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MEMORANDUM OF FEDERAL RESERVE SYSTEM INFORMAL POLICY GROUP ON FOREIGN INTERESTS WITH REFERENCE TO CERTAIN ASPECTS OF UNITED STATES GOLD POLICY AND PROCEDURES

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It is the view of the Policy Group that there should be in the world today some point of reference where there is a fixed price of gold in terms of domestic currency; that in the existing world that fixed point of reference must be the United States, the United States dollar, and the fixed price of gold in terms of United States dollars; and that there should be no unnecessary obstacles to the free purchase and sale of gold in the United States, at the fixed price, for the settlement of international balances - all to the end of promoting international monetary stability.

This view has led the Policy Group to consider not only Federal Reserve transactions involving gold, but also certain aspects of the Gold Reserve Act of 1934, as amended, and certain Treasury practices and procedures thereunder as well as related matters, as follows:

(1) Licensing of Gold Transactions for Foreign Official Account;
(2) Commercial Banks' Gold Operations at Premium Prices;
(3) Loans on Gold;
(4) The Treasury's 1/4 per cent Handling Charge;
(5) Sections 8 and 9 of the Gold Reserve Act of 1934, as amended.

The recommendations of the Group with reference to these matters, with some of the considerations involved, are as follows:

(1) Licensing of Gold Transactions for Foreign Official Accounts

Recommendation for action: That the existing Treasury procedures with respect to the acquisition of gold in the United States be amended by means of the issuance of a general license or otherwise so that foreign monetary authorities may convert free dollar balances into gold (for earmark or export) without the necessity of obtaining a specific license or complying with other formalities under the Gold Reserve Act of 1934, as amended, and the Provisional Regulations issued thereunder.

Comment: Among the factors that cause foreign monetary authorities to feel uncertainty concerning our gold policy, and especially concerning their continued ability to convert dollar balances into gold, one factor is certainly the present requirement that every purchase of gold from the United States by a foreign monetary authority must be the subject of a specific authorization by the Secretary of the Treasury. In connection with this authorization, the purchaser states the purpose for which the gold is to be acquired. Furthermore, if such gold is to be exported without first being placed under earmark, a specific license under the Gold Reserve Act must be obtained. These requirements have the effect of emphasizing continuously the fact that obtaining gold for dollars is not automatic and that this country could at any time discontinue sales of gold.

The present procedure would seem to have arisen from the desire that existed in 1934, when the procedures under the Gold Reserve Act were first established, to protect the gold stock of the United States. At present, with a United States gold stock three times its size in 1934 and an unprecedentedly large surplus in the United States balance of payments, there appears no reason why blanket authorizations and licenses should not be issued (with the approval of the President) and publicly announced by the Secretary of the Treasury, enabling foreign monetary authorities to convert any free dollar balances into gold without any such formalities. The psychological effect of eliminating such formalities would be of some benefit, although the United States would not be committed irrevocably to selling gold, since the blanket authorization that is suggested here could be terminated at any time.

If the procedure for selling gold to foreign monetary authorities is simplified as suggested above, it would seem appropriate at the same time freely to permit transfers of gold held under earmark in the United States between the governments and central banks of other countries in addition to those which are adherents to the Tripartite Declaration, except such countries as may be excluded for particular reasons.

With respect to purchases of gold by the United States, no change in the existing system appears to be necessary at this time, with the exception of the possible elimination of certain technical requirements - for the most part involving "paper" work.

(2) Commercial Banks' Gold Operations at Premium Prices

Recommendation for action: That the Treasury Department and the Board of Governors of the Federal Reserve System join in issuing a public statement along the following lines:

"It is well known that active speculative markets in gold exist in many financial centers throughout the world, some legally and others illegally. Under present circumstances, gold is quoted in many foreign centers (often in U. S. dollars) at premiums over official prices. The premiums differ from one center to another so that private speculators, although unable to purchase gold in the United States, can make large profits by purchasing gold against dollars in one foreign market and selling the gold for dollars in another.

"The International Monetary Fund has recently issued a statement deprecating international dealings in gold at premium prices, and requesting member countries to take such action as they can take within their jurisdictions to prevent such dealings. The Fund pointed out that these transactions tend to undermine exchange stability and that they cause gold to flow into private hoards rather than into monetary reserves. Furthermore, in countries where the gold is sold, payment is often made with dollars that have been illegally acquired or held, and one effect is to use up dollars that might otherwise have been used to acquire imported goods and equipment sorely needed in those countries.

"In view of these circumstances, and on general grounds of national policy, the Treasury Department and the Board of Governors of the Federal Reserve System request American banks to refrain from encouraging and facilitating this traffic and in particular to refrain from extending the use of their facilities and funds for the carrying out of such transactions."

Comment: Aside from the fact that gold is traded in many financial centers at premium prices in terms of local currency, there also appears to be an active market for gold at a premium against dollars in a number of countries. One of the principal causes of this phenomenon, aside from the fact that gold is in many ways a more suitable hoarding medium than dollars, is the view that there may be an increase in the official dollar price of gold in the near future.

Gold is traded in some countries at prices that are only moderately above $35 an ounce, while prices in other countries on a retail basis have ranged up to $80 an ounce not only in terms of local currency equivalents but also, in some cases, directly in dollars. The opportunities for arbitrage dealings in gold against dollars between different foreign markets have therefore proved tempting to American commercial banks. There is evidence to show that United States commercial banks, although not acting as principals, have been engaged in such arbitrage dealings in the capacity of agents for foreign buyers and sellers, and as a source of credit to finance such transactions while the gold is in transit. Frequently these banks get buying orders "at best" from their customers abroad with instructions to effect the purchase to the debit of the customers' accounts on the books of the United States banks.

These operations first received public attention in articles appearing in our press last January, and were brought more clearly before the public by the Monetary Fund statement of June 1947, but they seem to have been going on for quite some time. The stories of last January dealt with purchases of gold at premium prices by American banks in Mexico at the rate of 30,000 ounces a day and the sale of such gold (at a considerable profit - 50 per cent or more) particularly in China and Hongkong but also in the Near East. Unexecuted orders in the hands of one of our banks alone at that time were reported to Federal Reserve Bank of New York at around 100,000 ounces, but several other banks are also involved in these transactions. It is difficult to estimate the volume of this kind of business so far put through but one bank has estimated that since January 1946 at least $100,000,000 of gold has been sold to the Near East and Hongkong, much of it through our banks. While India, China, Hongkong and Macao have recently taken action to restrict private gold imports, this action may not be completely effective and in any case markets continue to exist in certain other countries.

Not only Mexico but other countries (Chile, Brazil, etc.) are reported to have become participants in this trade, presumably at times at the instigation of our banks. The latter have also turned to Switzerland and to Argentina, and it has been reported that gold has been acquired in Switzerland by an American bank in lots of around 30,000 ounces at the total cost of around $42 per ounce. This gold was shipped to Hongkong or the Near East by air and sold at prices which still allowed a profit to local dealers after the payment of a 5 per cent commission to the American bank.

When important American banking institutions participate in gold transactions against dollars at premium prices, they not only contribute to monetary instability, as the Monetary Fund statement points out, but they may also give special encouragement to foreigners' belief that the dollar is at a discount and may soon suffer a reduction in gold content. Such suspicions would not be altogether eliminated by ending the participation of American banking institutions in these gold dealings, but such a step might do much to clear the air. Furthermore, in most cases these transactions use up dollars which have escaped the exchange controls of foreign countries and which are being dissipated in the purchase of gold for private hoarding rather than being used for the purchase of goods and equipment sorely needed abroad, or for needed strengthening of official monetary reserves.

Participation by our banks in this traffic raises the question whether American banking institutions should engage in practices inimical to the interests of foreign countries and to our own interests in promoting economic recovery abroad. We believe that they would not wish to do so if they recognized the national and international interests involved, and that if the authorities will give them a clear lead, by the issuance of a statement along the lines suggested, the banks will follow it.

(3) Loans on Gold

Recommendation for action: That the Treasury and Federal Reserve System adopt a coordinated policy along the following lines with respect to the making of loans on gold by Federal Reserve Banks and by commercial banks (or other lenders) in the United States:

(1) The Federal Reserve Banks would continue their present policy of making loans on gold for an initial period of only three months, subject to renewal, but special Treasury-Federal Reserve consultation and review would be undertaken if any renewal is proposed beyond 12 months from the date of the original loan;

(2) The Treasury would decline to license any commercial bank loan on gold for an initial period of more than 12 months, and any application for a license to renew such a loan beyond 12 months would be the subject of special Treasury-Federal Reserve consultation and review;

(3) If a loan appears to be sought for predominantly speculative purposes, the Federal Reserve Banks would (as at present) refuse the loan or, in the case of a commercial bank loan, the Treasury would decline to license the transaction.

Comment: It is considered to be an appropriate function of the Federal Reserve Banks to make short-term loans on gold to foreign monetary authorities (central banks or governments) which require dollar funds to meet temporary requirements for foreign exchange. Loans on gold are made at the regular discount rate of the Federal Reserve Bank of New York, which is at present 1 per cent per annum, and because of this low rate, foreign monetary authorities would ordinarily borrow from the Federal Reserve. In some cases special factors may cause a foreign monetary authority to seek a loan on gold from private sources in the United States, rather than from the Federal Reserve Bank - e.g., in order to cultivate closer relations with the private lender; or the borrower may not be a central bank or government, in which case it will ordinarily not be acceptable as a borrower from the Federal Reserve Bank. Notwithstanding the fact that the making of short-term gold loans to monetary authorities seems properly a central banking function, there appears no reason why private lenders should not be allowed to make them also, provided that they are not for purposes that are predominantly speculative.

Unnecessary restrictions upon loans against gold would impair the usefulness of gold (especially gold held in New York under earmark), and diminish the inclination of foreign countries to hold gold. They would thus run contrary to this country's other policies which look toward a wider distribution of world gold reserves. Loans on gold are, however, subject to certain abuse. 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 false impression that the reserves remain intact. While such practices should certainly not receive any encouragement, the fact that some central banks engage in them should not be the determining element in our decision whether to make loans against gold generally.

A second more serious possibility of abuse arises, however, from the fact that any country which borrows dollars on gold rather than selling the gold outright is thereby placing itself in a position where it would profit from any increase in the dollar price of gold. It may appear from time to time that foreign countries are motivated simply (or mainly) by this consideration, and that in effect they are indulging in bets against this country's future gold policy. In any case in which it is reasonably clear that the purpose of borrowing on gold is predominantly speculative, it would seem desirable on grounds of public policy to refuse the prospective borrower access to lending facilities in the United States.

It seems especially difficult to justify the making of loans on gold for periods of more than 12 months. It would be much cheaper for the borrower to sell the gold and later repurchase it rather than to pay interest for any such extended period. Loans on gold running for more than one year should therefore be regarded as economically questionable; it would seem wise not to extend or facilitate such loans, except through renewals which would permit each transaction to be scrutinized periodically for evidence of its economic justification. Even if a foreign country appears genuinely to seek a loan on gold for psychological purposes, e.g., in order to utilize the proceeds while still continuing to show the gold as an asset, it would seem preferable for the loan to be made on a relatively short-term basis so that the situation could be reviewed at frequent intervals.

The coordinated policy which we recommend would not rigidly prohibit the renewal of loans on gold beyond 12 months, but it would exclude the extension of such loans for an initial period of more than one year. Commercial banks could continue to make loans up to 12 months if they wished; the Federal Reserve would continue to limit any one extension of credit to a three-month maturity, with the possibility of renewals on a relatively routine basis up to 12 months (the Federal Reserve Bank would probably indicate in advance to the borrower, as it does at present, that "we are prepared for the present to grant a loan or loans to you on the following terms and conditions, ... such loan or loans to run for 90 days but no loan or renewal thereof to mature later than ______ (up to one year) after the date of the first such loan").

A recent long-term loan on gold by an American bank against gold on deposit in Switzerland (a $7 million loan from the Chase National Bank to the Roumanian Government for a term of four years) illustrates a method by which private lenders in this country could avoid restrictions placed upon their activities through the Treasury's licensing procedure (which applies, of course, only to dealings in gold situated in the United States). Should the policy recommended above be adopted and should transactions of this sort become widespread, which seems unlikely, it might prove necessary to issue a further joint statement analogous to that suggested under (2) above, requesting American banks to refrain from financing long-term loans on gold abroad.

(4) Treasury's 1/4 per cent Handling Charge

Recommendation for consideration: That consideration be given to the advisability of eliminating, or reducing to an amount approximating the actual handling costs, the Treasury's 1/4 per cent handling charge on gold transactions, especially if such action were accompanied by corresponding action by the other members of the International Monetary Fund.

Comment: There appear to be two principal considerations that serve to justify the imposition of the present 1/4 per cent charge: the resultant spread between the buying and selling prices of gold deters capricious shifts back and forth between gold and dollars by foreign governments or central banks, and the charges provide additional revenue for the U. S. Treasury and the United States Stabilization Fund.

On the other hand, the continuance of the 1/4 of 1 per cent charge may be regarded as an obstacle to the realization of a fixed point of reference for gold in the world, and to that extent as a hindrance to the most effective working of the international gold standard.

One effect of eliminating or reducing the U. S. Treasury's 1/4 per cent charge would be to make it cheaper for countries having earmarked gold in New York, when needing dollars to meet temporary requirements, to sell and repurchase the gold, whereas in some cases it would now be cheaper to borrow and pay interest on short-term loans. There would thus be eliminated one reason (although probably not an important one) that may now cause countries to borrow on their gold rather than sell it. In some other cases, the elimination or reduction of these charges might induce member countries to sell (and repurchase) gold where it would otherwise have been more economical for them to draw on the Monetary Fund.

The International Monetary Fund has so far taken two actions concerning gold charges, namely (1) the Fund will not fix specific charges on its own gold purchases, but will levy such charges as will cover the estimated costs that would be incurred by the Fund if it used the gold so acquired to purchase the currency sold, and (2) the Fund has set 1/4 per cent as the margin above or below par within which any gold transactions between members must take place. Under existing Fund rules, if the United States should decide to eliminate or reduce its present 1/4 per cent charge, the Fund would automatically eliminate or reduce its own handling charges on gold transactions against dollars with members. The question may be raised whether the United States might offer to eliminate or reduce its present 1/4 per cent charge on condition that the Fund take corresponding action with regard to the margin permitted for transactions in gold between members. Since the whole subject of gold charges and margins above and below par continues to be under discussion by the International Monetary Fund and member countries, it would seem preferable that no action be taken by this country without prior consultation with the Fund.

(5) Sections 8 and 9 of the Gold Reserve Act

Recommendation for consideration: That consideration be given to introducing legislation at some appropriate time, perhaps in connection with other related legislation terminating the power of the Secretary of the Treasury contained in Sections 8 and 9 of the Gold Reserve Act to buy and sell gold "at such rates and upon such terms and conditions as he may deem most advantageous to the public interest". Pending such an amendment of the law, it is believed that some assurance to the market as to the present gold price would be given by a statement of the Secretary of the Treasury pointing out the limiting effect of Article IV, Section 2 of the Articles of Agreement of the Fund on the Secretary's authority to deal in gold, particularly if such statement were made in connection with an announcement by the Secretary respecting the proposed procedure for licensing of gold transactions for foreign official account.

Comment: These sections appear to delegate to the Secretary of the Treasury certain administrative freedom of action in fixing the price of gold in terms of dollars, and their existence seems to have nourished some of the speculative rumors in the market concerning a possible change in the dollar price of gold. It would seem desirable for legislation to be enacted repealing these sections. However, the importance of this matter should not be exaggerated and, in view of the present legislative situation, it is not suggested that any bill be introduced at the present session of Congress.

Notwithstanding the strong international position of the dollar there do exist, at the present time, economic and other factors which could lead the public to doubt the continued maintenance of the $35 price of gold. Such doubts have been accentuated since the war by the general political, economic, and social unsettlement in the world, and most particularly by:

(1) the depreciation and instability of currencies in many foreign countries;

(2) the substantial rise in the commodity price level in the United States, from which only the price of gold has been immune;

(3) the general worldwide price inflation which (combined with a heavy drop in new gold output during the war) appears to have convinced many observers that the world's supply of monetary gold is inadequate to support the postwar world price structure unless the price of gold is increased; and

(4) the fact that the price of gold in terms of dollars has risen far above $35 an ounce in various foreign black markets.

The fears or illusions, especially on the part of foreigners about the stability of the dollar in terms of gold, have been confirmed on a recent trip to South America of System representatives. In two cases, they were unequivocally informed that borrowing against gold was considered preferable as against the sale of such gold because of the present uncertainty of (a) the gold price in terms of dollars and (b) the seller's ability to buy back the gold in the United States at some future date. These fears and illusions can not be entirely removed since even under the Articles of Agreement of the International Monetary Fund the United States retains a certain freedom to alter the par value of the dollar by unilateral action. It would afford some assurance, however, if it could be made clear that a change in the dollar price of gold can be undertaken only by act of Congress and not by administrative action of the Secretary of the Treasury. This point might seem to have been rather clearly established by the Congress when it wrote into the Bretton Woods Agreements Act a provision reading as follows:

> "Unless Congress by law authorizes such action, neither the President nor any person or agency shall on behalf of the United States ... propose or agree to any change in the par value of the United States dollar under Article IV, Section 5, or Article XX, Section 4, of the Articles of Agreement of the Fund, or approve any general change in par values under Article IV, Section 7 ...".

However, this provision relates to the par value (i.e., the gold content) of the dollar and not to the market price for gold, and Treasury officials have in the past made a distinction between the two things, particularly in connection with Sections 8 and 9 of the Gold Reserve Act. These sections empower the Secretary of the Treasury to buy and sell gold in any amounts, at home or abroad, "at such rates and upon such terms and conditions as he may deem most advantageous to the public interest."* Mr. Harry White, in testifying before a Congressional Committee in April 1943, pointed out the distinction between the President's authority to change the gold content of the dollar (contained in Section 12 of the Gold Reserve Act and which was allowed to expire on June 30, 1943) and the power of the Secretary of the Treasury under Sections 8 and 9 of the Gold Reserve Act to vary the market price of the dollar in terms of gold and thereby change the exchange rate between the dollar and other currencies.

The situation has since been substantially altered through the acceptance by the United States of the Articles of Agreement of the International Monetary Fund which greatly limit any independent freedom of action which the Secretary of the Treasury might otherwise have had under Sections 8 and 9. Under Article IV, Section 2, of the Fund's Articles of Agreement, which prohibits any member from buying gold at a price above par value plus a margin prescribed by the Fund, the U. S. Government could not (as in 1933) depreciate the dollar in the exchange markets by buying gold abroad at more than the existing statutory price (plus such margin as the Fund may prescribe). From the legal point of view, since the par value of the dollar cannot be changed without an act of Congress, this seems to provide an adequate answer to those who believe that the effective dollar price of gold might be increased by unilateral administrative action, at least as long as gold tends to flow on balance to the United States.

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* The power to buy is subject to the approval of the President, and the power to sell is subject to the qualification that the Secretary "may sell the gold which is required to be maintained as a reserve or as security for currency issued by the United States only to the extent necessary to maintain such currency at a parity with the gold dollar".

However, Article IV, Section 2, of the Fund's Articles of Agreement does not specifically prohibit the United States from fixing its selling price of gold above the par value, a device which could conceivably be used to accomplish a *de facto* depreciation of the dollar at a time when there was a net gold outflow from the United States. The Article may, to some extent, prohibit such a device indirectly by prohibiting other members of the Fund from buying the gold at such prices, but it would not prevent the United States Treasury from selling gold for dollars at prices above par to private traders abroad (and perhaps to monetary authorities of nonmember countries). Thus, while the Fund Agreement would prevent that type of gold operation by the United States Treasury which seems to be most feared, the doubts of foreigners and some Americans with respect to the stability of the dollar may receive some nourishment so long as Sections 8 and 9 remain in the Gold Reserve Act.

It is recognized that the repeal or amendment of Sections 8 and 9 might not fully solve the problem under consideration because there are other provisions of law which might enable agencies of the U.S. Government to buy and sell gold at prices other than $35 an ounce. Such powers include, for example, the power of the Secretary of the Treasury to "deal in gold" for the account of the stabilization Fund (Section 10 of the Gold Reserve Act), and the powers held by the Secretary (and also by certain agencies such as the Reconstruction Finance Corporation) to issue obligations on such terms and conditions as may seem desirable. By Section 14(a) of the Federal Reserve Act, the Federal Reserve Banks are also given broad powers to deal in gold. It would be necessary to close a number of legal loopholes of this sort, by providing appropriate limitations on these authorities, if it were desired to give firm assurance that the Secretary of the Treasury could not indirectly engage in gold dealings at variable prices. This might be done by a general statutory provision to the effect that notwithstanding the provisions of any other law, no officer, agency or instrumentality of the United States may deal in gold at prices differing from the official parity by more than the established handling charge.