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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date August 15, 1939

To Chairman Eccles

From Mr. Gardner WRG

Subject: The President's devaluation power

The fight in Congress over extension of the President's devaluation power was a fight over a broken instrument. The broken instrument was important as a symbol of executive control of the currency; but it was only a symbol. It cannot today be used with assurance either to control the exchange rate of the dollar or to raise prices.

The speeches on both sides indicate that this fact is not understood in Congress. There is even grave doubt whether it is understood by high officials of the Administration. The testimony of these officials at the hearings and their remarks to the press when the devaluation section of the bill was defeated in the Senate assumed, almost without exception, that the power to alter the gold content of the dollar carried with it the power to alter correspondingly the exchange rate of the dollar. This assumption was not unreasonable under the conditions that existed five or six years ago when the President first obtained the right to devalue. Since then the situation has changed.

Why devaluation worked temporarily in 1933-34

In 1933-34 there was an important group of countries on the gold standard -- chief among them France. In these countries the central banks were under legal obligation to convert the currency into

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gold at a fixed price. The technical fact that some of these banks were free to convert into gold exchange does not detract from this statement. Payment in gold exchange is payment in gold abroad.

When, therefore, the United States reduced the gold content of the dollar it was inevitable that the dollar should fall correspondingly in terms of the gold-bloc currencies. Until this happened, private dealers could take francs, for example, convert them into gold, sell the gold to our Treasury, and sell the resultant dollars on the exchange market for more francs than they had used to start the transaction. The effect of these sales of dollars on the exchange market would be to drive the dollar down until the point was reached at which the lower exchange value of the dollar offset the rise in the dollar price of gold. The adjustment was swift.

This decline in the dollar was inevitable, however, only in relation to the gold-bloc currencies. The dollar did not have to fall in terms of sterling, for the British authorities were under no compulsion to sell gold at a fixed price. They could buy and sell gold at whatever price they chose; and had it been their policy to follow the United States in 1933-34 rather than to maintain a stable relationship between sterling countries and the gold bloc, they could have done so. It would not, however, have been so easy for them then as now; for in 1933-34 London was a favored center for money, and many capitalists in the gold bloc and in the United States at that time were

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apprehensive regarding the future of their currencies. The situation in the exchange market was frequently one of demand for sterling, and if the policy of the British authorities had been to reduce the sterling rate on gold-bloc currencies along with that of the dollar, they might have had to purchase large amounts of gold in order to throw sufficient amounts of sterling on the exchange market to depress the rate. Furthermore moving sterling contrary to the market tendency would not have been in accord with the principle upon which the British had been operating the Fund. This principle had been one of allowing sterling to move up or down under market pressures, while the Fund kept the movement gradual and orderly. In this case there was a special reason for observing this principle and not buying large quantities of gold from the gold bloc in order to depress sterling (gold could not be bought in 1933 from the United States); for if the gold bloc crumbled, the already favorable position of sterling relative to gold-bloc currencies might disappear. Hence the British authorities preferred to let the American experiment proceed in its own unorthodox way while they preserved a large measure of stability with the important gold-bloc group.

So long as the gold bloc was able to last under the added strain of American devaluation, that devaluation was largely successful in depressing dollar exchange. And the accompanying rise in American costs and prices tended to relieve somewhat the international strain.

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Why the devaluation power does not control exchange rates today

The gold bloc, however, is now a thing of the past. No significant foreign country, with the exception of Belgium, is on the gold standard; and Belgium, which has already broken with its fixed gold price once during the depression, could readily do so again if any radical change in its international position occurred. The standard as such no longer has the unquestioning popular acceptance that it had before the war and that it recaptured in the 1920's. Belgium's relationship to it has little tradition behind it and outside Belgium, the foreign world does not even pretend to be on the standard. Transactions abroad in gold today are discretionary. That is a cardinal fact.

A second cardinal fact is that the balance of international payments has for the most part been running heavily in favor of the United States. The chief factors in this balance of payments have been our surplus of merchandise exports now maintaining a rate of about $700,000,000 a year and a capital inflow which, so far as our reports can identify it, has amounted to about $1,600,000,000 in the year ending July 1939. There is evidence that the full capital inflow, recorded and unrecorded, has been considerably larger; but the year has been marked by war crises of unusual severity and floating capital abroad has been much depleted so that an annual figure of $1,600,000,000 is probably too great, rather than too small, a magnitude to bear in mind for the years ahead.

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The heavy favorable balance on international transactions of the United States means that the foreign demand for dollars with which to purchase goods, services, and capital assets has tended persistently to outrun the supply of dollars in the exchange market. This excess demand for dollars would, in the absence of gold shipments, drive the dollar up on the exchanges. It is only as gold has been shipped and sold to the United States Treasury and the dollar proceeds thrown into the exchange market that the excess demand for dollars has been met and exchange rates held stable. In the latter half of 1938, for instance, the British authorities were not selling enough gold to our Treasury to prevent the dollar rising in terms of sterling. In 1939 their policy became firmer; and though the excess demand for dollars was nearly as large as in 1938, they sold gold in sufficient amounts to hold the dollar stable at $4.68 to the pound.

At both periods it was only British willingness to sell gold that supported sterling. Had a currency war developed they could have exercised their privilege of not selling gold and have watched the market drive sterling down and the dollar up. Most foreign countries could handle their currencies in the same way in relation to the dollar. Their publics can no longer compel the central banks to pay out gold at a fixed price as they could in 1933-34. The decision as to whether to support their currencies or let them fall under the pressure of market forces now rests with the foreign authorities. Nor can we take that decision away from them by devaluing the dollar.

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What devaluation would do concretely in the international field

Should the President devalue the dollar by the full amount permitted under existing law -- i.e. to 50 percent of its old gold parity -- the price of gold would be raised from $35.00 an ounce to $41.34. The gold reserves of the United States would be raised from $16,300,000,000 where they are now to $19,300,000,000, creating problems that will be considered presently; but the important thing to establish at this stage is that this increase in the price of gold would not necessarily affect British or other foreign exchange policy. If the international balance of payments is running in favor of this country by, say $200,000,000 a month (during the past year it averaged $270,000,000) then that amount of gold would have to be shipped from abroad to keep the dollar from rising. At the present price of $35 an ounce nearly 6,000,000 ounces would be required monthly. At the higher price of $41.34 an ounce less than 5,000,000 ounces would be required. If the foreign monetary authorities were shipping all the gold, the only consequence of dollar devaluation for them would be that their gold reserves would last longer, because now it would take fewer ounces to obtain the $200,000,000 required monthly to meet the excess demand for dollars and hold their currencies stable. Up to this point there is no reason to conclude that devaluation would force the dollar down on the exchanges. In fact foreign monetary authorities would still have it in their power to force the dollar up by selling us

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only 4,000,000 ounces of gold or some still smaller amount. The decision so far rests with them.

But there is another aspect of the situation -- gold on the open bullion market outside official reserves. Suppose that at $35 an ounce $100,000,000 of newly mined gold is thrown on the bullion market each month and is immediately sold to the United States. That would provide half the $200,000,000 needed monthly to meet the excess demand in the exchange market and keep the dollar from rising. The authorities would have to provide only another $100,000,000. And if now the price of gold is raised to $41.34 the value of the monthly mine output would be raised to about $120,000,000, leaving only $80,000,000 to be provided by the authorities. This $120,000,000 would come to the United States so long as the United States offered the best market and it might be augmented by a growth of mine production under the stimulus of the higher price and by dishoarded gold. When these possibilities are taken into consideration and when it is realized that the flow of international transactions is irregular and that in many months the excess demand for dollars will be substantially less than $200,000,000, one can easily conceive of this country buying sufficient gold on the London bullion market at certain periods to drive the dollar down even if that were against the wishes of the foreign monetary authorities.

The flaw in this reasoning, however, is the assumption that the foreign monetary authorities would in such a case leave gold in the

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bullion market to be purchased by the United States. If they did not wish to see the dollar decline, they could bid for this gold, too; and since the Bank of England handles the output of the world's most important producer, South Africa, it seems probable that it could obtain a considerable portion of the new supplies. It would be particularly easy for it to do so if the United States could not go above $41.34 an ounce, for the Bank of England, in buying either for itself or the Fund, has no limit to the price that it can pay for gold. So the British authorities would still appear to have it in their power to keep the sterling-dollar rate stable in the face of devaluation here, even if the supply of gold in the bullion market were greater than the excess demand for dollars on the exchanges.

If they did so, the price of gold on the London bullion market would, of course, rise to the same extent as the American price of gold. Any seller of gold in London would have the alternative of selling to the Treasury of the United States and would not take less than our Treasury's price (with allowance for shipping costs). If other foreign monetary authorities also took whatever action was necessary to keep their exchange rates stable, the price of gold would rise in all countries to roughly the same extent as in the United States. We would find that by devaluing we had marked up the price of gold abroad rather than the exchange rate of foreign currencies.

Thus the existence of an open bullion market would not of itself render American devaluation policy effective; although if the

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bullion market supplies were large, the foreign monetary authorities might have to buy some part of them in addition to withholding their own sales of gold to the American Treasury.

This positive purchase of gold by the foreign monetary authorities would certainly be necessary if devaluation here or the threat of devaluation started capital flowing abroad again. Foreign deposits in our banks are now about $2,500,000,000, and an outflow would undoubtedly develop if a decline in dollar exchange were anticipated. We have seen that the dollar need not decline as a result of devaluation, but nevertheless the general public might mistakenly regard it as inevitable and act accordingly. If capital started flowing abroad again in large amounts, as it did in the fall of 1937, the exchange market situation would be favorable to a decline in the dollar; and if the movement was great enough, the foreign authorities might decide to give way before it and let their currencies rise. In fact we could force them to give way if we were prepared to refuse to sell them the gold necessary to hold their currencies stable in relation to the dollar. In this case the shoe would be on the other foot and the American authorities would be in control while the capital outflow lasted.

But a refusal to sell gold would be contrary to our established practice of buying and selling without limit at the parity price. It would result in the market price rising substantially above our parity and give us a two-price system in gold that would create complications of its own. And in any case the outward movement of capital would not be likely to last in the face of a world situation that has prevailingly driven capital here.

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There does exist a possibility that if this country were prepared to devalue without limit -- to raise the price of gold to whatever heights might be necessary to get results -- it might be able to shake off foreign countries and get the dollar down. Brief consideration will be given to this possibility later. Unlimited power of this sort, however, is not what the President was asking for in the monetary bill, and the conclusion of this section must be that devaluation within existing legal limits would be unlikely to have more than a temporary influence toward depressing dollar exchange. The cards are stacked against this country in such a game. Our balance of international payments is against depreciation of the dollar, and most foreign countries could now outbid us on gold if that were necessary. We should have to depend for our results largely upon popular misunderstanding; and even that might not work, or might work only partially or for a brief period of time.

Longer-term effect in the international field

There would, however, be a longer run effect of some importance. By raising the price of gold from $35 to $41.34 an ounce we would mark up the value of foreign gold reserves from about $11,000,000,000 to $13,000,000,000, raise the value of existing foreign gold production by over $200,000,000 a year, and probably stimulate a greater output of gold. The power of monetary authorities abroad to support their currencies would be enhanced; for the rising value of world gold production would cut the balance of payments deficit to be met from

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their reserves while the reserves themselves would be larger. This would encourage the foreign authorities to make a more spirited defense of their currencies if they were in the mood for defense. And it would enable them to hold out for a greater stretch of years. But if their purpose was competitive exchange depreciation, devaluation by the United States would do little to impede them. The mere fact that foreign monetary authorities had more adequate gold resources would not incline them to use these resources to support or raise existing exchange rates if lower levels were considered advantageous to their countries.

Domestic effects

Devaluation to the existing legal limit would also raise the value of the American gold stock. The profit accruing to the Treasury on the basis of the existing stock would be about $3,000,000,000. It would be difficult to prevent this profit from being spent. Since the Stabilization Fund has had no use for $1,800,000,000 of the original gold increment assigned to it, further additions to its resources appear to be out of the question. Other plans for immobilizing the $3,000,000,000 might be devised, but they would hardly gain the ready acceptance that was accorded the establishment of an American Stabilization Fund to match the British. The chances are good that this second gold profit would be used to cover the deficit either directly or indirectly. To that extent it would aid in keeping

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down the interest-bearing national debt; but it would do so only to the same extent as an issue of $3,000,000,000 of greenbacks under the Thomas Amendment. And in similar fashion it would add $3,000,000,000 to commercial bank reserves. Banks would be still further removed from the control of the Federal Reserve Board, and far more drastic legislation would eventually have to be passed if that control was to be restored -- legislation so drastic, in fact, that the chances of its timely adoption would be rendered remote. It is against dangers of this character in the domestic situation that the possible advantages on the international front must be weighed.

Objectives

What are these advantages? The argument so far has suggested the probable futility of an attempt to depress the dollar in the exchange market by reducing its gold content. But suppose the attempt was successful. Suppose that the tendency toward building up a surplus of merchandise imports for the country such as would follow a general readjustment downward of foreign currencies is effectively spiked. Our success would be measured in terms of a greater gold inflow than we should otherwise have had. The chance of matching the capital inflow over a period of time with goods instead of gold would have been diminished.

This conclusion calls for somewhat more careful analysis. While it seems evident that a readjustment downward of foreign curren-

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cies would act as a deterrent on our sales abroad and a stimulus to our purchases in foreign markets, there is a possibility that this shift might react adversely on our national income and that recession here would presently produce just the opposite effect on our foreign trade -- namely, more goods exported, fewer imported. This possibility of an adverse effect on the national income is what makes the necessary readjustment of our international position a work of statesmanship rather than of mere mechanics.

The adverse effect might be produced in two ways. In the first place any rapid transition is disturbing. A sudden and drastic depreciation of foreign currencies would alter the competitive position in world markets so abruptly as to cause American losses. Even a more moderate shift in foreign exchange at a critical period of the American recovery might tip the balance toward business contraction here. To avoid these bad transitional effects it is essential that the movements in foreign exchange be gradual, say, in the case of sterling not more than 5 or possibly 10 percent a year, and that they be so timed as to work a minimum of disturbance to the business movement. The decline in sterling in 1938, when American business was experiencing a well-founded recovery, appears to have been of this character; but the proper handling of the exchange situation remains a problem calling for an unusual degree of financial statesmanship.

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There is a second way in which an adverse effect might be produced, however -- one quite distinct from mere transitional upsets. Our gold purchases from foreigners result in a creation of purchasing power by the Government. The Government pays out dollars for foreign gold which it does not want and the foreigners make the new money active in our commodity markets when they buy our goods. If this subsidy were withdrawn as we developed a merchandise import surplus, one of the significant forms of Federal contribution to purchasing power would disappear. This would be disadvantageous under present conditions of unemployment and lagging private investment.

But why issue dollars to foreigners for this purpose? Why not issue them to the groups within our own community who could spend them with just as good effect and raise their own standard of living in the process? The only answer appears to be that it is politically easier to issue dollars to foreigners in exchange for gold that we do not need than to enlarge expenditures for public works and other public enterprises that add something to the nation's well-being.

Not only would domestic Government expenditures be just as effective in supporting business as the foreign subsidy, but presumably the domestic expenditures would be financed by borrowing rather than by the issue of currency. Hence they would not intensify the

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problem of excess reserves that at some stage of the recovery movement is certain to become acute. They might even diminish bank reserves; for as Government expenditures expanded national income, they would tend to increase American purchases of goods abroad, helping to curtail or reverse the gold inflow. But if politically it is not feasible to develop a domestic substitute for the foreign subsidy, then the maintenance of the gold inflow that a successful devaluation policy would foster must be credited with a stimulus to our lagging industry at the same time that it is debited with a major contribution to the problem of excess reserves -- a debit both because of the larger amount of foreign gold that we must buy and the increment on our existing holdings.

All this is posited, however, on a successful devaluation policy and we have seen that the chances are strongly against such success.

Note on the devaluation threat last December

Since success has been attributed by Administration officials to an implied threat of devaluation last December, a few words on this point may be in order. The threat was supposed to have persuaded the British to stop the decline in sterling.

It is highly questionable if the British authorities had any desire to see sterling continue its decline last year. On the contrary they were pouring gold into its defense and welcoming any signs of the market steadying. They did, however, need to be nerved to make

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a bolder defense and abandon their policy of an orderly retreat before market pressures, if the decline in sterling was to be stopped. Undoubtedly the veiled threat of dollar devaluation was a factor in nerving them to take $1,650,000,000 of gold from the Bank of England for use of the Fund, to issue informal restrictions on speculative exchange transactions in London, and then to stabilize sterling unflinchingly.

But it seems wholly unlikely that the veiled threat of devaluation was important because the British feared it would boost the exchange value of sterling. They might well have welcomed at that juncture some outside force that would have held sterling up. Certainly they must have known that if they wanted to get sterling down nothing would be easier for them to do. Their powers to put it down were far greater than those of the American Treasury to hold it up. What the British could not contemplate, however, was an open break with the United States -- a break such as would be signalized if we engaged in devaluation in an attempt to offset what we regarded as competitive exchange depreciation by the British. The British are too dependent upon our political and economic support should Germany run amuck. They are pathetically eager to align us with them, and an open financial break in the face of war dangers is out of the question. We could have achieved just as great a response from them by merely threatening to denounce the Tri-Partite Accord on the grounds that the British were violating its spirit. It is the open break with

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us that the British fear rather than the use of the devaluation instrument, which mechanically they can so easily counter.

The Dennis memorandum sent to Chairman Eccles

Lawrence Dennis in his memorandum of June 29, 1939, asserts that the power to devalue is essential. According to Dennis "there is only one way to scale down the public debt and that is by currency depreciation." His argument, however, is not based on the effects that would flow from depreciation of dollar exchange. "The ideal", he says, "would be to have all the currencies decline together in reference to gold and remain stable in value with reference to each other." His argument, which is confused and mystical, is apparently a mixture of Warrenism with a belief in the efficacy of larger excess reserves. In part he seems to think that raising the price of gold will raise commodity prices directly. He does not explain how, any more than Warren himself did. In part he takes the position that we must have monetary expansion and "flush our banks with surplus reserves." Just why existing excess reserves are not large enough to achieve whatever is possible in the way of stimulus from this source he does not explain, nor does he explain why, if larger reserves are desirable, we cannot obtain them through open-market operations without devaluing. Throughout he makes the assumption that a fixed value for gold in this country is inconsistent with monetary expansion and rising

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prices -- an assumption so absurd in the face of existing money supplies, excess reserves, and unused lending power at the Reserve banks that it calls for no further comment. He also assumes that the President's power to devalue is the power to control dollar exchange and that it is all that keeps the pound from falling. How doubtful his assumption is on this point is indicated in the preceding sections of the present memorandum.

In short Mr. Dennis appears to be badly confused as to the rôle that the devaluation power might play in the modern world, and to be in general more assertive than realistic in his argument. If he and his clients, however, act upon his ideas and other groups behave the same way, they may produce in some measure the effects they anticipate.

Devaluation power vs. unlimited flexibility of gold price

The power of the President to devalue is limited. He may alter the gold content of the dollar only within a range of 50 to 60 percent of its old gold parity. Since the gold content is now 59.06 percent of its old gold parity, his effective power is substantial in one direction only, i.e., downward. For this reason no consideration has been given in this memorandum to the consequences of raising the gold content of the dollar, nor has a lowering of the gold content below 50 percent of the old gold parity been considered.

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Quite aside from the devaluation power, however, the Secretary of the Treasury (with the approval of the President) has the right to buy and sell gold at any prices he deems to be in the public interest. This is as great a power as the British Treasury itself possesses. Dennis overlooked it in his memorandum. So did the President and the Secretary of the Treasury in their comments on the recent bill. Whether or not the devaluation power was continued depended upon the fate of that bill, but the much greater powers conferred by sections 8 and 9 of the Gold Reserve Act, permitting operations in gold at any price, are permanent and depended not at all on the fate of the bill. Throughout the fight in Congress -- even in the interregnum following June 30 when the powers covered by the bill had lapsed -- the Treasury was from a legal standpoint fully equipped to bring to bear on the exchanges and the bullion market whatever influence lies in a flexible price of gold.

The fact that these powers were never mentioned by the responsible officers of the Administration either in the hearing on the bill or in their public statements suggests that they do not feel free to use them. If they were free to use them, not only could they compete more effectively with the British and other foreign authorities in a depreciation race, but they could move in the opposite direction and take steps toward reducing the price of gold the world over. These

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two possibilities involved in the unlimited power to change the price of gold may be briefly considered, though they are somewhat beyond the scope of a memorandum devoted to the devaluation power alone.

(1) If this country were prepared to raise the price of gold without limit in order to depress the dollar or counteract a decline in foreign currencies, it would probably be successful. There is a limit to what is reasonable in the way of higher gold prices. If the price of gold were doubled and then tripled, mounting gold increments abroad, as well as at home, would threaten to burst the confines of stabilization funds and become inflationary. The world's annual output of gold would be swollen to enormous value figures. The danger of money markets flushed with funds would loom, and responsible authorities abroad would withdraw from competition with a country that appeared to have gone financially mad. Under those conditions the depreciation of the dollar would be helped along by a flight of private capital. And domestic cost and price developments would probably justify the declining dollar on the exchanges.

The thing could be done if we were prepared to throw the reins to the speculators in exchange and in commodities, to move without limit, and to disregard the consequences. But acting within the moderate range of the present devaluation power, there are,

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as we have seen, strong grounds for believing that foreign countries would keep pace with us and that the tendencies in our international balance of payments in recent years would continue prevailingly to force the dollar up except as foreign monetary authorities were willing to sell us gold to hold it down.

(2) On the other hand if this country were interested in curtailing the gold inflow through a downward adjustment of foreign currencies tending year in and year out to build up a merchandise import surplus, and through a lower price of gold that would correspondingly shrink world gold output -- if these were its objectives it could move toward them with considerable precision through an appropriate handling of its gold operations. Its international balance of payments would favor it. If the United States as a first step lowered the price of gold from $35 to $34 an ounce, other countries might well follow it keeping exchange rates the same. In this case the various currency prices of gold would move down together and the value of mining output would fall. If, however, other countries did not keep abreast of the United States their currencies would decline against the dollar.

The United States could force this decline by exercising its discretion with regard to the amount of gold it would purchase. When the British authorities, for instance, were offering the American Fund gold in order to meet the excess demand for dollars arising out of

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the balance of international payments, the American authorities could say they were not in the market at the moment. Then when the pound declined to the desired level in the exchange market, American purchases of gold could be resumed. It is true that if the adjustments were to be close, the British would have to continue their willingness to give up gold in support of the pound. Otherwise the pound might collapse. But the American Treasury could always play its part in forcing a gradual downward adjustment at periods most convenient to the American economy. Its action would be positive instead of purely passive as it is now when it buys gold in accordance with the instructions of the foreign authorities who, in turn, do the active business of determining exchange rates.

But such a policy, though it might constitute one of the most important cumulative influences in curtailing the gold inflow, would hardly reflect the purposes for which the devaluation power was politically created. In any case the devaluation power (as distinct from the gold price powers) could not be used in this direction. It can be used only in a direction in which the existing balance of international payments and the existing flexibility of gold prices abroad render it largely futile.

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