Form F.R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 16, 1936

To Chairman Eccles

Subject: The Capital Inflow Problem

From Lauchlin Currie
L.C.

GPO 16—852

I wrote the attached outline of the capital inflow problem today. I hesitate to send you such a hastily written and inadequate memorandum, but I assumed that you would be talking about the subject with the Treasury tomorrow and that you would prefer a hasty survey of the problem by me to none at all. The tax angle promises to be a hard nut to crack. By the way, that Dutchman pulled a fast one on us by securing changes in the Revenue Act of 1936, which actually encouraged foreign investment as contrasted with the previous law.

It occurs to me that the staff Federal Reserve - Treasury Committee might take up this question immediately as it concerns the Treasury as much as it does us.

November 16, 1936.

OUTLINE OF THE PROBLEM OF CAPITAL INFLOW

Factual Background

It is estimated that foreign owned capital in this country in 1932 amounted to approximately $4 billion and at the present time amounts to over $7 billion. With no further inflow, the total will grow steadily and substantially through appreciation as recovery proceeds in this country. Moreover, since recovery has still further to go in this country than in England and many other countries, and since the prospects of political stability and peace are better here than abroad, it is a reasonable assumption that capital will continue to flow toward this country unless measures are taken to check the flow.

The Case for Restriction of Capital Movements

1. Monetary Control

(a) In an upswing of business

The general experience in this and other countries has been that capital flows in during and upswing and out during a downswing. It is, in other words, inflamatory rather than compensatory in its action. The supply of checking deposits and currency outside banks has expanded by over $10 billion or 50 per cent in the past three years, and is now nearly $4 billion in excess of 1929. It is questionable whether much additional expansion should be permitted. A net inflow of capital taking the form of gold results first in a corresponding expansion of checking deposits, next in a demand for securities and a tendency to lower interest rates, and finally in an expansion of excess reserves of member banks. Excess reserves now amount to approximately $2.3 billion. If the remaining power to raise reserve requirements were exercised to the full at this time only some $1.5 billion of the excess reserves could be absorbed. The System holds $2.4 billion securities, a substantial part of which it would doubtless be prepared to sell to wipe out bank reserves. There is, however, always the possibility that member banks may borrow back at least a portion of these reserves. It is obvious that an outflow of capital and gold now would be desirable from the point of view of the excess reserve problem, and it is equally obvious that a further inflow of a billion or so would render that problem so serious as to force the government to hold large idle balances in the Reserve banks. (One way of looking at this is that a further capital inflow would be purchased at the expense of the Reserve banks and the Treasury since it would force the Reserve banks to sell almost all their earning assets and the Treasury to pay interest on a greater volume of indebtedness than would otherwise be necessary.)

(b) In a business downswing

When capital in the form of gold flows out in the downswing it decreases checking deposits correspondingly, it drives down stock prices and drives up interest rates, and it decreases the reserves of banks, which, unless offset, may lead to further liquidation.

It is apparent, therefore, that the unrestricted flow of capital into and out of this country makes far more difficult the problem of monetary control.

2. Security Prices and Interest Rates

One of the factors that makes more difficult the attainment of economic stability is the instability of security prices. Foreign capital movements tend to aggravate rather than moderate that instability.

3. <u>National Loss</u>

Insofar as there is appreciation of principal and increasing dividends foreigners will be in a position to take more gold from us than they gave. It is not in our interest to bring about such an expansion of incomes and prices in this country so that we will import capital in the form of goods (a large excess of imports), since it is dangerous to make an income and price adjustment to such an unstable thing as capital movements. Even if it were there would still be a national loss, as we would be in a position of giving more goods than we had received, assuming as before that there is appreciation of principal and increased dividends. In both cases there would be a national loss, which distinguishes foreign profits on the purchases of our securities from domestic profits derived from the same source.

Our imports of capital in the Nineteenth Century came in largely in the form of goods and performed a real economic service in supplementing our meager capital resources to develop a continent. Since the war we have had an abundance of capital and the problem in the future may be that of finding sufficient outlet for home investment to keep pace with the possible declining marginal propensity to consume. Imports of capital, therefore, no longer perform an economic service comparable to the disadvantages they entail.

4. <u>Threat to Our Freedom of Action</u>

The larger the size of foreign claims on us that can be converted into gold at any time, the more is our freedom of action circumscribed.

One need only recall how the threat of a loss of gold was used to block any constructive efforts to check the deflation under Hoover to realize the strength and importance of this argument. It becomes even more relevant if we plan deliberately to unbalance our budget in the next downswing.

5. War

Foreign dumping of securities on our markets at the outbreak of the Great War forced the closing of the Stock Exchange. This could happen again. Utilization by foreign governments of the property of their nationals in this country would not only endanger our neutrality status but would cause internal disturbance in our security markets and production.

6. General

This subject touches upon the broad question of nationalism versus internationalism in economic matters. Some people feel that the more restrictions of various kinds are imposed the stronger will be the growth of nationalistic feeling, the less the possibility of maintaining peace, and the lower the standard of living of all countries. To restrict foreign capital imports would invite reprisals and would eventually result in less capital movements and less trade than would otherwise have occurred.

On the other hand it can be argued that the causes of the intensification of nationalism since 1914 have their roots far deeper than in trade and capital restrictions. These are symptoms rather than causes. The contribution we could make by removing restrictions might very well be more than counterbalanced by the domestic loss. Moreover these is some question as to whether we might not make a greater contribution by solving the problem of domestic stability. The smaller our international dealings relative to domestic production the less will our economy be exposed to disturbances originating abroad. The more our production becomes organized for world trade the less possibility there is of maintaining domestic stability in the face of world instability. Difficult as the solution of the domestic problem may be, the problem of achieving world stability is incomparably more difficult. If, on the other hand, we can achieve a decent measure of stable prosperity at home, we will have made a great contribution to world stability. Our demand for imports will keep up and of even more importance our example may induce other countries to adopt our methods.

Our domestic market is so enormous and our resources are so varied that the gains from continuous full employment at home would far outweigh the losses arising from our failure to utilize to the full the advantages of the international division of labor if such utilization entails, as seems likely, greater domestic instability.

Possibilities in Restricting Capital Movements

1. Exchange Control

This would be the most effective method, especially in preventing capital outflows. It is, however, much too drastic to be practical politically at the present. Something of a much less drastic nature might be done along this line, however, in requiring registration of all dealings in exchange and a declaration of purpose in each case. We had something like this in 1933 and it did not meet with much opposition. Such registration and declaration of purpose would be a most valuable aid in checking the evasion of other controls adopted and would in addition build up a body of information and administrative experience that would prove invaluable if at any time in the future it should prove desirable and feasible to institute exchange control.

2. Taxation

(a) Present Status

Under the Revenue Act of 1936, capital gains accruing to nonresident alien individuals and corporations are exempted from tax. Nonresident alien individuals are subject to a 10 per cent tax on their income other than capital gains derived from sources within the United States. This is deducted at the source. Formerly all income including capital gains derived from the United States by nonresident alien individuals was subject to the normal and surtax rates applicable to residents of the United States.

Nonresident foreign corporations under the 1936 Act are subject to a flat rate of 15 per cent on the gross income from sources within the United States, exclusive of capital gains, except that the rate on dividends is 10 per cent. Formerly they were subject to a tax of $13\frac{3}{4}$ per cent on the net income including capital gains.

The rates applicable to residents of Canada and Mexico may be lowered to not less than 5 per cent by treaty.

It is apparent that the changes made in the Revenue Act of 1936 had the effect of making foreign investment in the United States more attractive.

(b) Capital Gains Tax

Capital gains of nonresident alien individuals and corporations might not only be made subject either to a high, flat, or a steeply graduated surtax rate, but the rates might be made much higher than those prevailing before 1936.

A high capital gains tax should make foreign investment here less attractive. A problem would immediately arise as to whether the tax should apply to stocks already held or only to future purchases. An argument for restricting it to future gains arising from future purchases is that otherwise "legitimate expectations" will have been disappointed and injustice done. Moreover it might be said we are only concerned with preventing future inflows of capital.

The validity of both these arguments is open to question. Foreigners have no guarantee that no change in tax legislation will be effected. That is one of the chances they take in investing in another country. We would not let the "legitimate expectations" argument weigh with us if it were a question of raising the capital gains tax on our own citizens and it is difficult to see why it should have greater weight in the case of foreigners. In the second place, we are not concerned solely with future inflows. The appreciation of existing foreign holdings would make our position more vulnerable and hence should be prevented as far as possible. Another argument for making the higher tax apply to securities purchased in the past is that it might induce some anticipatory sale of securities and removal of funds which would lead to an outflow of gold, a reduction in excess reserves and less possibility for appreciation of foreign holdings here in the future.

A high capital gains tax would by itself appear easy of evasion through the simple device of developing markets in our securities abroad. It might, however, be rendered more effective by being supplemented by the two following taxes.

(c) A Purchase Tax of Five or Ten Per Cent on Stocks purchased by or on Behalf of Foreigners

Foreigners would undoubtedly be deterred from purchasing our stocks if they had to pay substantially more than the open market price. They could, however, get around this by having Americans buy the securities for them or by having Americans sell them the securities abroad. This could, of course, be met by making any American buying stocks for or on behalf of foreigners responsible for the payment of the tax and by making Americans selling securities abroad pay the tax.

(d) A Higher Tax on Dividends

A higher tax to be deducted at the source on any dividends payable on stocks registered in the names of foreigners would not only act as a deterrent to foreign investment in our securities but would in addition act as a deterrent to the actual physical shipment of securities abroad in order to evade the capital gains or purchase taxes.

(e) Some General Comments

It is obvious that this subject requires careful study. The status of Canadian investors is one problem. The advisability of discrimination as between direct investment in plant, etc., on the one hand, and in securities on the other, would have to be studied. The advisability of discrimination as between types of securities (for example bonds and stocks) may also arise. Possibilities of evasion would have to be studied not only for loss of revenue and from the viewpoint of discouraging capital inflows but also from their repercussions on the security markets.

On the basis of a cursory survey it would appear desirable to impose various taxes which would supplement each other. Short of exchange control it would be difficult to prevent evasion if people were prepared to break the law. Breaking three or four laws, however, is more of a deterrent than breaking one. Compulsory declaration by Americans or alien residents of any operations on behalf of foreigners might be provided, with heavy penalties for failure to make such declarations. This, in conjunction with a declaration of purpose in buying or selling exchange, would act as a deterrent.

Even if there were a good deal of evasion the various measures suggested might prevent the bulk of capital inflows. It is not to be expected that reputable banks, insurance companies, and investment trusts abroad would care to break the laws of this country.

3. Variations in Exchange Rates

The greater the assurance that exchange rates will remain fixed the less is the risk of foreign investment here. It might be helpful, therefore, either as a normal procedure to cause sterling to vary up and down within a limited range, or, if we return to a modified gold standard, to set the gold points say 5 per cent apart. This suggestion was once made by Keynes as a means of discouraging capital movements in response to differences in interest rates.

4. Margin Trading

We might prohibit the borrowing on stocks by or on behalf of foreigners.