BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

STRICTLY CONFIDENTIAL (FR) April 9, 1963.

TO: Federal Open Market Committee

FROM: Ralph A. Young

SUBJECT: Additional staff paper.

At the Committee meeting of March 26, 1963, Mr. Mitchell requested the staff to prepare a memorandum on possible effects on the dollar of any sterling devaluation.

I enclose a speculative essay on that subject, prepared by Mr. Samuel I. Katz, Associate Adviser, Division of International Finance, Board of Governors. As in the case of the memoranda dealing with effects of possible changes in monetary policy, two copies are being distributed to each Reserve Bank President, one for his own use and one for the use of his chief economist.

Ralph A. Young

Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure.

STRICTLY CONFIDENTIAL (FR) April 8, 1963

POSSIBLE EFFECTS ON THE DOLLAR OF ANY STERLING DEVALUATION

(A speculative appraisal prepared for the FOMC by special request)

I. This paper attempts to analyze the possible effects of an assumed devaluation of the pound sterling--say of 5 to 10 per cent--upon the U.S. dollar.

1. From this analysis, it is concluded that these effects would be:

a. Immediately, to produce an expectation of a general realignment of exchange rates, and in consequence a massive private capital flow--certainly away from the dollar and probably into either sterling or European currencies, depending upon alternatives discussed below.

b. Beyond the immediate impact, to worsen the position of the U.S. dollar partly because of the adverse impact on the U.S. competitive position on trade account but mainly because of adverse flows of capital growing largely out of the confidence impact of the devaluation.

c. In the long-run, to affect the main components of the U.S. balance of payments; but these effects would only become apparent over such a long time (not in a few months) that they would be intermingled with other changes in the international payments picture (such as longer-term movements of prices and costs in this country and Europe). For this reason, this aspect of the problem will not be considered in this exercise.

2. From the point of view of U.S. financial policies, it is considered reasonable to conclude that existing international cooperative facilities presently available would be adequate to enable this country to ride out the immediate impact of the devaluation.

3. Even though the United States would continue to have pretty much the same policy alternatives as now exist, the adverse effects of the British action would make much more urgent the need for dramatic action to demonstrate a determination to bring the protracted U.S. payments deficit to an end.

II. The immediate response of private traders, bankers and investors would be to shift their assets from the "weak" dollar into currencies considered to be "safe havens" at the time of the devaluation.

1. The desire to benefit from any revaluation of a European surplus currency in terms of the dollar would prompt these private capital flows.

2. If the devaluation was substantially larger than the exchange market considerable "reasonable," it might well be considered an attempt to gain a competitive advantage from exchange rate depreciation and would, therefore, make all major currencies suspect. In this case, significant flows would probably be set off even from the "safe-haven" currencies into gold or into inflation-hedged assets, and the bidding for ownership of these assets might become intense indeed.

3. From the U.S. point of view, even a "reasonable" devaluation might immediately cause foreign-held dollar balances to be shifted into the hands of European central banks, probably on a scale much greater than the disorderly flows which occurred mainly against sterling but also against the dollar after the German and Dutch revaluations in March 1961.

   a. Financial resources in private hands and the flow of funds between major centers are much greater in 1963 than they were in 1961 and, more important, the exchange market interest in sterling has always been much greater than in D-marks or Dutch guilders.

   b. If the 1961 experience with two European revaluations is a precedent for judging the effects of a devaluation of a major currency, these shifts might be handled with existing financial techniques (that is, with special incentives for European private banks to hold dollars and by recourse to intergovernmental credit facilities).

   c. However, the European countries receiving temporary funds would have to be willing--as they were in 1961 and are likely to be in a disorderly situation at this time--to follow policies to neutralize as far as possible the private capital flows. Since 1961, more experience has been gained and a much wider range of financing techniques are available now than was the case in 1961.

4. In addition to shifts of existing foreign-held balances to "safe-haven" currencies, two general types of funds might move out from the U.S.:

a. Credits extended by U.S. financial institutions to non-residents (that is, direct borrowings by European residents or credits granted to non-Europeans which ended up in European hands to pay for goods or as a result of capital shifts). Some of this borrowing by foreigners and even by U.S. international corporations to finance foreign operations in dollars might be motivated in part by dollar devaluation possibilities, if there were any chance of repayment in cheaper dollars.

b. An outflow of funds of U.S. residents directly into non-dollar assets, most probably into sterling assets or into gold. Funds might also be scattered in limited amounts among European financial centers. These funds might be supplemented by borrowing, if market pessimism about the exchange value of the dollar became widespread.

5. Finally, a disorderly condition might be produced in the Euro-dollar market by a wholesale conversion of private dollar deposits into non-dollar assets. It is generally conceded that a sustained withdrawal of deposits in this market could create a serious threat to world financial stability. Fortunately, European central banks have the dollar resources, and probably would also have the will, to prevent a vicious circle of Euro-dollar credit contraction from getting underway.

III. Beyond the immediate confusion, the assumed devaluation of the pound would worsen the position of the United States dollar partly because of some impact on our trade position but mainly because of its impact on foreign confidence in the stability of the structure of exchange rates.

1. If exchange markets thought that further adjustments might be made among European currencies, between the U.S. dollar and European currencies, or in the U.S. price of gold, lessened foreign confidence in the dollar might result in:

   a. A shift of existing private foreign-held dollar balances into the hands of European central banks, which would threaten a continuing (and accelerated) draw-down of the U.S. gold stock; and

   b. A continued expansion in capital outflow from the U.S. (more borrowing by foreign residents and shifts by U.S. residents--partly perhaps with borrowed dollars--into non-dollar assets) which would increase the U.S. payments deficit, however defined.

2. On the foreign trade side, the improved competitiveness of British exports would have some, but probably limited, adverse near-turn effects on U.S. trade or on the size of the U.S. export surplus.

   a. In fact, an improved British export performance would enable Britain to maintain (or increase) current imports and, thereby, encourage a further growth in world trade in which the U.S. could participate.

   b. Britain's economic difficulties are so serious that a devaluation might do little more than give the authorities greater flexibility in efforts to improve Britain's competitive posture. Britain would find that the rate change had not solved the longer-run problems of sustained growth, of a lag in further technological advance, and of the uptrend in wages, costs and prices; nor would the rate change produce by itself a growing export surplus (on the Common Market model).

3. On the capital side, flows of private capital into "safe-haven" European currencies could produce accruals of official reserves which, unless countered by official policies, would reinforce market expectations of possible revaluations of the "safe-haven" currencies.

   a. An accentuation of payments surpluses in "safe-haven" currencies, at a time when distrust of the existing structure of exchange rates already existed to some extent, would confront European countries with difficult policy alternatives:

      (i) The surplus countries would have to be prepared to neutralize reserve accruals and to avoid larger drains on the U.S. gold stock.

      (ii) In addition, these countries would have to forego domestic monetary restraint as an instrument of internal policy and accept further internal inflation if they wished to effect a real transfer of capital and avoid accumulation of reserves from such inflow.

   b. These two problems would make the "safe-haven" countries increasingly concerned that the U.S. take restrictive actions to end our payments deficit; but, to avoid a devaluation of the dollar after a devaluation of the pound, they might be quite willing to cooperate in temporary arrangements designed to forestall such devaluation.

4. As a second type of capital flow, the attractiveness of yields in London at the new rate of exchange would encourage a shift of foreign-held dollars and a flow of U.S. resident capital into sterling assets.

   a. Maintenance of relatively tight domestic credit might well accompany any change in par value in Britain because the authorities would have to cope with the inflationary backwash of the devaluation and would also be concerned to forestall any further exchange-market weakness. After a test period, a gradual easing of British credit policy might be feasible, similar to the easing in Canada in the second half of 1962.

   b. Meanwhile, the continued credit tightening would make sterling attractive to U.S. as well as to European investors, especially as the new exchange rate wor market confidence.

   c. Accrual of official reserves would imply further U.S. gold losses because Britain has tended to keep only limited amounts of the official reserves in U.S. dollars or other foreign exchange.

IV. After the immediate market impact had passed, the major danger to the dollar from a sterling devaluation would seem to lie in either heavy reserve accruals by European centers (because private parties moved into "safe-haven" currencies) or by Britain (because the British authorities in defense of sterling kept yields in the London money market at levels attractive to U.S. as well as to European investors).

1. The key element in both these cases would be accelerated official reserve accruals by these countries.

2. These reserve accruals would undermine confidence in the existing structure of exchange rates in relation to the dollar or among European currencies and would, therefore, accelerate a flow of private funds from a "weak" dollar to European financial centers.

3. From the U.S. point of view, pressures to take dramatic corrective action to end our payments deficit would undoubtedly become more compelling.

   a. The terms on which the Fund or European "safe-haven" countries would provide temporary credits to the U.S. to neutralize the immediate "panic" capital flows might involve such corrective action.

   b. Should such measures be avoided at the time of the crisis (as they were in the case of the Basle credits to Britain in March 1961), the urgency for action would nevertheless continue to mount.

   c. As in the case of Britain in the spring of 1961, the U.S. might eventually be forced to resort to the I.M.F. and to present to the world a program to correct its payments deficit in order to cope with the lack of confidence in the dollar. A devaluation of the pound would certainly increase the likelihood of such a development.

Samuel I. Katz