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September 4, 1968

POLICY APPROACH FOR HANDLING U.S. MILITARY BALANCE OF PAYMENTS
DEFICITS IN NATO COUNTRIES

A. Facts

1. Balance of payments projections through CY 1972, concluded before the Czech crisis, show a net deficit on U.S. defense expenditures and receipts in NATO Europe of \$855 million in calendar 1970, \$1.2 billion in calendar 1971 and \$925 million in calendar 1972. This should be compared with \$412 million in calendar 1967, \$270 million in calendar 1968 and a projected \$168 million in calendar 1969. Clearly, these increasing deficits cannot be absorbed by special financial arrangements of the German type, which are unsatisfactory both to the United States and the central banks of the countries concerned as a long-term answer to U.S. payments losses resulting from U.S. force deployments in NATO Europe.

2. U.S. gross military expenditures in NATO in calendar 1967 could have been completely offset if our NATO allies, excluding France, had procured in the U.S. 46% of their defense procurement of major equipment, missiles and ammunition. A table showing the same picture for CY 1968-9 is attached.

3. The pursuit of a procurement policy yielding these results would have substantial budgetary and military benefits for all concerned, and would avoid the harsh necessity in the years ahead of being forced to choose between the security risk of withdrawing U.S. forces from Western Europe and the financial risk of large U.S. payments deficits to the international financial system.

B. Principles

1. In view of the Czech crisis and NATO re-evaluation of force levels it is necessary to secure NATO-wide agreement in principle--with implementation by bilateral arrangements--

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to achieve maximum offset to U.S. defense expenditures in NATO over the next 5 years.

2. Review by NATO countries (nationally and within NATO) of appropriate defense efforts over the short and longer run in view of the Czech developments should include attention at the same time to:

- a. National budget actions to increase European national defense efforts.
- b. Dealing with the military balance of payments deficit of the U.S. in NATO countries.

3. U.S. review of its future force posture in NATO should include the following approach--in addition to military and political factors:

- a. Reduce projected U.S. balance of payments expenditures by:
 - (1) Implementing now cost reductions without combat unit redeployments (e.g., present Defense Department REDCOSTE program).
 - (2) Maintaining the combat unit redeployment program being implemented in Germany (REFORGER).
 - (3) Considering further combat redeployments or reductions, replaced, if needed, by assumption by our allies of military and support functions previously carried by the U.S. (This requires increased defense efforts by the allies.)
 - (4) NATO-wide commitment in principle to alleviate the U.S. military balance of payments drain in Europe

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by new emphasis on military procurement in the U.S. and with decreasing reliance on special financial arrangements to neutralize the residual deficit.

4. The hard choice to be made clear to our NATO partners is:

- a. NATO-wide agreement in principle (implemented by bilateral actions) to offset the U.S. balance of payments costs of whatever level of U.S. forces the U.S. commits in Europe.
- or
- b. A weaker U.S. role militarily in Western Europe in the years beginning with CY 1970.

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C. Proposed Actions

1. Obtain agreement in principle at the Ministerial level in the NATO Council that:

- a. It is necessary to alleviate to the maximum extent U.S. military balance of payments drains from its expenditures for NATO mutual security.
- b. Alleviating the U.S. deficit should be accomplished through standardization of military equipment within the Alliance, in order to improve military capabilities of the Alliance, obtain the technological and economic benefits of the advanced U.S. arms industry and conserve budget resources.
- c. NATO organs and Defense Ministries should undertake an urgent review of the requirements for military equipment in national inventories to maximize standardization with U.S. forces over a long-term period.
- d. The U.S. review with individual NATO countries alternative means for production allocation (among two or three or more countries depending upon the specific equipment, production capabilities, etc.,) to fulfill their equipment requirements in a way which maximizes procurement in the U.S. At the same time appropriate attention would be given to insure production shares for foreign countries where it is economically feasible with a view to most effective use of defense budgets.
- e. Finance Ministries and central banks of NATO countries should consult bilaterally with the U.S. to devise longer-term arrangements for neutralizing residual

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amounts of the U.S. military balance of payments deficit in their respective countries, including investments in the U.S. which are convertible as required for payments by governments to U.S. military suppliers.

2. Mount a major political effort with our NATO allies which includes the following rationale:

- a. Czech developments and the economic and military realities of the world mean that we cannot practice business as usual.
- b. U.S. approach proposed in NATO is based on mutual gain for the security of all members, economic production shares for foreign countries and international financial viability.
- c. The undesirable alternatives to hard choices in long-term production allocation and financial cooperation are a weaker U.S. role abroad militarily or financially, or both.

3. Undertake an urgent U.S. study on a country-by-country basis of the following:

- a. Equipment requirements of our allies.
- b. Major potential areas for production allocation (for example, main battle tank, truck modernization, aircraft replacement, naval missiles and fire control, etc.)

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- c. General magnitudes of U.S. and other national production shares which would cover the foreign exchange drain of U.S. forces deployed in foreign countries.
- d. Residual foreign exchange drain requiring financial neutralization cooperation.
- e. Possibilities for bilateral or multi-lateral techniques for implementing the U.S. approach.

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Comparison of NATO Military Procurement and U.S. Defense Expenditures
(\$ Million)

	NATO European Countries				Canada		U.S.	
	With	France	Without	France	CY 67	CY 68-69	CY 67	CY 68-69
	CY 67	CY 68-69	CY 67	CY 68-69				
A. U.S. Defense <u>1/</u>								
1. Expenditures	1,529	3,009	1,529	3,009	239	523		
2. Receipts	851	977	851	977	32	69		
3. Net	678	2,032	678	2,032	207	454		
B. Military Budgets <u>2/</u>	22,030	44,051	16,359	32,019	1,817	3,372	74,210	155,900
C. Procurement Amount <u>3/</u>	4,344	8,678	3,330	6,532	240	445	22,491	47,238
% of B.	19.7%	19.7%	20.4%	20.4%	13.2%	13.2%	30.3%	30.3%
D. % of C to Equal A.1.	35.2%	34.7%	45.9%	46.1%	100%	117.5%		
E. % of C Spent in U.S. (A.2.)	19.6%	11.3%	25.6%	15.0%	13.3%	15.5%		

Changes if Average Annual Procurement During 1961-67 is Substituted for CY 67 in C.

C. Procurement Amount	7,646	5,998	488
% of B	17.4%	18.7%	14.5%
D. % of C to Equal A.1.	39.4%	50.2%	107.2%
E. % of C Spent in U.S. (A.2.)	12.8%	16.3%	14.1%

Sources:

1/ DOD Comptroller. (Data as of July 8, 1968)

2/ Country plans as reported to NATO and estimated in AC/127-WP/218.

3/ "Procurement" is as reported to NATO in the categories of "major equipment, missiles and ammunition." The actual amount for CY 1967 is obtained from NATO Secret Document ISM (67) as summarized in DOD (ISA) April 5, 1968 chart for Secretary Clifford, "Defense Expenditures and Related Data." CY 1968-69 amounts are projected on the assumption that the same percentage used for procurement in CY 1967 is continued in CY 1968-69.

Treasury

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