BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 10, 1947

To Chairman Eccles

Subject:

From Mr. Knapp JBK

I am transmitting herewith a copy of a report concerning the problem of loans on gold which has been prepared by the Staff Group on Foreign Interests for the consideration of the Policy Group.

Also attached is a copy of Mr. Sproul's letter to the Secretary of the Treasury dated November 8, 1946, which precipitated our discussion of this subject.

I am sending copies of these documents to Governor Evans and Mr. Sproul in their capacity as members of the Policy Group. Shall I circulate copies to the other members of the Board? Also, shall I send copies of the Staff Group report to the Presidents of the other Reserve Banks? In this connection I would call your attention to the fact that Mr. Sproul has put the subject of loans on gold on the agenda for the coming Presidents' Conference.

Attachments 2

February 7, 1947

To: Policy Group on Foreign Interests   Subject: Loans on Gold

From: Staff Group on Foreign Interests

On November 8, 1946 President Sproul of the Federal Reserve Bank of New York addressed a letter to the Secretary of the Treasury proposing a conference among representatives of the Treasury, the Board of Governors, the Federal Reserve Bank of New York, and perhaps the State Department, to discuss policy questions relating to loans on gold. President Sproul transmitted a copy of this letter to Chairman Eccles with the suggestion that the matter might be studied by the Staff Group on Foreign Interests, a suggestion with which the Chairman concurred. The Staff Group has discussed this subject and desires to submit to the Policy Group the following recommendations:

A. Recommendations:

(1) Short-term loans on gold by the Federal Reserve Banks

It is an appropriate function of the Federal Reserve Banks to make short-term loans on gold to foreign central banks (and governments) which require dollar funds to meet temporary requirements for foreign exchange. In order that all foreign correspondents of the Federal Reserve Bank of New York may be fully aware of this facility, it is suggested that the Board and the New York Bank consider including in their next Annual Reports a descriptive statement covering this and other services performed by the System for foreign correspondents.

(2) Loans on gold by private institutions in the United States

A foreign central bank (or government) may desire to pledge its gold under earmark at the Federal Reserve Bank of New York as collateral for a loan from private sources in the United States, either because the loan is of a type that the Reserve Bank would not desire to make, or because of other reasons. At present no barrier should be raised to such a transaction by denial of facilities at the New York Bank or by refusal of the appropriate treasury gold licenses, unless the proposed loan appears to be requested primarily for speculative purposes.

B. Discussion:

Loans to foreign central banks and governments against the security of gold were not unusual before 1933; they were made by many central banks and by the large commercial banks in New York and probably in London and other large financial centers abroad. Such loans were not frequent, however. Since 1933, the Federal Reserve Banks have been asked to make, and have made, such loans with increasing frequency, but the large American commercial banks made but one such loan* until February 1945, when a syndicate headed by the Chase National Bank made a 100 million dollar loan to the Netherlands Government against gold earmarked at the Federal Reserve Bank of New York. Since then, a number of applications have been made by American commercial banks for licenses under which gold earmarked with the Federal Reserve Bank of New York would be set aside as collateral for loans to be made by them to various foreign banks. The increase since 1933 in the frequency of applications by foreign countries for dollar loans against gold appears to be due in the main to two factors: (1) the fact that since the early thirties the world has not had an international monetary standard based on an unrestricted flow of gold between

* A $300,000 loan on gold located in London, made in the early thirties.

countries, even with respect to balance-of-payments settlements by central banks and governments; and (2) the need of various foreign countries for dollars for the reconstruction of their economies and the reestablishment of their foreign trade at a time of extreme unsettlement in their financial, economic, and political affairs.

Although the Gold Reserve Act of 1934 restored convertibility of dollars into gold and of gold into dollars, it contains provisions for Treasury control (in the form of a licensing system) that give grounds for some uncertainty as to the ability of foreign countries to buy and sell gold freely in the United States. It also contains provisions, as yet unrepealed, which apparently have led to questions abroad as well as at home as to whether the price of gold in this country may be changed by administrative action.* Furthermore, under Treasury regulations, a 1/4 per cent handling charge for purchases and sales of gold was imposed, which makes it cheaper for foreign countries to meet short-term needs for dollars by borrowing from the Reserve Banks at present interest rates rather than by selling and subsequently repurchasing gold.

In view of the possible influence on the increase in applications for gold loans of these three factors, i.e., the Treasury gold licensing system, uncertainty about the United States' gold price arising from certain existing legislation, and the Treasury's 1/4 per cent handling charge for gold transactions, the Staff Group expects to give further consideration to these matters with a view to possibly formulating

* I.e. because of the power of the Secretary of the Treasury to buy and sell gold at such prices as he may deem advantageous to the public interest (Secs. 8 and 9 of the Gold Reserve Act of 1934). Section 12 of the Act, authorizing the President to alter the gold content of the dollar, was permitted to lapse by the Congress on June 30, 1943.

recommendations, which could be communicated to the Treasury at an appropriate time, with respect to desirable changes in the Gold Reserve Act, and in the Provisional Regulations issued thereunder.

The principal consideration which has led the Staff Group to recommend that no barrier be raised at this time to foreign loans on gold for legitimate purposes is that the prohibition of such loans would impair the usefulness of gold (especially gold held in New York under earmark), and diminish the inclination of foreign countries to hold gold. A wider distribution of world gold reserves is considered to be in the interests of the United States. Undue concentration in this country of the ownership of monetary gold reserves might lead to pressure for demonetization of gold in the rest of the world and would in any case force this country to hold for an indefinite period an unproductive international asset. Loans on gold at least have the merit of leaving the unproductive asset in the hands of foreign countries. Since we want to encourage foreign countries to continue the policy of holding reserves in the form of gold, we should try not to interfere with their ability to raise funds readily by either selling or pledging their gold when any need arises. Indeed, if we deliberately restrict the usefulness of gold as collateral, foreign countries may be induced increasingly to switch their international reserves out of gold and into interest-bearing U.S. Treasury securities, which would be usable as collateral on dollar loans; in such case, the United States not only would acquire an unproductive international asset but also would incur an interest obligation to foreign countries.

It is recognized that loans on gold are subject to certain abuses. As suggested by President Sproul in his letter to the Secretary of the Treasury, foreign central banks may at times engage in the improper practice of continuing to show gold in their reserve position even though it has been pledged against a loan, thereby in effect making use of the gold while giving their public the impression that the reserves remain intact. Most central banks which have engaged in this practice, however, seem to have shown a corresponding foreign exchange liability in their balance sheet and where this has been done the deception is not a very flagrant one. While the practice of including pledged gold in the monetary reserve should certainly not receive any encouragement, the fact that some central banks engage in it should not be the determining element in our decision whether to make loans against gold generally, nor should a foreign central bank be refused a gold loan which has sound economic justification merely because it indulges in the aforesaid practice. It would, moreover, be inappropriate for the System to make it a condition of any gold loan that the pledged gold be deducted from the borrower's monetary reserve. It may be desirable, however, to call the attention of the U.S. Executive Director in the International Monetary Fund to any undue spread of the practice of not revealing pledges of gold for dollar loans, with a view to possible action by the Fund to discourage this practice.

A second possibility of abuse arises from the fact that any country which borrows dollars on gold rather than selling it outright is thereby placed in a position to profit from an increase in the dollar price of gold. The same is true of course of a country which borrows dollars in any other form while retaining gold reserves, or which liquidates dollar reserves instead of gold reserves to meet a balance of payments deficit. Indeed any action by which a country seeks to maintain (or increase) its gold holdings can be said to involve an element of speculation on the future price of gold. The Staff Group believes that this factor should not be ignored and that where the speculative element appears dominant access to lending facilities in the United States should so far as possible be denied. It is of the opinion, however, that loans on gold should not be refused to countries whose requests appear to be governed by their needs for foreign exchange rather than by speculative intent. A policy of refusing such loans would lead logically to restrictions upon other forms of borrowing in the United States by a country which at the same time was holding gold reserves, and it would not give adequate weight to the interest of the United States in encouraging a broader international distribution of world gold reserves. In any case, American commercial banks might escape restrictions imposed through the licensing procedure by making loans against gold located abroad.

As an example of an operation in which the speculative element would appear to have been dominant, the Staff Group would cite the recent experience with the central bank of Uruguay. This Bank had bought dollar exchange forward from exporters who could not move their goods abroad because of wartime shipping shortages. In order to convert its long dollar position into a long gold position, this Bank borrowed an equivalent amount of dollars from the Reserve Banks against the pledge of earmarked gold and invested the proceeds in further gold purchases. Indeed it sought to renew its loans for this purpose after the original occasion for the loans -- i.e. the shipping shortage -- had apparently passed. Following informal discussion of the matter in the Staff Group, the New York Bank, with the approval of the Board of Governors, declined to grant renewals. It had become clear that Uruguay was not borrowing to meet a demonstrated need for foreign exchange, but was motivated simply by a belief that gold was a better asset to hold than dollars -- i.e. that an increase in the price of gold was to be expected. It is possible to argue that the action of the central bank of Uruguay was more in the nature of a "hedge" than an outright speculation, since _if_ dollars were to depreciate against gold without a corresponding depreciation in the gold value of the Uruguayan peso, the Bank might suffer a loss in terms of pesos from the maintenance of a long dollar position. Opinions differ as to whether any hedge was ever really necessary (i.e. as to whether in practice it was reasonable to believe that Uruguay would not follow the United States in any change in the gold price), but in any case with the passage of conditions requiring the central bank of Uruguay to take an abnormally large forward dollar position, any special need for a hedge disappeared.

The Staff Group desires to offer the following further comments on its recommendations, noting that in all cases of loans on gold it is assumed that "political clearance" will continue to be obtained from the State Department:

(1) _Short-term loans on gold by the Federal Reserve Banks_

These loans on gold have ordinarily been made to foreign central banks (and governments) in order to meet short-term (one year or less) or seasonal foreign exchange needs. In the past they have occasionally been made against gold in transit to the United States for sale to the Treasury, but in recent years they have been made only against gold held under earmark for foreign account in the vaults of the Federal Reserve Bank of New York.

Loans for periods of up to six months secured by gold held under earmark at the New York Bank have the obvious justification that the interest cost to the foreign country is less than the handling charges and other fees which would be incurred if the gold were sold to the Treasury and subsequently repurchased.

In practice the New York Bank and the Board of Governors have been prepared at all times to approve short-term loans on gold held under earmark at the Bank, provided that the proceeds of the loans were needed to meet temporary balance of payments requirements. Such loans have been made at the Bank's regular discount rate. However, the existence of this facility may not be known to all foreign correspondents of the New York Bank, and there have recently been cases in which foreign central banks have negotiated for short-term loans on gold in the New York market at rates higher than the discount rate of the New York Bank, possibly in ignorance of the terms which would have been available to them from the Bank. In fairness to the foreign correspondents of the Bank, therefore, it seems desirable that they should all be made aware of the available facilities, possibly by including in the next annual reports of the Board and the New York Bank a descriptive statement covering this and other services performed by the System for its foreign correspondents.

(2) <u>Loans on gold by private institutions in the United States</u> Even with the facilities available at the Federal Reserve Banks generally known, there might still arise occasional cases in which a foreign central bank (or government) would prefer to obtain a short-

term loan on gold from a New York commercial bank, even though the cost were somewhat greater. (For example, such a loan might be sought in order to cultivate closer relations with the commercial bank.)

In addition, there are two types of loans on gold held under earmark at the New York Bank which might be made by private institutions in the United States but which would not be considered suitable for the Federal Reserve Banks. These are:

(a) loans on gold to foreign central banks and governments for terms longer than those customarily extended by Federal Reserve Banks, and

(b) loans on gold (for any period) to foreign borrowers other than central banks and governments.

Licenses have recently been requested for transactions of both types.

It is true that long-term loans on gold do not have the same economic justification as that cited above for short-term loans; the interest cost on long-term loans will substantially exceed the cost of selling the gold and subsequently repurchasing it. But if a foreign central bank (or government) does decide to borrow for a period of years rather than to liquidate part of its gold reserves, the pledging of the gold will enable it to obtain better terms (indeed, without such collateral the loan may not be forthcoming at all). It need not be assumed that in these circumstances the foreign central bank (or government) is necessarily impelled by the desire to speculate upon a rise in the dollar price of gold.

Other psychological and technical factors may play an important role in its choice. In view, therefore, of the general arguments presented above, the Staff Group believes that no barrier should be raised to long-term loans on gold to foreign central banks (or governments) by private institutions in the United States unless more positive evidence appears in specific cases that the loan is being sought primarily for speculative purposes.

In the case of transactions described under (b) above, the only difference from the cases examined previously is that the foreign borrower is not a central bank or government, even though the gold pledged as collateral belongs to such a bank or government. (A recent instance is a proposal to use gold belonging to the Czechoslovakian National Bank to secure an acceptance credit to be extended by a New York commercial bank to a nationalized commercial bank in Czechoslovakia.) The Staff Group sees nothing objectionable in the mere fact that the foreign borrower is not a central bank or government, and indeed the specific Czech case may indicate a desirable tendency to return international financial transactions to more normal banking channels.

The Staff Group has considered the question whether, whenever a foreign correspondent of the Federal Reserve Bank of New York expresses a desire to pledge its gold for a long-term loan, the Bank should point out to its correspondent the apparently uneconomic character of the proposed transaction. Opportunities may well arise for tendering such advice informally, but the Staff Group does not believe that such action should be taken as a matter of System policy. It is doubtful whether any foreign central bank or government wishes tutelage in the elementary economics of gold transactions, and the only other relevant factor, i.e. the chances of an increase in the dollar price of gold, is not one concerning which the System would desire to commit itself in any formal communication.

The Staff Group believes that the subject of loans on gold is one which the International Monetary Fund might well consider from the international point of view, when the Fund is sufficiently organized. If any adverse decision is to be made as to the future use of gold as collateral for loans, it would be better for it to come from an international institution and to be addressed to borrowing and lending countries alike, rather than to be imposed unilaterally by the United States, the largest holder of gold and largest potential source of credit.

In conclusion, it should be stated that the views expressed in this memorandum have been formulated in the light of present conditions. The Staff Group suggests that it would be desirable for it to examine periodically into the pertinent circumstances surrounding loans on gold for the purpose of determining whether a more restrictive policy should be adopted at any time in the future.