STANDARD FORM NO. 64

Office Memorandum • UNITED STATES GOVERNMENT

TO : Mr. Martin

DATE: March 18, 1949

FROM : G.A. Eddy

SUBJECT: Gold Sale to China

I understand that Mr. Walton Butterworth has telephoned you requesting the Treasury to reconsider its willingness to sell the requested $3.5 million of gold to China and that he gave as his reason that it was analogous to the Greek case. Furthermore, for various reasons, Messrs. Stuart, Arnold, ~~Hyman~~, and McNeill also now oppose the sale. OFD of the State Department either favors it or has no objection and believes it a Treasury question.

I definitely favor the sale. If the principles which seem to be implied in a rejection of this Chinese request were allowed to prevail, Treasury gold policy would, in my opinion, be gravely and foolishly impaired. It would also be a violent break from the policy which has been followed under the Gold Reserve Act of 1934 and been followed by every other country for centuries. Still further, refusing this request under present circumstances would be an ineffective, futile gesture.

A cable from Bern last week reported that President Keller of the Swiss National Bank, in addressing the general meeting of the bank, said that it is of the utmost importance that the United States dollar, which is the universal currency at the present time, should remain stable in relation to gold. The economic predominance of the United States and its preeminence in gold holdings, he continued, impose upon this country an international responsibility which it has not hitherto had. He went on to elaborate the importance of the stability of the dollar and the price of gold as a prerequisite for monetary adjustments throughout the world.

The delay of over two weeks in acting on this Chinese request is regrettable, and both continuation of the delay and, worse, rejection of the request may well be grounds for doubt about the convertibility of dollars into gold at the request of a great many countries.

The standard policy of the Treasury since 1934 in selling monetary gold has been to sell gold bars to foreign governments and central banks who offered dollars without any regard to whether or not they were selling gold in their domestic markets either at premium or parity prices. There have been scores and scores and probably hundreds and hundreds of such sales since 1934, totalling over a billion dollars and extending right down to the present. There is only one case of rejection of such a sale so far as the Treasury staff now recalls and that incident was highly informal, confused, complicated by several extraneous factors, and decided in a hit-or-miss way.

Neither the fact that the United States is giving some dollar aid to a country (which in the case of China is approaching the vanishing point at the moment) nor the fact that a country may be selling some gold in the domestic open market, even at premium prices, nor a combination of both of these conditions is, in my opinion, proper or sufficient grounds for making dollars in the hands of those countries inconvertible into gold at the United States Treasury.

Mr. Butterworth has mentioned an analogy to Greece. I am not informed on how closely he argued there was a parallel. In any case, for reasons stated below that analogy seems false. There are a number of important differences between the Greek case and the Chinese. Far worse than that, however, is the apparent corollary that if China is refused the right to exchange dollars for gold, so should a great many of the other countries of the world. Among the countries which seem to parellel Greece and China in one way or another are all ERP countries and perhaps a good many in Latin America, notably Mexico, Chile, Brazil, etc., which are receiving or applying for dollar loans. If the suggestion of Messrs. Butterworth, Stuart, Arnold, and McNeill is adopted and that position is then applied consistently to other countries, it would seem to involve a drastic narrowing of Treasury gold selling policy and making the dollar inconvertible into gold in the U. S. for most of the leading countries.

Sales of monetary gold bars for dollars to central banks or governments is and should be both virtually automatic and also administered by the Treasury. Monetary gold sales should not be political favors requiring negotiation with State Department political desk personnel, particularly with respect to the general monetary principles involved.

The established precedent is all in favor of selling the gold

Prior to 1933 there was of course no conception of not selling gold to foreign countries if they were selling gold to the public. Similarly, in the years 1934-46 the Treasury sold gold without any thought of whether the buying country was selling gold in its domestic market. In the period from 1934 to 1939 most of the countries to which the Treasury sold gold were selling gold to their public. In fact many of the Treasury sales in those years were directly to private buyers abroad. It would have been regarded as a serious interference with other countries' sovereignty, descretion and responsibility for the U. S. to have taken the position that any country which sold gold to the public would not be allowed to buy gold from the U.S. It would also have vitiated the main purpose of our buying and selling gold, namely, to hold the dollar to parity in terms of the par values of other currencies or in the case of countries with floating exchange rates, hold the dollar up to the floating value of gold in the foreign currencies. There were and are enough countries and enough people in the world which have entirely different problems regarding gold and paper money to make it vital to any satisfactory gold policy for the U. S. not to try to interfere with those countries' buying gold.

Last year the OEEC recommended that 3 billion dollars worth of gold be furnished to member countries to start reconstituting their monetary systems. Whether or not the United States complies with that recommendation is an intricate and delicate matter for U. S. Foreign Aid and Monetary policy to determine. But for us to go to the opposite extreme and say that if a country is receiving dollar aid or is selling gold to the public then they will get no gold from us, would, I believe, be an irresponsible and doctrinaire mistake.

The Treasury rightly has had no compunction against selling gold to Switzerland or Mexico during the war and postwar years when they were freely selling gold to the public. Mexico still is and Switzerland has only recently stopped for special reasons.

During the war the U.S. abetted Chinese gold sales ~~during the war~~ even to the extent of ferrying gold over the Hump at enormous cost. More than half of the earnings of the Stabilization Fund arose from war-time sales of gold in India and the Middle East directly to the public at high premiums, and assisted the British Government in their part of the joint program. As a matter of interest though not as proof, it may be noted that a letter written in 1944 by Ray Mikesell and initialled by E.M. Bernstein, Harry White, Harold Glasser and Bill Heffelfinger states, for example, "Moreover, these gold sales have been beneficial to (Iran) in helping to combat inflation."

The purpose here is not to argue in favor of public gold sales as a device against inflation. Much less is it an advocacy of the United States lending or giving the gold to permit such sales. This paper is entirely non-committal on those two points. The only contention here is that in the selfish interests of the United States and in consideration for the rights and responsibilities of other countries and for the U.S. role regarding gold policy, the Treasury should not refuse to sell gold to a country offering dollars for gold, if our only grounds for doing so is that they are selling gold to their domestic market. U.S. foreign aid policy should certainly consider how far it should go in financing or tolerating public gold sales by Governments receiving aid. The writer happens to believe that the recent Treasury arguments against <u>all</u> such sales is <u>in some cases</u> superficial and short-sighted. But the point being urged here is that Treasury gold policy should not make the convertibility of dollars into gold a thoroughly doubtful matter dependent on uncertain administrative discretion.

<u>The differences between the Greek and Chinese cases</u>

The differences between the Greek case and the Chinese case include the following:

1. Whereas the United States Government is doing everything in its power to control Greek finances and to get the Greek Government to follow U. S. advice in all financial policies, in China the State Department policy for at least several years has been uniformly to avoid assuming any responsibility for Chinese financial policies. If we refuse to sell this gold for any reason, the Chinese would rightly ask us what we want them to do instead and expect us to be responsible for the success or failure of our alternative program.

2. No request from Greece to buy gold has been refused as yet. There are some people who have limited responsibility for Greek affairs and who are confortably living 6,000 miles away who speak with scorn of the gold selling program there, despite the fact that every American economist who has worked there for any length of time in the last two years, plus a majority of the foreign economists, in Greece, believes it to be unavoidable. If it can be avoided under present conditions in Greece with any semblance of preventing inflation, it will be because of the huge import program financed by the U. S., because the U.S. is financing a large part of their military program, and because the U.S. Mission there really takes over the management of Greek finances. The first two conditions are not now true of China to a remotely comparable degree, and the third has already been cited above as being a sharp distinction.

3. Greece buys gold from us only in the form of sovereigns exclusively for sale to the public, and could not get sovereigns at the $35 price for gold from any

other source, so far as we know. China, on the other hand, is asking only to buy standard gold bars. This is what we stand ready to sell to every government and central bank" for legitimate monetary purposes." We have specifically not declined to sell gold to a country merely because it is releasing some gold to its internal market. In this case, the Chinese Central Bank has said that the gold will not be exported at premium prices. This is not a hollow statement, because the flow of gold is inward to China and not outward from it.

4. Our refusing to sell this gold to China for dollars may accomplish little or nothing other than to create a small nuisance. China, if it wanted to, could sell the dollars in its domestic market and thereby dissipate foreign exchange for domestic purposes just as fast as by sales of gold to the domestic market. Moreover, China could buy gold bars at $35 per ounce from many other sources. Accordingly, our refusal to sell China this gold for dollars would probably not prevent the Chinese from carrying out any operation which they choose.

5. Whereas the U.S. Treasury's sale of British sovereign coins to Greece beginning in December 1947 was unprecedented, the Chinese representative has made it quite clear that they know that the United States sells gold virtually automatically in regular transactions between central banks and governments. There has in fact been no refusal for a good many years, with the exception of a tentative feeler from China two years ago during a time of extensive U.S. aid and when they were systematically selling gold at a <u>specific</u> premium in what may have been then an illegal market.

<u>Arguments in the Stuart-Arnold Memorandum: 1. The Premium Price</u>

The spokesman for the Legal Division on gold and Fund matters was in favor of the sale to China and helped persuade me to favor it until he learned that the Central Bank of China had amplified its original cabled request for gold "with a view to replenishing our reserve in gold." The amplification consisted of a cable to a Chinese official confirming that the Bank sometimes intervened in the now free and legal market, where gold of course sells above a crossrate $35 per ounce. Even though we had had previous reports that the Chinese were doing this, this legal opinion apparently was reversed when the Chinese told us something more specific along those lines than the phrase that the gold was to replenish their reserves.

I believe U. S. Treasury gold policy is going to be in continual danger of cutting its own throat and permanently injuring the world-wide conception of the relationship between dollars and gold until the economic policy-makers of the Treasury assert that a country's selling gold internally at "premium prices" is not an act of such iniquity that the U.S. Treasury should commit the far more important violation of basic gold-policy principles of denying convertibility into gold bars of dollars held by those foreign governments and central banks.

The International Monetary Fund itself has issued no policy statement of any kind which would even suggest that the United States should refuse to sell

gold to China under these circumstances, and it is my confident expectation that if the Fund Staff or even the Board of Directors were asked whether the United States should turn down this request, they would say there was no Monetary Fund reason for the rejection and a general Fund presumption in favor of it.

The contention of the Legal Division spokesman and this memorandum from Messrs. Stuart and Arnold extends a Monetary Fund dogma into entirely new territory. The Fund's 1947 statement on premium gold transactions does not touch upon this gold transaction or what China itself proposes to do with its gold. The Fund statement reads, "For these reasons, the Fund strongly deprecates international transactions in gold at premium prices and recommends that all of its members take effective action to prevent such transactions in gold with other countries or with the nationals of other countries...The Fund has not overlooked the problems arising in connection with domestic transactions in gold at prices above parity. The conclusion was reached that the Fund would not object at this time to such transactions unless they have the effect of establishing new rates of exchange or undermining existing rates of other members, or unless they result in a significant weakening of the international financial position of a member which might affect its utilization of the Fund's resources."

In this case, the international transaction will occur at the U.S. parity price. The proposed intervention in the Chinese domestic market is excluded from the Fund's objections. Furthermore, since China has not certified a parity rate to the Fund, the Fund does not consider that its transactions in gold domestically are above parity. There is no chance of China's utilizing the Fund's resources so long as it has not certified a parity.

Although I hesitate to try to prove anything by the Articles of Agreement, I feel sure that the general implication of the Articles is all in favor of the United States selling gold to China for dollars at the parity price. Surely the general purport of the agreement is that members should sell gold to each other at the parity price. Secondly, the only way by which the United States qualifies as fulfilling the undertaking of Article IV, Section 4b to maintain exchange transactions within the prescribed margins, is by our readiness to "in fact freely buy and sell gold within the limits prescribed by the Fund." There is certainly no hint that we should not freely sell gold if a country is selling gold domestically for its own currency at premium prices.

Thirdly, according to the terms of Article VIII, Section 4, it would appear that the United States is under obligation to settle this Chinese dollar holding either in gold or by tendering Chinese money. The only way that we could refuse to buy back the Chinese holdings of dollars under that Article, so far as I can see, would be for the United States to declare that it is not permitting transactions involving capital exports to be made and that the Chinese holdings of dollars are the product of capital transactions. We could not prove that the dollars were the result of capital transactions in the first place and, in the second place, it would be a prohibited form of discrimination to say that capital transfers to China were not being settled currently, whereas everybody knows we have no reason to refuse settlement of capital transactions to any other country.

In summary of this point, I believe that the Legal Division has taken a false interpretation of the Monetary Fund doctrine against international gold sales at premium prices, and that the Legal Division has even misapplied its misinterpretation. The Fund would say that it was more important for us to sell gold at the parity price than to try to police its policy against premium gold sales by refusing to sell gold at the parity price, and the Fund would say actually that the proposed Chinese transactions are not in violation of the Fund's international premium price policy.

As a matter of fact the Chinese authorities might easily be persuaded to sell gold at $35 an ounce for dollars, if that will satisfy the United States. It would be a mistake to do so in my opinion, but it would be interesting to learn the Chinese response if this "premium price" argument is given weight in a Treasury rejection of the request.

2. <u>The position of the Chinese Central Bank</u>

The Stuart-Arnold memo then indicates a second line of defense: There is something "inexplicable" about the Chinese desire to buy this amount of gold when they nominally have much larger holdings of gold (3.95 to 6 million ounces as against 100,000 ounces requested for purchase in this transaction). The purpose of referring the transaction to the political desk of the State Department at all was to give the opportunity to the political officers to assert that the applying bank was no longer recognized by the United States as an official central bank of a recognized government. This the political desk did not say and in all probability will not say, since the United States still recognizes both the National Government and the Central Bank of China as the Government's central bank. Instead, the political desk replied with an economic principle which is outside its jurisdiction, subject to serious dispute on both economic and factual grounds, and an improper intrusion into Treasury gold policy.

The suggestion that something is awry with the Central Bank of China would be a valid reason for rejecting this request to purchase

gold mainly if the State Department wishes to reject the right of the Central Bank of China to carry on any transaction with the United States. In that case, the receipt of dollars from the Central Bank is as much an offense as selling gold to it, since the receiver of the dollars would lay himself open to suit for having accepted assets which the payer had no right to transfer. Until the State Department political desk wishes to assert this position formally, they should not be given a dominant vote in this Treasury matter.

3. Gold sales as a stabilization measure

The Stuart-Arnold memorandum then mentions a third line of defense: namely, that the present gold sales program is "unavailing as a price stabilization measure." The contention of this paper is that that is not an adequate reason to upset the basic convertibility of dollars into gold. The writer has doubts about the accuracy of the assertion that the gold sales program is as unavailing as Messrs. Stuart and Arnold assert. The evidence cited, of a large increase in prices, is irrelevant to the Chinese contention that market intervention keeps things from going bad faster than they now are going. But it seems necessary not to let this gold sale argument be diverted into a debate on the effectiveness of internal gold sales as a stabilization measure. The Chinese officials, who alone have responsibility for the problem, assert that they want to carry on such a gold-selling program. It is an improper intrusion into their sovereignty and responsibility for the U.S. to make a unique violation of its standard practice on gold in order to tell the Chinese that there are some people in the U.S. Government who think the Chinese are mistaken about the usefulness of the program.

References have also been made above to the ease with which the Chinese can buy gold from other sources and the easy availability of their selling dollars in the open market.

The sentence in the memorandum which says, " The attitude of this Government, at least since the middle of 1947, has been wholly consistent as regards the possible efficacy of the currency stabilization measures of the sort which have been proposed or attempted by the Chinese since that time", is inconclusive on several different counts. In the first place if this sentence implies that, as a result of this "wholly consistent" attitude, the U.S. Government refuses to sell gold in exchange for dollars, the implication is wrong. The Treasury is currently ready to sell gold freely to countries which are selling gold internally as stabilization measures, Mexico for one, and Switzerland for another since mid-1947. Secretary Snyder and Mr. Southard, the Treasury and the rest of the Government have authorized and assisted in the carrying out of a gold selling program in Greece. The fact that one telegram has been sent saying that ECA hopes to stop this program beginning a couple of months from now, does not change the fact that we have filled

all the Greek applications to buy gold since 1947 and before.

The sentence quoted at the beginning of the last paragraph about the Treasury attitude since mid-1947 is really a boast that in the last year and a quarter the U.S. Treasury has consistently tried to overthrow the 4,000 year old monetary habits of peoples in many parts of the world.

I propose at the earliest opportunity to write another memorandum attacking the Treasury-State position that on technical grounds no aid against inflation in China will be availing until the "continued massive Government deficit" is ended. That assertion amounts to saying that the United States on technical grounds will be unable to help the Chinese against inflation until the Chinese stop fighting the Communists. However, this memorandum is not the proper place to discuss that issue.

Those responsible for deciding on the kind and amount, if any, of U.S. aid to China can consider whether or not the Chinese should be pressed to discontinue interference on their open market for gold. The current program of aid, however, now rapidly drawing to a close, has not been designed in any way to take notice of whether or not the Chinese are selling gold internally. If ECA wants to, they can say that they will cut off even the remaining program of aid unless China stops such sales. The attitude of the ECA, however, is that it does not wish to interfere in China's internal affairs.

Making this gold sale in exchange for dollars carries no implication regarding a prospective request from the Chinese Government for a loan of gold or silver.

4. <u>The nominal purpose of the gold purchase</u>

The semi-final argument of the Stuart-Arnold memorandum, "that the sale is not for the purpose of strengthening monetary reserves," is playing with words. The authors have in mind some special conception of what "strengthening monetary reserves" means. It would seem impossible to deny as a matter of ordinary English that this gold purchase will strengthen their monetary reserve, if changing dollars into gold is considered strengthening. Since Messrs Stuart, Arnold and others oppose such a conversion, the obvious implication is that it is astrengthening of China's monetary reserve. The Treasury has never and could never insist that "strengthening monetary reserves" means that the country must always keep the gold locked up. Likewise, it would seem necessary to torture the common meaning of words to deny that redeeming these dollars in gold is a "settlement of an international balance." A Chinese holding of dollars is an international balance, and their getting gold from us for the dollars is the classical way of settling it.

5. The opinions of the State Department

It is indeed embarassing that the political desk of the State Department has presumably taken some position or other opposed to this gold sale. In a number of passages above, the opinion has been advanced that the political desk of the State Department is not the proper place to decide a general economic gold policy. There is no case known to the writer where the political desk has decided a gold sale question on economic grounds. Every effort should be made to prevent any such procedure from developing.