FEDERAL RESERVE BANK

OF NEW YORK

PERSONAL

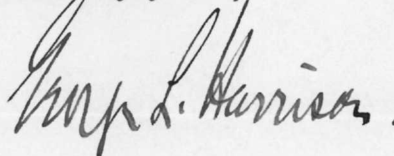
March 12, 1936.

Dear Marriner:

The enclosed informal memorandum was prepared here in the bank for our own information and use. It discusses a subject in which you are interested, however, and I thought you might like to read it, so I am sending it to you quite informally.

One comment should be made, today, concerning the memorandum: while it takes cognizance of fears of future wars in Europe as an important factor in the existing situation, it does not discuss the situation which would be presented if war actually were declared by any of the major European States. Such a development, of course, would create its own special problems which need not be anticipated for the purposes of the memorandum.

Faithfully yours,



Hon. Marriner S. Eccles,
Chairman, Board of Governors
of the Federal Reserve System,
Washington, D. C.

Enc.

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THE FRENCH FRANC

Recent strength of the French franc in terms of dollars, and recent gold movements from this country to France, have temporarily obscured the real position of the franc. In fact, there has been no change in the underlying position of the franc during recent weeks, that position being one of technical strength with an undercurrent of basic weakness, and the question of eventual devaluation or depreciation of the franc still is very much to the fore.

Devaluation or depreciation of the franc is not inevitable. The French balance of payments on current account has been brought approximately into balance largely through the imposition of import quotas and similar measures, which have reduced imports to a level about in keeping with the low volume of exports, the remaining excess of merchandise imports being covered by income from foreign tourist expenditures and shipping services. The gold reserves of the Bank of France would supply the ammunition for a considerable further period of defense of the present parity of the franc in the event of continued outward movements of capital. Furthermore, an outward movement of capital presupposes the existence of a safer currency than the franc, and adverse developments abroad, particularly such as might reflect upon the exchange value of sterling or the dollar, would be a barrier to such a movement. Finally, it is not certain that devaluation or depreciation of the franc, under present conditions, would solve France's economic difficulties, and the possibility of eventual readjustment through the continuance of other internal measures and further recovery abroad is present. Nevertheless, the next turns of the political wheel in France and the urgency of the French Treasury's financing problems may force the issue, and the mere existence of devaluation as a public question tends to create the conditions which eventually might bring it about.

It seems to be pretty generally conceded that the French elections to be

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held in late April probably will result in the return of a Leftist Government. It is claimed, but not generally conceded, that such a government would probably resort to devaluation of the franc to avoid the continuance of so-called deflationary measures, and to relieve the Treasury's position. It is generally conceded that no party is anxious to take the responsibility for devaluing the franc prior to the elections, this reluctance testifying to the uncertainty as to whether popular opinion would support such a move. What is not so certain is whether any government which may happen to be in power during the next two months would not embargo gold exports, in the face of further heavy gold losses, thus exposing the franc to depreciation. It may be said, I suppose that prior to the general election, if some semblance of government stability is preserved, devaluation or depreciation will be resisted, but the development of a political crisis, accompanied by a domestic flight from the franc, might upset this position. After the election, if some more or less homogeneous group of parties has a substantial majority in the Chamber of Deputies, the possibility of affirmative action will be present.

The French Treasury's position appears to be critical, and the permanent staff of the Treasury is reported to be receptive to the idea of devaluation. This may be due to the hope that devaluation, by strengthening France's competitive position in world markets and permitting more liberal import quotas, would prove to be a stimulant to French business, thus increasing revenue from taxation; that, by encouraging dishoarding of gold and currency, and repatriation of flight capital, it would relieve the present tightness of the money and capital markets, making conversion issues possible at low rates, and leading perhaps to a revival of new capital outlays; or even that some of the so-called profits of devaluation might be used to relieve the Treasury's position. The total budget has been out of balance for a period of years, and the deficits have continued despite recent efforts to reduce expenditures and increase revenues. It is estimated that the Treasury has to find a sum of perhaps as much as francs 2 billion new money, per month, during

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the first six months of 1936, and 18 billion francs during the calendar year. In addition, outstanding Treasury bills must be rolled over at the rate of approximately francs 2 1/2 billion per month. Refunding of old loans or raising new money by a long term issue seems doubtful of success under present market conditions - a 30-year sinking fund issue announced in December 1935 for francs 2 billion and yielding at least 5.45% was taken reluctantly, the books being open for 29 days. Additional borrowing by means of Treasury bills during 1936 seems to be faced with difficulties since the maximum to be outstanding has been fixed by law at francs 15 billion, which is about the present amount outstanding. Thisseeming prohibition of new issues of bills may possibly be avoided, but the market for these bills is no longer good. In the circumstances there have been persistent rumors, not lacking in some degree of officialconfirmation, that a Treasury loan (three months with renewals?) will be placed in London for anywhere from £40 million to £60 million (approximately fr. 3 billion to fr. 4.5 billion).* This would only meet the temporary situation which exists pending the elections and the accession of a government strong enough to take more permanent measures. In the circumstances, a Treasury leaning toward devaluation is understandable.

On the whole there is sufficient possibility of devaluation or depreciation of the franc during the present half-year, to warrant considering where we fit into the picture.

If France decides upon a change in the gold content of the franc she may (1) removethe obligation of the Bank of France to sell gold at the statutory price (convert its notes into gold) or embargo gold exports, and let the franc seek a new and lower level; or (2) she may devalue overnight and immediately reestablish the gold tie of the franc on the new basis. It is considered wholly unlikely that France will adopt exchange control on the German model.)

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*Subsequently announced as involving £40 million for nine months at 3%.

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It is not believed that the way of depreciation without defined limit will be deliberately chosen, although if the abandonment of the present parity took place during a period of political confusion this might be the way adopted. Such a step would do little to restore confidence in France and would increase international currency disorders. It is probable that the flight of French capital would continue or be accentuated in such circumstances, assuming that depreciation became effective in producing a surplus on current account which could be left abroad, and fear of inflation might promote a flight from the franc into commodities, equities, and real properties. Little would be accomplished toward relieving the stringency of credit. Because of her post-war memories of depreciation, and because of the temperament of her people, a depreciation without defined limit would be more dangerous and is less likely to be chosen as the vehicle of devaluation than in England or the United States. If this way should be chosen, the present elastic link of sterling with gold through Exchange Equalization Account operations in francs would be severed, leaving operations in the London bullion market as the only remaining link, and our own policy governing the sale of gold for export from the United States would be left in something of a vacuum. This possibility suggests the importance of continuing to press for a liberalization of our gold export policy so as to permit the sale of gold for export to any foreign central bank or monetary authority willing and able to pay our established price in dollars, in order that some link between the pound, the dollar, and gold may be established. If the Treasury does not wish to take such action prior to clarification of the situation with respect to the franc, it should be prepared to act, if and when the franc should be divorced from gold.

A moderate and fixed devaluation of the franc, however, if considered to be more likely than a policy which would permit depreciation without defined limits. Apparently by common consent the term "moderate devaluation" has come to mean a reduction in the gold content of the franc of from 15% to 25%, which would

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mean a franc worth about .056585 in case of a 15% devaluation, and worth about .04975 in case of a 25% devaluation. As far as we are concerned, a devaluation of the franc of this magnitude probably would be beneficial:

a. Removal of the handicap of an overvalued currency should promote a revival of production and trade in France and in other European gold bloc countries, whose currencies probably would be devalued following franc devaluation even though their economic and budgetary position is not wholly similar to that of France. This should be accomplished both through a strengthening of the competitive position of the export industries in the gold bloc countries, combined with a relaxation of import quotas, and through a restoration of confidence and consequent easing of money market and credit conditions;

b. Devaluation of the franc (and other gold bloc currencies) should permit import quotas to be relaxed, thus allowing expansion of imports as well as exports. French exports (and other gold bloc exports), on the whole, are generally not competitive with American products, and there is no reason to expect that our trade with other countries would be much affected by increased French (or other gold bloc) competition in world markets. On the other hand, increased imports into France (and other gold bloc countries) would benefit our trade directly or indirectly. The fact that the gold bloc countries have not participated in the partial recovery under way elsewhere in the past three and a half years has doubtless operated as a limiting factor in the recovery of these other countries, including ourselves. Moreover, the acute tension which has characterized both the internal politics and the external

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relations of most European countries probably has not been wholly unrelated to economic conditions, and there is some ground for hoping that European economic recovery might serve to relieve these tensions somewhat;

c. Devaluation of the franc, assuming that the prevailing attitude toward the pound and the dollar is not greatly changed, should result in a covering of short positions in francs, some repatriation of flight capital held in London, New York and elsewhere, and a dishoarding of gold. The effect of a moderate and definite franc devaluation on the foreign exchange market probably would be:

1. to depress sterling and related currencies, although this would doubtless be moderated by Equalization Account operations;

2. temporarily to cause an outflow of funds and gold from the United States;

3. eventually, if not immediately, to remove the premium on gold in London with relation to the sterling-franc rate.

The magnitude of the probable return movement of funds to France following a devaluation of the franc would depend greatly on surrounding conditions. In France, the popular opposition to devaluation is probably stronger than it has been in any country which has devalued its currency, making it difficult for any French Government to take bold and decisive action. It is possible, therefore, that devaluation would be preceded, accompanied, or followed by serious ministerial instability, thus preventing the development of a comprehensive financial and economic program and dissipating to some extent the renewed confidence in the currency which might otherwise be expected. This is merely to indicate that a substantial and rapid return movement of capital to France following devaluation is not a certainty. A reasonable guess is that devaluation would be followed, immediately, by some return movement of funds to France but that, thereafter, the return movement might be halting and gradual. It follows that we should expect some decrease in the amount of foreign funds held in this market immediately following devaluation, but after the initial withdrawal has occurred, subsequent reductions might be made only

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slowly. Since the London market would also lose funds under these conditions, and since a countervailing decline in sterling might be expected, the outflow of funds from New York to the European gold countries might be accompanied by a transfer of other balances from London to New York.

Furthermore, it seems unlikely that European war fears will subside sufficiently in the near future to encourage a large and continued movement of funds from New York to Europe.

d. If devaluation of the franc should lead to a decline in sterling, the latter movement might be expected to have some depressing effect on prices of certain international commodities in this country, and because of the importance which has been attached by the financial community to the dollar-sterling rate, security prices and prices of [illegible] actively traded commodities might also be temporarily depressed, particularly if speculative markets were in an extended and vulnerable position at the time. This possible development probably is not so important as it once might have been;

e. Devaluation of the franc should remove what has been considered to be one of the obstacles to a fuller world recovery and to ultimate general currency stabilization.

On the whole, it appears that a devaluation of the franc, such as has been discussed above, would be beneficial to this country. Our cue would seem to be

1. to stand fast upon the present gold content of the dollar, indicating that the change in the French currency is not looked upon as the beginning of another cycle of depreciation of currency units;

2. to facilitate the export of whatever gold might leave this country as a result of a return movement of funds to Europe following such devaluation. This gold should be drawn from the Treasury's general monetary stock rather than from the Stabilization Fund holdings, in order that the movement may have its full effect on excess reserves;

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3. to renew our suggestion (if not already acted upon) that our gold policy be liberalized to permit the sale of gold for export to any foreign central bank or monetary authority able and willing to pay the established price in dollars;

4. to re-explore the possibility of conversations looking toward an international understanding on currency stabilization, and more particularly cooperation between ourselves and the British.

Federal Reserve Bank of N. Y.

February 11, 1936.
February 18, 1936.
February 29, 1936.

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