automobiles sold in America last month were imported. I think there is going to be greater pressure from imported automobiles. We are going to have to be competitive.

It is not just steel. I am not singling out steel at all. But it is a very basic and vital industry and this Nation, at almost any cost, has to maintain a very strong and viable steel industry. It applies to a great many commodities in this country as well.

Q What can you do beyond public statements such as this one to try and get industries such as steel not to raise prices and come forth with wage settlements you would consider reasonable?

SECRETARY CONNALLY: Basically, as you well know, I don't know of but two ways to do it. One is to try to continue to be as responsive as we can so far as the Government is concerned. I think the Government has done that. The Government has tried to keep its expenditures within full employment revenue levels and we have tried to maintain that type of stability. We are trying to ask management and labor throughout the country to do the same in their own self interest.

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The only other thing, other than a continuing program of asking, of seeking, of educating, is to impose mandatory wage and price controls, which, in my judgment, are not justified and in my judgment the President will not do at the present time.

Q Getting back for a second to the international thing, you seemed to be saying a minute ago that the Government does not plan to apply any further brakes to the economy, either to straighten out this interest rate disparity with Europe or to cool inflation.

SECRETARY CONNALLY: Don't put words in my mouth. I didn't say that. I said that this Nation was continuing its fight against inflation and we are making more progress than almost any industrialized country in the world that I know anything about. And we are going to continue to do it.

I said that we are going to have an expansion in this country that is going to, in my judgment, improve our balance of payments, our trade balances in particular. We are going to have an expansion that will permit us to reduce unemployment to a significant degree the latter part of this year and next year. We are going to do it at the same time that we continue the unrelenting pressure on the rate of inflation in this Nation We already have a rate of inflation that is less than most of the countries involved.

Q Mr. Secretary, are you saying that you and the Treasury and Government would not adamantly resist the upward valuation of the mark and other European currencies?

SECRETARY CONNALLY: I am saying that a large part of this is not our decision. This is a matter for other sovereign nations to decide. We are not dictators of the international monetary system. We are saying to all of them that we think that it is in the interest of everyone that the parities be maintained. We are saying that we want to cooperate and we want to help in every way that we can to relieve the pressure that exists at this time which we know results largely from the short-term flow of capital. We are saying that we are going to continue to work to bring about these ends.

Now, so far as us trying to dictate to other nations what they are going to do, we are not going to do it.

Q Mr. Secretary, do you plan any specific action to deal with the current crisis of the dollar?

SECRETARY CONNALLY: Well, that is a difficult question to answer. I don't have any plan at the moment that I want to talk about. I simply want to say to you that we are watching the situation. We think it will stabilize. We hope it will. We hope that the parity will be maintained. But we plan to do whatever is necessary, I think, to try to quiet the situation, to try to insure the stability that we think is so necessary in the international monetary field.

Q Can you tell us what things might be necessary?

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SECRETARY CONNALLY: No, because I don't want to anticipate now that things are in such a grave condition that any action is required at the moment.

Q You mentioned something about international securities. Is that what you had in mind?

SECRETARY CONNALLY: Yes, that was precisely what I had in mind, plus, we can borrow directly or we can issue special securities and so forth. It could be a number of things that are traditional in the monetary field.

Q On Lockheed, aren't you tampering with sort of a basic part of the free enterprise system; if you can't cut it you go broke?

SECRETARY CONNALLY: Yes, you sure are. I don't like to do it. The President doesn't like to do it. I don't think we are tampering with it. I think we are injecting a Government guarantee into what has been in this particular company a free enterprise operation, but we do that. It is not without precedent. It is not a course of action that we just relish, that we want to take. We don't want to get involved in their business. We have tried to stay out of it as much as we can, but we think that the price that would be paid by this nation for the failure of this company would be of such proportions that we are entirely justified in taking the action which the President has decided on.

THE PRESS: Thank you, Mr.Secretary.

END (AT 1:00 P.M. EDT)