W.R.G.
Feb. 13, 1937

TAX PROGRAM TO CURB FOREIGN PURCHASES
OF AMERICAN SECURITIES

Movement of capital and gold to the United States

The table below brings out the fact that the movement of gold to the United States since revaluation of the dollar has been predominantly a reflection of the movement of capital. At the outset this movement took chiefly the form of a return of American funds and a building up of foreign short-term balances in the United States. Beginning in May 1935 foreign investments in American securities assumed increasing importance. Since the new currency arrangement went into effect, foreign investment in American securities has been the leading factor.

The proposal to increase the tax burden on foreign investments in the United States, therefore, is aimed at the type of capital movement which is currently most responsible for the gold flow.

MOVEMENT OF GOLD AND CAPITAL
TO THE UNITED STATES

(In millions of dollars)

	Gold imports	Inward movement of capital				
		Total	Net foreign purchases in United States		Short-term balances	
			American securities	Foreign securities	Increase in foreign balances here	Return of American balances from abroad
1934	1,134	386	- 25	219	86	106
1935	1,739	1,381	320	131*	566*	364
1936	1,117	1,195	601	151*	350*	93
Total	3,990	2,962	896	501	1,002	563
Sept. 30, 1936 - Feb. 3, 1937	491	429	330	150*	- 22*	- 29

* Funds set aside for redemption of securities are assumed to have been already applied to redemption.

Tax program and the international currency arrangement

The current gold flow is a threat to the international currency arrangement. It is true that for the last three months our takings abroad have been less than the output of foreign gold mines; but during October and the first two weeks of November we absorbed foreign gold at the rate of nearly $2,750,000,000 a year and might do so again. It would greatly help to ease the foreign situation if reserves abroad could be built up by the full output of foreign mines for a period of years. Furthermore the foreign capital which is bringing gold to this country is needed at home. That the British consider this to be the case is evident from the Treasury's ~~ban~~ restrictions on new foreign issues in England. ~~This ban is~~ These restrictions are only partially effective so long as British investors are free to buy outstanding foreign issues. The French Treasury has tried time and again to persuade French capital to seek investment at home. If an American program is developed for discouraging European capital from seeking investment here, it should be possible to present this program to the British and French authorities as a move which will assist them in solving their problems and which will strengthen to an important degree the international currency arrangement for which all three countries are responsible.

The Board's interest in the program

Federal Reserve interest in the program arises chiefly from the fact that (1) foreign investments in this country affect the stock market, and (2) the incoming gold may ultimately affect member bank reserves to an important extent.

The stock market is always one of the chief problems of a period of recovery. Since it anticipates the future, it inevitably runs ahead of the current business situation. At a time when the current business situation may still need the support of an easy-money policy, the stock market may be developing speculative characteristics that require control. Yet control of the stock market is extremely difficult when the public is amply supplied with funds and business is being successfully stimulated. The Board has twice raised margin requirements to curb the use of borrowed funds to purchase securities. It would now be greatly assisted in meeting its problem if the hundreds of millions of fresh money being poured into the stock market by foreigners could be eliminated.

At some future date the problem may be reversed. Foreign selling might start or accentuate a decline in the stock market. The greater the volume of foreign holdings at that time, the more difficult such a selling move would be to handle. It is possible that such selling might be started by the outbreak of a European war and would not only create financial problems but might also embarrass the neutrality policy of the United States.

Member bank reserves are not at present being enlarged by the steady inflow of gold. Under its new gold policy the Treasury is adding the gold to an inactive stock at the expense of maintaining a larger public debt. This policy is working smoothly at the present time; but should the Treasury have to acquire several billion dollars of gold in the ~~new~~ next few years, and should money rates rise above their present abnormally low levels, Congress might well grow restive at the sight of the Treasury holding an enormous stock of unused gold and paying interest on it to the banks at increasingly burdensome rates. It is easily conceivable that Congress might insist upon liquidation of the whole policy. Should this occur, the inactive stock would be thrown bodily into member bank reserves and would upset Federal Reserve policy completely until drastic new powers for the System were obtained through legislation. The $1,800,000,000 of gold now held unused by the Stabilization Fund is problem enough to handle in the future without possible billions of additional inactive gold thrown in with it.

Scope of tax program

Since the current inward gold movement is largely the result of foreign investments in the stock market, measures to curb these investments would achieve both objectives of the Board, i.e., restraining stock speculation and the growth of inactive gold which may later be thrown into member bank reserves. To curb investments in stocks it appears necessary not only to raise the existing 10 percent tax on dividends paid to foreigners, but in addition to reestablish the capital gains tax on foreigners which was dropped in the Revenue Act of 1936. The tax was dropped because of the difficulties of imposing a graduated tax on foreigners based upon reports of their income. The proposal below suggests that the capital gains tax be reestablished as a flat rate tax paid at the time the capital gains are realized, without any reference whatsoever to the foreigner's income. Such a tax appears to be feasible. Its necessity arises from the fact that, to a great extent, investment in stocks is in anticipation of future capital gains.