Form F. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 19, 1937

To Chairman Eccles

From Mr. Gardner W.R.G.

Subject:

I have finished off this memorandum rather hastily along the lines on which I had started before I talked with you today. It is not in shape to pass on to others, but I believe you will find in it the material for your conversation tomorrow with Wayne Taylor. I forgot to ask when I saw you whether you had yet obtained from the Treasury a full statement of the Brazilian and Chinese agreements. Some time ago you were planning to do so, and since these agreements affect gold and capital movements and member bank reserves it would appear appropriate for the Board to be accurately informed in regard to them.

W.G.

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BOARD OF GOVERNORS
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FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 19, 1937

To Chairman Eccles

From Mr. Gardner W.G.

Subject: Measures that can be taken now to deal with "hot money"

Measures to curtail the inflow of gold to the United States fall broadly into three classes: 1) those of an informal character capable of immediate negotiation with foreign treasuries; 2) those requiring fresh legislation from Congress; and 3) those requiring definite international agreements. Measures requiring a definite international agreement (such as an arrangement looking toward curtailment of new gold production) must be preceded by ample discussion and can be pushed only when the situation is ripe. Legislative measures are now postponed until the next session of Congress, when it is hoped that a comprehensive program can be advanced. But this is no reason for postponing those steps which can be taken without formal international negotiations and without asking fresh legislation from Congress.

One important step of this character has already been initiated. The Treasury's letter to the Swiss authorities, which was in preparation at the end of June, states in substance that each central bank (or exchange fund) should hold its reserves in gold. The building up of balances in foreign centers merely throws the problem of sterilizing gold on the foreign center. In particular the building up of dollar balances by central banks in this country during the spring accentuated an already abnormal movement of gold toward the United States.

Copies of the Swiss letter were sent to the British and French Treasuries for their comments. It is not known what replies were received nor whether the letter was sent to the Swiss authorities in the form in which it was seen by certain Federal Reserve officials. If it was, it has not been understood and acted upon by the Swiss. They have, to be sure, kept intact the $35,000,000 of earmarked gold in New York, which in June they prepared to convert into balances; but far from reducing their abnormal dollar balances already here they have gone on expanding them week after week.[1/] They had increased these balances from $2,000,000 at the end of March to $61,000,000 at the end of June. By August 11 they had built them up to $97,000,000. Other countries also leave something to be desired in this respect. The Dutch during June and July increased their dollar balances with the Federal from a negligible amount to $69,000,000, and recently Sweden has shown signs of starting on the same path. The relevant figures on these countries are given in the accompanying table.

If the Swiss are under the impression that they are conforming with the Treasury's policy of refraining from converting this $35,000,000 gold earmarked here into dollars, further steps should be taken to make that policy clear. It would also appear appropriate to apprise the Dutch of the policy since they are members of the international currency arrangement. In fact it should not be difficult to let Governor Rooth of the

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1/ That is, they have expanded week after week their dollar balances handled by the New York Federal Reserve Bank. We do not know to what extent they may have transferred accounts from other New York correspondents to the Federal.

of the Swedish Riksbank know that we consider the acquisition of balances here by foreign central banks in excess of working needs to be undesirable under present circumstances. If our attitude is made clear, it is unlikely that responsible central banks abroad will undertake to circumvent it. They will respect our policy in our own market.

Another situation has arisen in recent months, however, in relation to which it is much harder to define policy, although some sort of informal understanding appears to be called for. This situation has largely been created by the handling of the British Fund. On two occasions in recent months the British Fund has been so handled as to throw the burden of gold sterilization on the American Treasury.

The first of these occasions was in April. Had it not been for the British action at that time there is a chance that the gold movement to the United States would have dwindled away instead of bursting into still greater activity for a period of three months. During the first half of the new currency arrangement the force that had been pulling gold to the United States had been foreign investment in securities here -- chiefly in American stocks. Argentina had, to be sure, been depositing substantial sums for redemption of called Argentine bonds; but this program had largely been completed. The chief potential pull left in the situation lay in continued foreign interest in our stock market. When the stock market started its decline in March, foreigners began to reduce their purchases. In April they turned sellers. With the pull of the stock market temporarily out of the way, with little tendency for European balances here to increase after the substantial fall decline, and with an adverse balance of trade, the stage was set for a rapid ebbing of the gold inflow if not for its reversal.

It was at this point that the British consciously or unconsciously so played their hand as to check what might have been a reversal of the gold flow and to turn the tide back to the United States. They practically stopped buying gold. The United States with its unlimited offer to buy gold at $35 an ounce from all comers found itself purchasing the new supplies on the London market. These supplies were at that time being augmented by sale of Russian gold, and the demand for sterling resulting from the American gold purchases were a major factor in pushing up the exchange value of the pound. As the pound rose, the forward discount on sterling widened since the market did not regard the higher level of the pound as permanent. The forward discount on sterling made it more profitable for British banks to place funds in New York than in London. (See accompanying chart.) Consequently, instead of British funds returning home as interest in our stock market waned, additional British money flowed to New York. A golden opportunity to check the movement of funds to this country was lost because the British failed to take the gold that would have come to them had they maintained sterling stable.

Not only did British policy in April lead to a movement of funds to this country, but it appears to have been one of the largest factors in the spring gold scare. The patent unwillingness of the British to buy gold early in April even though sterling was being pushed up on the exchanges led to a question how much longer it would be before the United States developed a similar unwillingness. How long before the

British would force the hands of the American authorities by making them take all the gold? The uncertainty became such that American banks presently decided to cease purchasing gold in London lestthe American authorities should come to imitate the British before the gold could be delivered in this country. A wide discount on gold developed in London and aroused the general public to the fact that important financial interests were uncertain about the future of gold. The United States Treasury never ceased buying all gold offered at $35 an ounce and American banks, following the President's statement that he knew of no plan to change the price of gold, resumed their purchases in London. But the discussions of the "gold problem" which had been started did not die down. The potentialities of the situation were too deeply impressed on too wide a public, and as the various phases of the discussion proceeded, gold dishoarding rose to an extraordinary volume. It was at this time, also, that the Swiss authorities decided to convert considerable amounts of gold into dollar balances. Undoubtedly the flow of funds from Switzerland and other countries, in addition to those from England, was strongly influenced by the uncertainties as to the future of gold which British policy had stimulated.

The British resumed substantial gold purchases at the end of April and for the next two months the pound was held relatively stable. notwithstanding the continuance of gold dishoarding and the development in June of a flight of capital from France. As the market became used to the new level of the pound there was some tendency for the forward discount to decline. The advantage of holding British funds in New York diminished; and at the end of June the readjustment downward of the franc and the new French financial measures led to a substantial, if short-lived, backflow of funds to France. The pound was still high and the French position not very strong, but with dishoarding on the wane it was at least a situation which might, with proper handling, have shifted home again some of the foreign deposits piled up here as a result of the spring movement.

British policy, however, again interfered. Just as in April at the end of the investment movement the pound was allowed to rise, so in July at the end of the dishoarding movement the pound again rose on the exchanges. It did so in the face of a repatriation of French funds from London. The British fund sold gold to the French as necessary to balance the return of French money and allowed comparatively minor market forces, such as the movement of Japanese funds, to lift the pound on the exchanges. The forward discount on sterling, which had shown a tendency to narrow, widened again, and a return flow of British funds to London was discouraged.

Thus on two recent occasions the British authorities appear to have acted at the strategic moment to prevent a return flow of funds to Europe. Undoubtedly, if questioned on their policy, they would take the position that they have never attempted to stabilize sterling at a fixed rate, that they have always allowed it to move about under the pressure of the market, and that the Tri-Partite Declaration commits them to nothing new in that respect. It is hard to avoid the impression, however, that both the April and the July developments were quite unnecessary. In neither case was the British Fund faced with a market movement that it would have been dangerous to combat. Both appear to have been deliberate maneuvers to attain some end.

It would seem as if the American authorities should at least ascertain what that end is. Are the British reluctant to allow their capital to return home carrying gold with it? Do they feel that a higher pound more accurately reflects their present international trade position? Why do they let the pound rise to new high levels at this juncture when they have ample powers to prevent it? It would seem as if the time had come to raise such questions as these in a friendly way and arrive at some sort of understanding. The consequences of British policy upon our own situation are too important for us to disregard. It may not be possible to set up any clear principle as in the case of the Swiss, the Dutch, and the Swedish reserves; but if we could know what the British are after, and they were apprised of the repercussions here, it should be possible to create a better working arrangement -- one more in accordance with what appears to be the spirit of the Tri-Partite Declaration.

August 13, 1937

DOLLAR BALANCES OF FOREIGN CENTRAL BANKS
HANDLED BY
NEW YORK FEDERAL RESERVE BANK

(In millions of dollars)

Date	3 countries			Switzerland			Holland			Sweden		
	Total	Deposits	Bills	Total	Deposits	Bills	Total	Deposits	Bills	Total	Deposits	Bills
March 31	8	8	--	2	2	--	1/	1/	--	6	6	--
June 2	58	42	16	55	40	15	1/	1/	--	3	2	1
16	83	52	31	59	44	15	21	6	15	3	2	1
30	110	79	31	61	46	15	46	31	15	3	2	1
July 7	115	84	31	62	47	15	49	34	15	4	3	1
14	126	78	48	71	51	20	49	24	25	6	3	3
21	135	83	52	75	50	25	54	29	25	6	4	2
28	162	108	54	84	59	25	69	44	25	9	5	4
August 4	170	115	55	92	67	25	69	44	25	9	4	5
11	179	118	61	97	72	25	69	44	25	13	2	11

1/ Less than $500,000.