Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 30, 1939

To Chairman Eccles
From W. R. Gardner W.R.G.

Subject: Secretary Morgenthau's 28-page letter on gold minimizes excess reserve problem and calls disadvantages of gold inflow minor.

Excess reserve problem minimized

On March 22 Secretary Morgenthau sent a letter to Senator Wagner in which he undertook to answer the more important questions that have been raised concerning the gold flow to this country and its effects. The letter runs to 28 pages. I think you should know that in all these 28 pages the part played by the gold inflow in creating the excess reserve problem is mentioned just once. On page 22 the Secretary says:

> ...."the prospect of continued large inflows of gold has been a cause of some concern on the part of those who consider a large volume of excess reserves as constituting a potential danger of inflation, though I do not regard this problem as one of immediate import."

You will observe that even in this slight mention of the problem, the Secretary states that it is "a cause of some concern on the part of those who etc." carefully avoiding stating it as his own position. All he says as to his own position is that he does "not regard this problem as one of immediate import." It is evident from this statement, buried inconspicuously in 28 pages that otherwise disregard the subject, that the Federal Reserve can expect very little help from the Treasury on the outstanding financial problem connected with gold inflows.

The rest of the letter is on the whole similarly complacent in tone. On the question of whether we have too much gold the Secretary on page 16 says:

> "Gold performs two monetary functions. First, it serves as a specie base for the monetary system. Secondly, it serves as the medium for settling international balances."

As regards the first function he concludes that the twelve Federal Reserve banks now have more than enough gold in excess of their 40 percent requirement against notes and their 35 percent requirement against deposits to protect the public against an inadequate supply of currency and bank credit. As regards the second function he

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concludes on page 19 that

> "Without greater ability to forecast future political and economic developments than is vouchsafed us, it is impossible to say with certainty that we have too much gold."

In this three page answer to the question there is no mention of the fact that the counterpart of the great gold stock which this country now has is to be found in member bank reserves swollen beyond the power of the Federal Reserve Board to control.

Gold inflow does not call for action

In dealing with the question "What action, if any, should be taken with respect to the gold situation?" the Secretary says on page 21:

> "The major conclusion we have drawn is that any measure which would take the form of restrictions on the flow of gold into this country would have, at this time, detrimental effects upon our economy.
>
> "What disadvantages may be associated with the gold inflow are fortunately only of minor magnitude....."

Not only are measures for diminishing the capital inflow rejected but the Secretary emphatically argues against any shifting of the international exchanges in the direction of a lower level for foreign currencies -- a shift which, if gradual and properly timed, would tend to alter our foreign trade balance in the direction of an import surplus and thus curtail the gold inflow. He implies on pages 10-11 that the dollar is at its proper level (the analysis at this point is misleading) and on pages 13-15 he takes the position that a small shift downwards in the level of foreign currencies would be ineffectual in altering the trade balance and a large shift would be disastrous. He does not consider the possibility of the cumulative effect over a period of years of a series of moderate readjustments downward of foreign currencies. Nor is there any evidence that the Treasury has estimated broadly how large a merchandise import surplus might be necessary to balance off service items and those elements in the capital inflow that are of a recurrent, rather than a transitory, nature. The Treasury's policy seems to be embodied in a single rule of thumb: "Resist, if possible, any decline in foreign currencies."

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Power to alter gold content of dollar given exaggerated importance as an exchange control

In order to resist such declines more effectively, should they threaten to become extreme, the Secretary asks for extension of the President's power to reduce the gold content of the dollar. The letter goes astray as regards the effects of changing the gold content of the dollar. The assumption is made on pages 13-14 that a change in the gold content of the dollar must correspondingly alter the exchange rate of the dollar. If the rest of the world were on a fixed gold standard and would stay fixed in the face of American manipulations, this assumption would be true. With the rest of the world in fact employing flexible gold prices, it is far from true. A reduction in the existing gold content of the dollar might fail completely to prevent a decline in foreign currencies since foreign gold prices can change more rapidly than ours and they are changing daily in accordance with shifts in the exchange market. Later on page 22, where the same line of argument is again employed, the Secretary's statement is rendered academically correct by the insertion of the phrase "in the absence of similar changes in the gold value of other currencies"; but although this eliminates the logical error in the previous argument, it remains a naive assumption. The misleading analysis in these two sections of the letter will strengthen the beliefs of those who are arguing for further reduction in the gold content of the dollar to help cotton or other American products sold on international markets.

Note on permanent powers to change dollar price of gold

Incidentally the way in which the Secretary makes his plea for continuance of the President's temporary powers over the gold content of the dollar probably commits him further against using the permanent powers over the gold price that he already possesses. The Secretary repeatedly implies that the administration's ability to change the price of gold is limited to the President's right to alter the gold content of the dollar. He implies that if this right were not continued the administration would be helpless to change the gold price. The real fact is that he, himself, with the approval of the President, has permanent legal powers to raise or lower the dollar price of gold without limit in either direction and quite irrespective of whether the powers of the President to alter the gold content of the dollar lapse. The fact that the Secretary, possessing these permanent powers (as great as those of the British Treasury), says nothing about them and answers questions of Congress as if they did not exist seems to commit him against the use of them.

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<u>Letter likely to be regarded as the official statement on the gold problem</u>

My comments on the Secretary's letter have been critical; but I should not wish to leave the impression that I consider the letter a bad job. On the contrary it is an extremely able piece of work, marred though it is by several slips in reasoning and fact in addition to those mentioned in this memorandum. It is just because the letter is in general so competent and so likely to be regarded as the official statement on the gold problem that I thought your attention should be called to what appear to be certain major deficiencies from the standpoint of the Federal Reserve Board.

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