Fund.

Board of Governors
of the
Federal Reserve System

OFFICE CORRESPONDENCE

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To Federal Reserve Board

From Walter R. Gardner

Subject: The White Plan and control of the gold inflow

This memorandum is in anticipation of the Board meeting next Wednesday with Harry White and his staff. It covers the main points in the Treasury Plan at which an endeavor has been made to embody the suggestions of the Federal Reserve staff. Our suggestions have been directed toward setting up a Fund that would meet the needs of foreign countries more adequately than the Treasury Plan but which, at the same time, would offer maximum protection to the United States against a large gold inflow. Protection against a large gold inflow, however, with its corresponding effects on the money supply and member bank reserves, is only partly a question of the way in which the Fund is set up and handled. Much depends upon the sort of policies this country pursues on its own responsibility. The last two-thirds of the memorandum is devoted to a discussion of some of the major factors, operating both inside and outside the Fund, that can be employed to curb the gold inflow to the United States.

Foreign gold and the Fund

The great contrast between the White and Keynes plans is one of magnitude. The White Plan calls for a contribution by the United States of 2 or 3 billion dollars; the Keynes Plan for a potential United States contribution of 25 billion dollars or more. The Federal Reserve staff suggested a plan which, while keeping the United States contribution down to the level of the White Plan, would have provided international means of payment for the weaker countries on a scale more comparable with those of the Keynes Plan. This was to be done by drawing more foreign gold into the arrangement and concentrating Fund assistance on the weaker countries in proportion to their weakness. We knew that the stronger foreign countries with adequate gold reserves would be reluctant to exchange them for a corresponding right to draw upon the Fund since this would subject them to the discipline of the Fund and the Fund itself might not function properly. We proposed, therefore, a measure that would overcome this reluctance -- a provision, namely, that member countries should buy gold only through the Fund. Once the United States announced its adherence to this policy all countries with substantial gold interests would be under the strongest possible inducement to join the Fund in order to preserve their right to convert gold into dollars. But the Treasury would not hear of such a measure, or even allow it to be considered in the international meetings, for fear that it would impair the prestige of gold. This is a point on which the Board members may wish to have some further discussion with the Treasury.

The purpose of such a discussion would be to reach a better understanding on the rôle of gold and to remove some of the more mystical fears of the Treasury with regard to the effect of centralizing gold operations in the Fund. Ultimately some such measure may have to be adopted for the purpose not only of dealing with non-members, but also of curtailing new gold production. The way should be prepared. So far as the current international discussions are concerned, however, it is too late to make so basic a change.

Without the gold centralizing provision it proved impossible to interest foreign countries in contributing more of their gold (instead of national currencies) to the Fund. The Federal Reserve staff developed the proposal in a general meeting with foreign countries on June 16, but those who would have to contribute more gold were quick to raise objections. Even though they would get a right to draw upon the Fund an amount at least equal to their full gold contribution, they felt that their reserve position would be weakened. In drawing upon the Fund they would be subject to its judgment as to whether they were pursuing appropriate policies and there would be the further danger that the Fund mechanism might be abused by other members and break down. Both of these causes for reluctance only emphasized the value of getting foreign gold into the Fund. The main value of the Fund to the United States is that it can be used to correct the balance of international payments that has brought this country so much gold. The more foreign gold there is under the discipline of the Fund and the less there is subject to independent policies outside, the more effective the instrument will be from our standpoint. And the fact that foreign countries, contributing large amounts of their gold, would be eager to see the Fund so managed that their gold did not all flow to the United States in the process of financing some other country's trade -- this fact would range such countries side by side with us in seeking corrective action.

But in the absence of an inducement the objections of the countries with adequate gold reserves were sufficient to force a considerable modification of the Federal Reserve proposal. The Treasury draft now has in it a sliding scale arrangement under which a country contributes 30 per cent of its gold reserves on that portion of its reserves not in excess of its quota, and 10 per cent of its "excess" gold reserves until its gold contribution amounts to 50 per cent of its quota. Thus gold contributions may range all the way from zero, if a country has no gold, to 50 per cent of the quota if a country's gold reserves are three times its quota or more. Strictly speaking it is not gold alone but gold and foreign exchange that is the basis of the formula. Whether foreign exchange should include only that held by governments and central banks, or that held by private citizens as well, is still open for discussion.

This formula deals gently with foreign countries that have ample gold reserves. It would bring about 2 billion dollars of foreign gold into the Fund as against 5 billion under the Federal Reserve proposal, which would have required members to pay their whole quota in gold providing this did not take more than half their existing gold reserves. But 2 billion dollars of foreign gold is much better than the mere half billion that would have been paid in under the original Treasury proposal, and all the American technicians are in agreement that it is probably as much as foreign countries can be persuaded to contribute in the absence of a provision centralizing gold operations in the Fund.

Furthermore a provision has been inserted in the new Treasury draft designed to keep countries with adequate gold reserves from hoarding them while they draw on the Fund. Any country whose gold reserves exceed 50 per cent of its quota must pay half in gold (and half in national currency) for foreign exchange purchased through the Fund. This will reduce the burden on the Fund in the early years when the dangers to its solvency may be greatest. It should enable the Fund to do more for the weaker countries in the initial period and hence is a move in the direction of the Federal Reserve proposal. In the end, however, it does nothing to correct the wasteful distribution of quotas to countries that already have adequate gold reserves except in the case of countries unwilling or unable because of internal legal requirements to use their gold. Such countries will be prevented from drawing their full quotas from the Fund.

United States voting power

Under the Federal Reserve proposal the United States would have entered the Fund with a limited contribution and a correspondingly limited vote (about 12 per cent if all countries joined). The contribution of the United Kingdom would have been slightly larger; that of other countries less. The United States would have remained one of the crowd in this fashion just so long as the Fund was properly managed and did not start calling upon the United States to finance a chronic maladjustment in the balance of international payments which the Fund itself was failing to correct. If there developed a one-way gold flow to the United States, however, the United States vote would have increased correspondingly because under the Federal Reserve proposal the amount of gold which a country purchased net from the Fund was added to its original quota in determining its vote.

The new Treasury draft has a somewhat similar provision. For certain purposes it increases the basic vote of the creditor and diminishes that of the debtor by 1 vote for every $2 million of their respective credit and debit balances in the Fund up to the amounts of their quotas. This provision is stronger than the Federal Reserve proposal in one respect -- it adjusts debtors' votes downward at the same time that it adjusts creditors' votes upward. It is considerably weaker than the Federal Reserve proposal, however, in other respects: 1) it is slower acting; 2) the maximum increase or decrease it permits is equivalent to only one-half the quota; 3) it does not apply at all to gold acquired from other sources than the Fund although there will be much more foreign gold outside the Fund than in it. The Federal Reserve provision was simple. Since all gold that this country purchased would come to it through the Fund, the full credit in the United States balance of payments would be reflected in its vote instead of only that small portion of it which happened to represent the original contribution to the Fund. It was less harsh on debtors, but offered far more comprehensive protection to creditors than the Treasury provision.

Another aspect of the new Treasury provision is that it is intended to apply only to two special cases -- Fund financing of capital transfers and Fund assistance in excess of the so-called "permissible" quota.

Since it is not of general application and since it is based on part of the gold flow only, this provision is hardly of the same order as the Federal Reserve proposal; but the Federal Reserve proposal itself is fully appropriate only when the United States is starting with a small vote and hence needs protection against an improperly managed Fund. Under the existing Treasury plan the United States has a large vote from the outset irrespective of how the Fund is managed.

No more need be said of the voting provisions, which at best remain confusing and wide open to discussion. In considerable part the uncertainty with regard to them springs from the fact that the Treasury has never been able to supply figures for the type of quotas it is suggesting, except in a few cases, and even in these cases the figures are quite unreliable. The quota formula itself is a confusing mixture of factors designed to measure a country's ability to contribute and its need for assistance with the result that it measures neither one.

Do we really wish to stop the gold inflow?

No amount of ingenuity in working out voting provisions to protect the United States will lead to much if this country does not want to protect itself. On the other hand, if it does wish to protect itself from an unbalanced international situation it can go a long way no matter what its position in the Fund.

What an unbalanced world situation does to us is to lead us into giving the products of our farms and factories to foreign countries in exchange for their gold which we do not need. We do not need the gold because we already have more than 22 billion dollars worth — much more than we can hope to use for exchange stabilization purposes. For that purpose 5 to 10 billion dollars should be ample. Nor do we need it for domestic circulation, which is now illegal. Since the currency is not redeemable in gold for domestic purposes, there is no longer any economic reason for the 40 per cent requirement against Federal Reserve notes or the 35 per cent requirement against deposits. These are self-imposed and arbitrary requirements that can be altered whenever they become a nuisance. The only real need of the country for gold is for purposes of international settlement, and it has already been noted that 5 to 10 billion dollars is ample for such a job. The rest is surplus. We can get something for this surplus only as we succeed in shifting from a creditor to a debtor nation -- i.e., only as we succeed in turning the capital flow outward and in reversing our foreign trade balance. Failure to reverse the gold flow to the United States will mean failure to realize on an otherwise useless stock. It will mean that, instead of helping the American standard of living, we are continuing to drain foreign countries of their reserves, forcing them to take defensive measures that tie up international trade, while we create an almost unmanageable domestic credit problem for the Federal Reserve authorities by enlarging both the mass of money in the hands of the public in this country and the already swollen reserves of the member banks.

So stated, it would appear that the country would be eager to correct an unbalanced world situation. And undoubtedly lip service will readily be given to the principle that the United States should take foreign goods rather than gold. The difficulties will begin when the abstract principle is applied concretely to farmers and business men; for application of it will mean that our exporters will find it harder to compete abroad and Americans producing for the home market will encounter more foreign competition. All the familiar arguments that cluster about the tariff will be raised again.

The chances of obtaining an effective program will be enormously helped if we achieve and maintain a full production economy. In fact if our domestic expansion is more rapid than that of foreign countries, our buying power will increase more rapidly than theirs with the result that American imports will grow faster than American exports. Should this happen nothing more might be needed to correct our balance of trade.

This is, however, unlikely to happen. The probability is that major foreign countries which have been more battered by the war than the United States will in the process of recovery undergo a more rapid expansion than we shall experience. The monetary stabilization plans themselves, by providing foreign countries with larger international reserves will enable them to push their domestic expansion programs faster and farther than would otherwise have been the case. Therefore the trade balance is not likely to correct itself as an automatic consequence of the United States moving toward full civilian production in the post-war period.

But movement in this direction and assurance that unemployment will not again be permitted to develop on a substantial scale in this country would be of inestimable help in getting American farmers and business men to accept the sort of readjustments in our foreign trade that will be necessary if the gold flow is to be stopped (or better yet reversed). Once assured that they will not be thrown out of employment, they might be ready to see our tariff duties steadily lowered and sterling and other exchange rates dropped to levels at which foreign enterprise could offer vigorous competition in all the markets of the world.

<u>The exchange rate problem</u>

The problem of exchange rates is of crucial importance and is intimately connected with both of the monetary stabilization plans. Perhaps the best opportunity that we have had for a generation to get the foreign world into the right market relationship with the United States will occur in the transition from war economies to peace. This will be a period in which farmers and business men are meeting new situations on every hand. Techniques and markets will be radically changed from the pre-war period. If under these circumstances foreign countries link up with the dollar at exchange rates which are on the low side rather than the high side, the competitive pressures from abroad on particular American enterprises will be merely one of a host of new problems that they are meeting and that are inducing them to start in new directions. Exchange rates will not be singled out for blame. Such difficulties as there are in returning to the old markets will be attributed, and correctly so, to the far-reaching upheavals of the war itself.

With sufficiently low exchange rates foreign countries may be able to overcome our tariff barriers which yield but stubbornly and slowly to the direct action of trade agreements. They may be more nearly able to hold their home markets and compete in third markets against our highly efficient export industries. The exchange rate system can set up a persistent influence tending toward a smaller export surplus from the United States -- one that can be balanced by permanent financing operations rather than by the purchase of gold. In the end this tendency might carry far enough to start surplus gold flowing out of the United States in exchange for goods with which to raise the American standard of living.

A policy by the United States favoring moderate under-valuation of foreign currencies would be something new in the world. All our efforts in the 1930's were directed toward maintaining foreign exchange rates above the level to which market forces were tending to drive them. During the whole decade we fought against strengthening the competitive position of foreign countries although gold was flowing to the United States at an unprecedented rate.

In part this unwillingness to permit corrective action through exchange rate readjustments was due to the fact that much of the gold inflow represented what we called "hot money". We overlooked the substantial portion of this flow that represented the return of American capital from abroad and we probably underestimated very greatly the degree to which the so-called "hot money" represented a permanent shift of foreign resources to this country -- a shift which should have been balanced by goods rather than by gold. Even that portion of the gold inflow that resulted from our merchandise export surplus we came to regard as justified because of its effects on our domestic economy. If the problem was to build up the public's purchasing power and Congress would not let the Government distribute enough purchasing power to the American people in exchange for public works, but would let it distribute purchasing power to foreigners in exchange for gold for which we had no use, then it was constructive to buy the gold and obtain the stimulus to our industries that would come from the foreign spending of the dollars we had created. The difficulty with continuing such a policy is two-fold: 1) it assumes that the American people cannot be freed of their illusions and therefore must be denied the benefits of a more rational policy; 2) the policy which builds upon their illusions can last only so long as foreign gold lasts; and when the end comes it leaves us with a situation in which foreign countries are stripped of reserves and have tied up international trade in a desperate defense of their position while we are flooded with reserves and threatened with inflation. Whatever justification there may be for such a procedure when we are suddenly caught in a national emergency without an adequate domestic policy, it certainly cannot be justified as a permanent policy for the future. Yet in the meeting of June 21, when the American technicians were discussing among themselves what line to take with the British, an assistant to the President expressed grave concern lest the pound should be fixed too low and argued that this would be deflationary and we should be strongly on guard against it.

This is an attitude which would never let us realize on our accumulated gold. If the Federal Reserve System really wishes to prevent an inward gold movement and to get rid of some of our surplus gold to countries that can make effective use of it, it must be prepared to combat the viewpoint that is strong among the American public and Congress and even within the Administration that an export surplus is a good thing even though paid for in gold. To combat this attitude successfully, we must be able to suggest the broad outlines of a domestic program adequate to take care of whatever shifts in agriculture and business the alteration of our foreign trade balance may involve. Since this alteration should amount to only 1 or 2 per cent of our national income it ought not be too difficult for the country to manage -- particularly as the export surplus will be large, and legitimately so, for many years after the war. All that is necessary is that the surplus should be held within such limits that a gold outflow will develop. This, as the next section will argue, is quite consistent with a continuing, or even growing, export surplus financed by other means.

The investment program

While the stabilization mechanism is a wholly inappropriate device to finance a continuing export surplus from the United States, other financing on a large scale will be not only appropriate but necessary in the post-war period. Undoubtedly some billions of relief expenditures will be required. Relief will start even before the war is ended but it will terminate soon thereafter. Much more significant for the longer period is the possibility that international investment may be raised to a new pitch.

The Treasury is proposing a world investment bank as a companion piece for the Stabilization Fund. Others are thinking in terms of international and national development authorities financed in various ways. What is common to these plans is the endeavor to create machinery through which public funds will be turned into broad investment programs that will be based on the needs of a country's economy as a whole (and perhaps even of regions embracing more than one country) over long periods of time and at low rates of interest. The scale contemplated is larger than anything that we have known in the past. It is hoped that private investment as well -- particularly direct investment by concerns that can supply the necessary technical skills -- will be encouraged by the building up of roads, railways, communications, power resources, etc. through the public investment program and by the removal of exchange instability through the monetary agreement that is now being prepared for formal negotiation. The flow of public and private capital from the United States to the rest of the world might finance a very considerable merchandise export surplus for a long time to come. Not until new investments were overtaken by repayments on the old would the export surplus have to disappear or be paid for in gold.

There is another interesting possibility in the investment program as it is now being conceived in several quarters. It might be deliberately aimed at rendering the world less dependent on American exports.

Industrialization of agricultural or raw material countries would in some measure enable them to produce for themselves what they now import from us. It might also improve the prices that they get for their staple exports since it would cut their production of these or at least give them more diversified economies.

To help such countries to meet the drastic effects of business decline on the prices of their staple products another form of financing has been proposed. It has been suggested that international commodity corporations should be formed to purchase primary products at certain minimum prices and sell them again at certain maximum prices. How these prices would be determined and kept in adjustment with changing conditions need not be explored in this memorandum. Suffice it to note that such corporations might enable the primary producing countries, whose exports were hit by a decline, to continue for a period of years to buy from us more than they could sell.

The investment program taken as a whole, therefore, might finance an American surplus during the business cycle and during the much longer period in which new investment of a more permanent character was exceeding repayments; and it might also go far to reduce our export surplus through rendering foreign countries less dependent on our manufactures and through enabling them to obtain better prices on their commodity exports to us. All of this would serve to keep gold from flowing to the United States. It might conceivably reverse the gold flow.

Restraint on inflation abroad

A full production economy in the United States, relatively low exchange rates for foreign currencies, and large American investments abroad will all work in the direction of reversing a potential gold inflow; but their influence in this direction may be completely offset if inflation sets in abroad. There is a considerable chance that it will. Most European countries coming out of this war will face major problems of reconstruction. They will be committed to easy money policies and their Governments will be expected to act vigorously and on a broad front to get the job done. Reconversion of war industries to peace, rebuilding blasted areas, moving populations into properly equipped communities, supplying farm machinery and other agricultural needs -- in all these and other directions private or Government funds must get things moving. The demands, if liberally financed at home, may so far outstrip the physical capacities of the countries involved that prices will rise and the purchasing power will spill abroad. Much of it will be directed to United States markets unless prices rise correspondingly here. The measures mentioned at the beginning of this section may delay the process, but if foreign countries take advantage of them to respond more readily to what will seem to be the entirely legitimate demands of their own people, the day when foreign reserves will begin to be drawn upon to meet a chronic deficit with the United States will surely come. How far foreign countries can respond to the demands of their people will depend upon how large a volume of reserves they are prepared to throw into the breach. The more ample their reserves, the farther they can go. It is for this reason that it is important to bring their reserves under the discipline of the Fund and to give the United States viewpoint sufficient influence to achieve a Fund policy of restraint if over-expansionist policies are being pursued abroad. The danger is that the United States will be outvoted by the debtor countries, and hence the Federal Reserve technicians proposed a method of voting that would increase the United States voice in proportion to the extent to which foreign purchasing power massed on the United States through the Fund. Under their plan this would have been measured by the total gold inflow.

This is the chief way in which the Fund may help us to solve our gold problem. While it increases the potential gold problem by adding 2 or 3 billion dollars to foreign gold reserves in the form of an American contribution to the Fund, it gives us a recognized voice in foreign policies. Through the Fund we can influence both the pattern of world exchange rates and the domestic policies of foreign countries in such a way as to check the potential gold inflow and keep it from materializing.

If our own policy is clearly in this direction, if we are prepared to use our powers to act upon our own economy as well as upon foreign countries through the Fund, then we may go far toward achieving our objective. The precise voting system within the Fund may not matter too much. The other countries will not forget that they must keep the United States a member if they are to enjoy the credits that the Fund provides.

But if we are divided in our own minds, if half of us feel that an export surplus financed by gold is a good thing, then we shall not take the steps outside the Fund that will help eliminate this export surplus, and within the Fund we shall block foreign exchange rate reductions and be readily persuaded by the debtors that they should pursue their expansionist policies indefinitely and buy American goods since to make them live within their means would be deflationary. Under these circumstances not only will we get more gold under the Fund arrangement because the Fund itself supplies additional reserves, but we may also be sure that when dollars get short the Federal Reserve Banks will be called upon for extensive new credits to the Fund in order not to let American export industries down. These demands may be thrown upon us in such a way that to refuse them will bring us into opposition with the Administration -- even though to grant them will add new billions to member bank reserves on top of the billions already created by purchasing foreign gold.

Federal Reserve position

All of this means that inevitably the Federal Reserve System is deeply concerned with this country's attitude toward an export surplus financed by gold. It should use the occasion of the present international discussions to make that concern clear. The System is just as much affected and should be just as much interested in gold that may come here outside the plan as in the contributed gold of the Fund. It should continue to explore ways and means to use the Fund idea to gain control over the total gold movement. Partly this is a matter of alteration in the plan itself although the scope for further alterations now appears limited. Partly it is a matter of coming to an understanding with the Treasury that the System's interest in the policy of the Fund will be fully recognized. The arrangement by which this will be given effect should probably be worked out now before the System commits itself; for a Fund managed without reference to the System's credit problem would be worse from our standpoint than no Fund at all. We would be left facing increased foreign gold reserves without the protection of a Fund policy designed to keep them from flowing to the United States. The attitude of the Treasury on foreign exchange rates in the 1930's and its general lack of resourcefulness in developing measures to stem the gold inflow of that period augur none too well for the management of a Fund in which the United States is represented by its Treasury acting alone.

It must be recognized, however, that even the best administrative set-up cannot move much ahead of the country; and until the country is prepared to take the domestic and international measures necessary to reverse the inflow of gold, no politically feasible program will prove adequate for the job. The System should be prepared, therefore, for continuance of the gold inflow to a significant degree. It should also be prepared for participation in other forms of international financing in connection with the other international agencies that will make up the post-war program as a whole. Conceivably, the System will have so wide a margin of control over domestic credit in the post-war period that it can absorb 10 to 20 billion dollars of international financing without obtaining new offsetting powers. But the initial evidence indicates the contrary (see pp. 9-10 of the February 17 memorandum on "The British Proposal for an 'International Clearing Union'"); and if this is the prospect, the System should be developing the program and doing the preliminary educational work now to prepare the Administration, Congress, and the public for the requests that may later have to be made for powers adequate to enable the System to play its post-war rôle in the domestic and the international fields simultaneously. Here, too, it would be helpful to have an understanding with the Treasury that it appreciates the need for such a program and will lend it its support.

W.R.G.