BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 10, 1948

To Mr. Eccles

Subject:

From Mr. Carpenter

Federal Advisory

CONFIDENTIAL

At the last meeting of the Federal Advisory Council in connection with a discussion of the gold policy of the Federal Reserve System and the Treasury, the Council stated that it would welcome any data and information from the Board of Governors which would be helpful in a study of the whole gold policy and the present legislation regarding gold. The Council was advised that, to the extent possible in the light of its confidential character, the Board would be glad to supply the Council with further information on the subject as a basis for further study and discussion.

Pursuant to this commitment, the attached statement has been prepared in the Division of Research and Statistics. At Mr. Szymczak's suggestion, the statement is being placed on the agenda for the meeting of the Board on the afternoon of Monday, November 15, when the Board will consider the topics to be discussed with the members of the Federal Advisory Council, with the thought that in the absence of objection from members of the Board, the statement would be handed to the members of the Federal Advisory Council at the meeting with them on Tuesday, November 16.

Attachment

CONFIDENTIAL

November 9, 1948.

NOTES ON PRESENT UNITED STATES GOLD POLICY

Following is a brief outline covering some of the aspects of United States gold policy that the Board has had occasion to consider or may be considering in the near future. This paper must be regarded as confidential because some of the facts that are included have not been released outside the Treasury and the Federal Reserve System.

These notes are arranged under six general headings, as follows:

(1) Relation of Gold to United States Currency
(2) Ownership of Gold Outside the United States
(3) Licensing of Gold Transactions for Foreign Official Accounts
(4) Sections 8 and 9 of the Gold Reserve Act of 1934
(5) Treasury's 1/4 per cent Handling Charge
(6) Loans on Gold

(1) Relation of Gold to United States Currency

The monetary system of the United States is based on a gold bullion standard, with gold being held as monetary reserve and made available for international settlements. The gold value of the dollar is fixed at 1/35 of a troy ounce of fine gold.

Convertibility between currency and gold is subject to two principal restrictions: (1) ownership of monetary gold in the United States is confined to the Treasury, and (2) the Treasury sells gold for monetary purposes only to foreign governments and central banks and only where a legitimate monetary purpose is indicated. This policy has been consistently followed since 1934, and no change is now under contemplation, although various kinds of suggestions to permit private ownership of gold have been received.

The United States Treasury's readiness to buy gold, or to sell it to foreign governments and central banks in exchange for dollars, maintains the dollar at parity with 1/35 of an ounce of gold in all legal exchange transactions between the United States and foreign countries. All Treasury transactions in monetary gold are at $35 per ounce, plus a handling charge of 1/4 of 1 per cent on sales or minus a similar handling charge on purchases.

At these same prices the Treasury buys gold from domestic producers or importers, and sells it to domestic users for legitimate industrial, professional, or artistic purposes, within the amounts specified in their licenses. Licensed dealers and users in the United States may also buy gold directly from producers, refiners, or other dealers; the prices in such transactions are unregulated, but are of course determined primarily by the Treasury's readiness to sell or buy at $35 plus or minus 1/4 of 1 per cent.

(2) Ownership of Gold Outside the United States

United States Government policies in general favor the keeping of foreign-owned gold in monetary reserves as opposed to the movement of gold into private hoards. The United States Government has therefore been concerned at the considerable increase since 1945 in the volume of gold transactions on black markets or in legal free markets, where the prices (whether in U.S. dollars or in some foreign currency) have ranged considerably higher than the official prices.

There have been two types of gold markets at premium prices: not only is gold traded in a number of countries in terms of local currency, but there also appears to be an international market in which gold is traded primarily against U.S. dollars. The latter market, in particular, received public attention in this country and attracted American commercial banks which, although not acting as principals, engaged to some extent as agents for foreign buyers and sellers and as a source of credit on gold in transit.

The United States position regarding international gold transactions has been set forth in the report of activities of the National Advisory Council for the six months ending September 30, 1947, as follows:

> "The Fund (International Monetary Fund) considered the problem arising from transactions in gold in various countries at prices above monetary parities. While in many instances, these transactions in gold took place illegally, in others they occurred in legal open markets or tolerated black markets. The Executive Directors of the Fund realized that exchange stability might be undermined 'by continued and increasing external purchases and sales of gold at prices which directly or indirectly produce exchange transactions at depreciated rates.' Since these transactions also involved a loss to monetary reserves when the gold moved into private hoards the Fund was of the opinion that such transactions were not conducive to the objectives for which the Fund had been established. The Fund accordingly issued a statement on June 24, 1947, deprecating international transactions in gold at premium prices and recommended that all of its members take effective action to prevent such transactions with other countries or with the nationals of other countries.....
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> "The National Advisory Council fully agreed with the position taken by the Fund with regard to gold sales at premium prices. Accordingly, on July 18, 1947, the Secretary of the Treasury and the Board of Governors of the Federal Reserve System issued a joint statement requesting American banks, business enterprises,

and individuals to refrain from encouraging and facilitating traffic in gold at premium prices."

Copies of the Monetary Fund's statement and of the Treasury-Federal Reserve joint statement are attached.

To implement the Fund's request and the United States policy, the Treasury Department gave notice on July 31, 1947, that it was considering amendments to the regulations issued under the Gold Reserve Act of 1934. After holding a public hearing, the Secretary of the Treasury issued a number of amendments, effective November 24, 1947, which restricted the export of fabricated, semi-processed and scrap gold, and the export of gold obtained from imported gold-bearing materials. These amendments are based on the general principle that gold may be exported from the United States only when its import into the country of destination does not violate the laws of that country. Where the gold or gold-bearing material has first been brought from some other country into the United States, the series of transactions must also comply with the laws of the country of origin.

The problem of gold transactions abroad at premium prices in terms of local currency, which is not covered by the statements of last year, continues to be under careful consideration by the Federal Reserve and the Treasury, as well as by the International Monetary Fund. The existence of internal "free markets" in certain countries causes gold to be diverted from exchange reserves into private hoards and puts additional pressure on the customs and exchange control administration of neighboring countries. The United States Government has a direct interest in these effects of free gold markets and in the possibility that its sales of gold to foreign countries might supply speculative groups in these markets instead of strengthening the monetary position of the countries concerned and contributing to international monetary stability.

With regard to the payment of gold subsidies by foreign governments, the attitude of the United States Government and the International Monetary Fund has been to oppose any direct subsidies that would have the effect of increasing the price paid for gold. On the other hand, no objection has been raised to subsidies paid by foreign governments to marginal mines where the purpose is to enable such mines to meet higher costs and to continue operations.

(3) <u>Licensing of Gold Transactions for Foreign Official Accounts</u>

With rare exceptions, the United States promptly grants all applications by foreign monetary authorities to purchase gold with their dollar balances. Nevertheless, many foreigners appear to feel uncertainty about the continuation of this policy. This uncertainty may have arisen largely from the requirement subjecting foreign monetary authorities' purchases and exports of gold to specific authorization and license from the Secretary of the Treasury. Because of this requirement and in accordance with Treasury policy, the form used by the Federal Reserve Bank of New York in communicating with foreign central banks regarding gold transactions had the effect of reminding them that obtaining gold for dollars is not automatic and that foreign monetary authorities could not be given unqualified assurance that they could continue to convert their dollar balances into gold.

These procedures 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. Under present circumstances with a much larger United States gold stock and an unprecedentedly large surplus in United States balance of payments, it appeared that the procedure for selling gold could be simplified and foreign monetary authorities be given reasonable assurances of their ability to purchase gold, all without committing the United States Treasury irrevocably to sell gold at any time for any purpose.

In line with these views the United States Treasury has taken two steps, namely:

(a) In connection with an inquiry from a foreign central bank in June 1948, the Treasury authorized the Federal Reserve Bank of New York to omit in its reply the customary reference to the Treasury's authorization for purchase of gold, and to state that "Treasury sells gold readily for legitimate monetary purposes such as increasing monetary reserves and settlement of dollar balances of payment". The principal purpose that is not included in this statement would be that of reselling in the open market; the only case in which the Treasury is known to have rejected an application since the war was a case where the purchaser contemplated resale of the gold in the open market.

(b) In October 1948, the Treasury revised the gold license held by the Federal Reserve Bank of New York so as to authorize that bank to acquire or transfer gold "for account of any foreign state or foreign central bank, or the International Bank for Reconstruction and Development, or the International Monetary Fund, or the Bank for International Settlements or any other institution designated by the Secretary of the Treasury, provided that without specific authorization from the Secretary of the Treasury no transfer of gold in earmark or in custody shall be effected to or from the account of any foreign state or foreign central bank or any institution which the Secretary of the Treasury may have designated as being subject to such specific authorization".

It is expected that these two steps will give greater confidence to foreign monetary authorities concerning their ability to convert dollar balances into gold to meet legitimate needs.

(4) Sections 8 and 9 of the Gold Reserve Act of 1934

Although the presidential power to alter the gold content of the dollar (Section 12 of the Gold Reserve Act of 1934) ended in 1943, Sections 8 and 9 of the same Act still empower the Secretary of the Treasury to buy and sell gold at such rates and upon such terms and conditions as he may deem most advantageous to the public interest. These sections appear to delegate to the Secretary 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 the possible change in the dollar price of gold.

However, the importance of Sections 8 and 9 should not be exaggerated. Congress, in the Bretton Woods Agreement Act, has fixed the price of gold at $35 an ounce for purposes of the International Monetary Fund, and has prohibited any change in this figure without Congressional approval. Treasury officials have in the past pointed out that Sections 8 and 9 appeared to give the Secretary legal power to pay a higher or lower price for gold without altering the par value of the dollar. But it should be noted that Article IV, Section 2, of the Articles of Agreement of the International Monetary Fund specifically prohibits a member from buying gold at a price above par value (plus a margin which the Fund has fixed at 1/4 of 1 per cent). As long as gold flows to the United States, this country could not raise the price except by buying above $35 an ounce, which would be a clear violation of the Fund Agreement.

For these reasons, no bill to amend or repeal Sections 8 and 9 has been introduced in Congress. It might be feasible, however, for the Secretary of the Treasury to issue a public statement containing some assurance to the market about the dollar price of gold.

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

There appear to be two principal considerations that serve to justify the imposition of the Treasury's present 1/4 of 1 per cent handling charge on purchases and sales of gold: the resultant spread between the buying and selling prices of gold deters capricious shifts back and forth between gold and dollars, and the charges provide additional revenue for the United States Treasury.

If this charge were reduced or eliminated, one effect 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.

The question of gold charges and margins above and below par pertains to the field of monetary policies of the International Monetary Fund, which has set 1/4 of 1 per cent as the margins above or below par within which any gold transactions between members must take place. In view of this, it would be desirable that any policy action taken by the United States in this matter be coordinated with corresponding action by the Fund with regard to the margins permitted for transactions in gold between members generally. It does not seem likely, however, that the matter will be considered sufficiently important or urgent to be pressed further at the present time.

(6) Loans on Gold

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 and governments) which require dollar funds to meet temporary needs 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 1-1/2 per cent per annum, and because of this low rate foreign monetary authorities would ordinarily borrow from the Federal Reserve rather than from other lenders.

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. The making of short-term gold loans to monetary authorities is properly a central banking function, but there appears no reason why private lenders should not be allowed to make them also, provided that they are not for purposes that run counter to United States monetary and financial policies.

Loans on gold may, however, be subject to certain abuse. Foreign central banks may at times continue to show gold in their reserve position even though it has been pledged against loans. A second and more serious possibility of abuse arises from the fact that any country which borrows dollars against gold rather than selling the gold 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 official gold policy.

Loans on gold for any extended period--say, beyond one year--are especially questionable from an economic viewpoint. It would be much cheaper for the borrower to sell the gold and later repurchase it rather than to pay interest for any extended period. This suggests that any proposed loan for more than one year, or any renewal beyond one year, be subject to special scrutiny with a view to preventing the use of lending facilities in the United States for speculative purposes or for purposes contrary to the public interest.