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Confidential

THE GOLD PROBLEM

by

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The problem

Since the dollar was revalued in terms of gold in January 1934 this country has added $5,000,000,000 to its central gold reserves. The acquisition of this gold has been the dominant factor in the increase of member bank reserves. In order to prevent the market from getting entirely out of hand, the Board has raised reserve requirements to the full extent permitted by law, and the Treasury, beginning December 24, 1936, has added all its regular gold purchases to an inactive account, thus preventing the current gold movement from again building up excess reserves to unmanageable proportions.

It may not, however, prove feasible to continue this inactive account of the Treasury indefinitely. The account was instituted at a time when the market for Government bonds was at its peak, tax returns were being overestimated, and there was little significant talk of economy. During 1937 this picture has changed considerably. The market for Government bonds has been a matter of concern, tax returns have proved disappointing, and an effort to balance the budget is under way. Funds for crop insurance, low cost housing, and other important purposes may have to be pared, and many demands with strong pressure groups behind them may have to be denied altogether. With Congress made uncomfortable by these restrictions growing out of the situation of the budget and the public debt, it is a question how ready it will be to permit the Treasury to go on increasing the public debt without limit for the benefit of foreigners unloading their gold on the United States. Congress may presently want to know why this country should be subsidizing the gold production of the British Empire and Soviet Russia when American needs are going unsatisfied. The chances of a Congressional revolt on the gold sterilization policy will increase the more conspicuous and burdensome the inactive account becomes.

At present the account is in excess of $650,000,000. This accumulation has occurred in less than five months. During this period the United States has been running a substantial excess of merchandise imports and the flow of interest and dividends, tourists' expenditures, etc., has on balance involved some payment to foreigners. The inward movement of gold during the period has been due entirely to the movement of capital. How much further is the capital movement likely to go?

During the first seven months of the new currency arrangement the movement of capital was largely in the form of purchase of securities. Europe was faced with grave political uncertainties, and the American recovery was in full swing and finding reflection in a buoyant stock market. With the reversal of the stock market advance in March, however, foreign buying of American shares dwindled and finally turned to sales, although redemption of foreign dollar bonds in this market continued. Then in April came (1) the reluctance of the British Fund to buy gold,

(2) heavy American purchases in the London bullion market where the regular supplies were being augmented by offerings of Russian and dis-hoarded gold, and, (3) partly as a consequence of these American purchases, a strong tendency for sterling to rise. The rise in sterling on the exchange market to levels well above those that had obtained during the seven months of the new currency arrangement was regarded by speculators as temporary -- particularly as there were persistent rumors of a revaluation upward of the dollar -- and short-term funds moved from London to New York. Thus a gold movement which in its early phases reflected the attractions of our stock market and the ability of prospering raw material countries to buy back their dollar bonds became in April almost wholly a matter of the speculative movement of short-term funds.

If this were the whole story, if the stock market movement were permanently ended and only the speculative movement of short-term funds remained, there might be good grounds for anticipating that the gold flow to the United States would soon shrink to small proportions. As speculators became used to the higher level of sterling, the movement in anticipation of a decline of sterling would cease. England could not through its reluctance to buy gold permit sterling to be driven by American gold purchases to $5.00 and beyond without violating the spirit of the Tripartite Declaration. It seems improbable that the British will go to any such extreme. To avoid it they must be prepared to buy gold to whatever extent it is necessary to hold sterling down.

The Fund has in fact been holding sterling stable at approximately $4.94 since the end of April. If this becomes the accepted rate, the current movement of speculative short-term funds from London to New York will cease.

But two major possibilities remain. In the first place a resumption of the upward course of the stock market is wholly probable. As it develops it will once again attract foreign investment capital. There is some question whether the returns to be made in our stock market will draw capital from the rest of the world only during the period of swift business recovery or whether we are still a relatively young country which for the next generation will attract foreign capital because we are paying more for it than are competing borrowers. Looking to the longer future it may be that the raw material countries and backward industrial areas will be found to exert a greater attraction for capital than the United States which, once recovery is out of the way, may reveal itself as a relatively mature country with an abundance of domestic capital for which it is difficult to find outlets. Already recovery in the raw material areas has reached such impressive proportions that much British and Continental capital may be expected to turn toward these regions instead of expanding American positions that have become overdeveloped. But while the upward movement of business is in progress in this country, American stocks will undoubtedly remain the largest, and in many ways the most attractive, outlet for the mass of disturbed European capital.

In addition to this major reason for expecting a continuance of the capital inflow over the next few years, there is another reason more subtle and more difficult to appraise. The world is uncertain about gold. A market has to be found for the output of mines now running at the rate of $1,200,000,000 a year with every prospect of a substantial increase. The United States Treasury has billions of gold which it cannot use and the British, if they revalued at the current market, would have an enormous gold increment which they in turn could not safely use. Among the smaller peoples the Dutch are being seriously embarrassed by a persistent gold inflow and the Swedish have been considering reducing their price for gold in order to control their domestic cost of living. With supplies of gold on the bullion market rising and the most important outlets surfeited, what is the assurance that the value of gold in world currencies will be maintained? Gold, which through the depression has been regarded by many as safer than any currency, and has, with few interruptions, either risen or maintained its high level as against the leading currencies, is now threatened with perhaps a substantial decline in price. At best no further advance is in prospect. If this view of the situation spreads and takes a strong hold, not only may the already large dishoarding movement grow but, what is more important, a <u>general</u> unwillingness on the part of foreign governments and central banks to add gold to their reserves may develop. To be sure those countries which have a favorable balance of payments must add to their international reserves in order to prevent an uncontrolled rise in their currencies. But the authorities in these countries can stabilize their exchanges just as easily by purchasing dollars as by purchasing gold. And if they are of the opinion that any shift is likely to be in the direction of a lower price for gold and a higher price for dollars, they may well prefer dollars. That is, a situation may develop in which gold will no longer be distributed in accordance with the international movements of trade or even the flow of private capital; central banks abroad may reverse this private balance of payments by themselves accumulating dollar reserves to whatever extent may be necessary to turn the tide of gold toward the United States. This would be a development of the first magnitude. It would mean that any action we might take to destroy the attractiveness of our stock market to foreigners or to encourage imports of foreign goods would be without material influence upon the inward movement of gold. It is not likely that such a viewpoint abroad will ever take hold 100 percent. Gold has too long a tradition behind it and there is, furthermore, a limit to the amount of dollars that foreign monetary authorities abroad would be willing to acquire. But the idea may become sufficiently persuasive to lead to a very substantial growth of foreign central bank balances in this country.

Thus both in securities and in balances there are possibilities of a sustained inward movement in the next few years. Further deterioration in the political fabric of Europe, or even the absence of improvement, would contribute to the movement. For several years at least the Treasury may have to continue accumulating gold at the rate of $1,000,000,000 or more a year unless action is taken to stem the investment inflow and to curtail the offerings of new gold. These are the possibilities that must be faced by the Treasury. And the Federal Reserve Board is even more concerned than the Treasury, for should the latter stop its sterilization policy and liquidate the inactive account, the whole gold accumulation since 1936 would be dropped into member bank reserves. The fact that such a move might materialize in 1938 or 1939 when the business situation might call for restraining action would make it the more serious.

First step: assurance of adequate powers to offset gold inflow

All measures to deal with the situation in a fundamental way will take time. Meanwhile the Treasury must continue with its present sterilization policy. If it comes to be attacked by Congress it can be defended as an essential instrument of credit policy which is costing the Treasury only a few million dollars interest a year. At the present Treasury bill rate of 0.7 percent the annual carrying charge on $700,000,000 of inactive gold is $5,000,000. The fact would remain that the United States is continuously giving foreigners valuable American goods and securities in exchange for unwanted gold; but it can be argued at the moment that $5,000,000 a year represents the only difference between the new policy of sterilization and the old policy of crediting the gold certificate fund of the Federal Reserve. It should be possible to put up a vigorous case for paying this cost many times over in order to prevent inflation and preserve an orderly business recovery.

The fact remains, however, that the policy may be abandoned. It is essential, therefore, for the Federal Reserve System to prepare for the day when it may have to handle the task now performed by the Treasury. It is probable that to handle such a task the Board will require additional powers to raise reserve requirements and that these additional powers can be effectively exercised only if the bulk of the banking system is compelled to retain its Federal Reserve membership. Power to issue debentures, while useful in short emergencies, would not appear suitable for handling an increased gold base that might last indefinitely. It would involve too great a drain upon the system's earnings which ought always to be sufficient to be disregarded. Whatever course is decided upon as feasible should be pushed at this time in order to be ready for the day when the Treasury's sterilization job may have to be taken over.

<u>Second step: specific action to curb the inflow of investment funds</u>

While we prepare to handle a further large inflow of gold, we should adopt measures designed to diminish the flow as much as possible. The factor which has bulked largest in the gold inflow of the past year and which appears to have the greatest future potentialities (aside from a refusal of foreign central banks to buy gold) is foreign participation in the stock market advance. This factor can be curbed by action specifically directed at it -- namely, heavier taxation of the dividends and capital gains paid to foreigners. Both international good will and effective enforcement would be served by keeping these taxes in rough equivalence to the American tax burden; this should permit doubling the present taxes on foreigners. The move could be explained abroad as one designed to assist in the maintenance of a stable international currency system and as such it would probably be accepted. Together with the less assured prospects of steady advance in our stock market it might go far to keep foreign investment down.

Third step: checking the sale of bullion market gold to the United States

Even if foreign investment in the United States were completely stopped, however, the gold flow to this country might not cease. There would remain the problem of disposing of the annual product of the mines ($1,200,000,000 in 1936) and sales from existing hoards (now probably less than $1,000,000,000) and from Russian reserves (perhaps $1,000,000,-000) to say nothing of dishoarding from India which is now dwindling and may presently reverse itself.

Now if the faith of monetary authorities in gold at its present price is unimpaired and if exchange stability is still their object, then this bullion market gold should give rise to no insuperable problem for the United States. But if central banks in foreign countries with favorable balances of payments have greater faith in the dollar than in gold they will settle their international balances and hold their currencies stable by purchasing dollars instead of gold. It is here that the possibility developed on page 6 comes into play -- namely, that the

United States may willy-nilly and for some time to come be made to buy a very substantial part of the gold thrown on the bullion market. How to deal with the problem created by the gold mines and other sources of bullion market supply?

This is undoubtedly the most difficult problem to be faced. It may prove so little possible of solution that dependence will have to be placed on measures such as those suggested in the previous two sections. A more fundamental solution, however, is desirable. Certain possibilities are examined in the remainder of this section.

The most radical possibility is outright abandonment of gold. This would stop all accretions to reserves through the bullion market, but it would also deprive the world of what has hitherto proved to be the one generally acceptable international means of payment. Without it, it would be difficult to maintain a stable international monetary system. If the abandonment of gold were general, the dollar could be kept from shooting about under the influence of capital movements only by operations in foreign currencies; and the United States authorities, who command $12,000,000,000 of gold, have only a few millions of foreign currencies. A position that is now absolutely secure against foreign withdrawals would overnight become completely vulnerable. The United States with the largest stake in gold of any country today cannot afford to contemplate the abandonment of gold.

On the other hand it would be technically feasible to confine gold operations to the circle of participants in the new currency arrangement. The United States, which now sells gold only to these participants, could confine its purchases also to these participants, and the other members could similarly limit their gold transactions. At one stroke this would freeze out the bullion market which would then have to sell to industry, to hoarders, or to central banks outside the scope of the currency arrangement. None of these outside banks are under any compulsion to buy gold at current market prices. The price of gold in the bullion market would undoubtedly fall precipitately. But this fall in turn need not affect the countries in the agreement. They would be acting independently of the bullion market and stabilizing their currencies by gold transactions with one another at quite a different price -- possibly at the present $35 an ounce. One of the unwritten rules of the group would have to be that inasmuch as the danger of fresh accretions from the bullion market was past and gold was subject to their common management, they would operate in it freely for stabilization purposes and would not settle international balances by accumulating one another's currencies. That is, there would have to be a gentlemen's understanding that the monetary authorities would not hold balances in other countries in excess of operating needs. Any surplus would be immediately converted into gold. This gold would be distributed according to the flow of private international transactions and not arbitrarily concentrated in any one country through the reluctance of monetary authorities elsewhere to hold it.

The chief weakness of this plan would be its very effectiveness. It would ruin the gold industry. The British Empire which produces $650,000,000 of gold a year (more than half the world's output) would never consent to a plan which, it could plausibly argue, was mainly for the benefit of the United States. It would be necessary to adopt some compromise -- possibly an arrangement by which each participant would be permitted to buy its own production. Incidentally the United States has a production of $150,000,000 a year.

Such a compromise would exclude Russian and dishoarded gold, but would do nothing to reduce the accretion to monetary gold stocks from the annual output of the mines. While the British Empire would be the primary buyer from the mines, much of the gold might later pass to other participants through the balance of international payments. The United States, however, would receive only such gold as its balance of payments brought -- it would be protected by the gentlemen's understanding from the arbitrary shifting of the gold movement to this country by the preference of monetary authorities abroad for dollars rather than gold. This, together with the cutting off of Russian and dishoarded gold, would be a major step.

The British Empire on the other hand would have kept open world markets for its gold production to the extent that the international balance of payments carried gold elsewhere; and this is all it could legitimately ask. The fact that under the arrangement it had to purchase all the gold from its own mines and hold it till there was an international use for it would probably make it seriously consider steps toward restriction of outputs. South Africa might be offered the alternative of receiving a price for its gold from the British Fund considerably below the monetary price or of putting much heavier taxes on its mines -- taxes sufficient to bring a real restriction of output. In the former case the British Fund would make a profit out of such gold as the British balance of payments enabled it to sell abroad. In the latter case the South African Government would receive larger revenues. Either method would be more to the advantage of the Empire than a cut in the world monetary price for gold -- a cut with which the Americans might threaten them unless they took steps of their own. And however it came out, the growth in South African production of gold would be deterred.

A cut in the monetary price of gold, however, would probably be the least satisfactory of the three methods. For a number of reasons -- psychological effects, existing monetary legislation, the limited amount of gold increments from which the cut would have to be taken -- a 20 percent reduction in the monetary price of gold would be almost the maximum possibility at the present time. A cut of this magnitude would have little effect upon production in South Africa, which is the world's greatest producer. In recent years South Africa has expanded its plant and attracted a large additional supply of native labor into the industry without any advance in wages. Gold production costs are up only because a lower grade ore is being mined in order to take advantage of the high current price for gold. Should the price now be reduced 41 percent to the old level of $20.67 an ounce, South Africa could shift back to the same grade of ore it was mining in 1931 when production was almost as large as it is now. This would shorten the ultimate life of the mines, but the probability is it would not curtail current production, for prices and costs would be roughly the same as in 1931 and plant and labor supply would be greater. A 20 percent reduction in the present price of gold might not even stop the mining of much low-grade ore. Under the arrangement suggested in this section, however, a real restriction could be achieved either through the British Fund reducing the price offered to the mines to a point low enough to be effective or, better, through heavy taxation by the South African Government -- the inducement to such action lying in the reluctance of the British to accumulate further gold reserves.

An arrangement of this character in which each country dealt with its own gold producers might later evolve into some general move to place gold mines under a system of world control. Certainly any plan to buy the mines could be more easily effected after a period in which the precariousness of their position had been made evident. And one of the major drawbacks to such a plan -- namely, that Russian mines could not be bought, thus leaving the world's second largest and fastest growing producer free to expand United States and European reserves -- would be met by the fact that the group of countries would buy gold only from each other.

Although this group would start with the six countries now adhering to the Tripartite Declaration there would, of course, be every advantage in enlarging its scope. A country like Sweden could presumably join at any time. It would, however, be necessary to limit membership to countries with stable currencies and reasonably free exchange markets -- otherwise the all-important understanding that gold should be allowed to follow the international balance of payments on private account would be of doubtful significance.

Fourth step: lowering the price of gold to curb a boom

Up to this point it has been suggested that immediate action must take the form of sterilization measures; that a substantial increase in the tax on foreign investments here, however, would go far toward making sterilization measures unnecessary were it not for the sale of bullion market gold to the United States; and that the bullion market could perhaps be controlled by an arrangement which would exclude dishoarded and Russian gold and would provide for the distribution of mined gold in accordance with the international balance of payments on private account. It was also suggested that the arrangement offered a practical point of departure for measures to curtail mine output.

Nothing has been said so far about using gold policy to raise the dollar rate of exchange. This is not because a major upward shift in dollar exchange is regarded as ineffective. On the contrary, it would be one of the most pervasive influences that could be brought to bear.

It would play directly upon our whole balance of trade and would probably affect the longer prospects for recovery to such a degree as to have severe reprecussions in commodity and security markets. Therein lies the difficulty. Although a major upward adjustment of the dollar would undoubtedly hasten the day when the gold inflow will cease to be important, it might do so to the bitter expense of our domestic situation. It would be distinctly dangerous to contemplate it in any form in the present rather chastened state of business.

Furthermore we could not undertake it without an agreement with foreign authorities, since they can change their gold price pari passu with ours. It is very doubtful whether England at this jucture is prepared for a $4.00 or even a $4.50 pound. England has an armament program on its hands at the moment. What is called for now is not financial reserves as in 1931, but physical production. A high pound will tend to keep British production at home and service it with cheap raw materials. A low pound will assist only in bringing the country gold or price inflation -- one of which it does not want, the other of which it is beginning to dread.

The time to attempt a substantial upward revision of dollar exchange will be when its deflationary effects in this country will be deliberately intended because a business boom is under way, and England will be inclined to accept the shift because its own boom has passed. Such a time may come within the next few years.

Meanwhile it seems best to stick to the currency arrangement inaugurated last September and the system of exchange rates which it was designed tentatively to stabilize. The course of our balance of trade and of various international services indicates that we are working steadily toward a position that, aside from capital movements, would lead us to lose a substantial amount of gold. The capital movements may be temporary and can best be controlled directly by taxation. The more fundamental balance -- the balance which reflects relative costs of production -- appears to be satisfactory. No shift in dollar exchange is indicated on this account.

On the other hand, should a phase in the recovery be reached in which a rise in dollar exchange would act constructively on the domestic situation, our international position is strong enough to stand the rise. If it should lead to a sustained flow of gold from this country to the rest of the world, it would be a fortunate outcome. Most foreign countries can stand some building up of their reserves available for international use even if it drives them to impose legal reserve requirements upon their commercial banks.