BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 6, 1961

To Chairman Martin

Subject:

From Arthur W. Marget

The attached memorandum, by Mr. Furth, was prepared somewhat hurriedly in order to enable you to use it as a briefing paper, if you choose to do so, for your appearance before the Joint Committee. The discussion of "special facilities" for foreigners is to be found on page 5.

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Attachment

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FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 6, 1961.

To Mr. Marget

From J. Herbert Furth

Subject: Speculative capital movements, balance of payments, gold transfers, and interest-rate differentials.

Short-term capital movements were important in the U.S. balance of payments deficit and in the decline in the U.S. gold stock during the second half of 1960 (see the attached table).

These movements can be explained in part by interest-rate differences between the United States and other financial centers, but in large part also by other factors, including (but not limited to) uncertainties as to the future gold value of the dollar.

Two types of policies have been proposed to prevent such movements from harming the international payments system and the U.S. economy: first, policies aimed at reducing the movements to tolerable proportions; second, policies aimed at neutralizing unfavorable effects of such movements as may nevertheless occur.

Importance of short-term capital movements in the second half of 1960

In the second half of 1960, U.S. exports of merchandise and services failed to cover what may be called "basic" U.S. payments (imports of merchandise and services, military expenditures, pensions and remittances, recorded outflow of long-term capital and U.S. economic aid) by a seasonally adjusted amount of $1-1/2 billion at an annual rate. This compares with a similarly computed deficit of $2 billion for the first half of 1960, and $4-1/2 billion for 1959.

The second half of 1960 also saw an outflow of recorded U.S. short-term capital and of unrecorded capital of $3-1/2 billion at an annual rate, in contrast to an outflow at an annual rate of less than $1 billion in the first half of 1960 and an inflow in 1959. These capital movements raised the deficit in the U.S. balance of payments (as conventionally computed) to an annual rate of $5 billion in the second half of 1960, while such flows contributed very little to the deficit in the first half of 1960, and actually reduced the deficit in 1959.

The influence of such capital movements on the deficit in the second half of 1960 was probably even larger than indicated by these figures because there is reason to assume that some of the flows included in long-term capital outflows actually represented speculative short-term transactions and because there usually is an inflow rather than outflow due to unrecorded transactions. At the very least, however, the short-term capital movements accounted for 70 per cent of the total deficit in that period.

Such movements played an even larger role in the drain on the U.S. gold stock during the second half of 1960. Withdrawals of foreign private holdings of liquid dollar assets may add to that drain although they do not

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affect the U.S. balance-of-payments deficit (as conventionally computed) since these holdings are already considered a liability in computing the U.S. international liquidity position. However, such withdrawals, by increasing foreign official at the expense of foreign private dollar holdings, result in gold transfers to foreigners whenever a foreign monetary authority decides to convert its dollar acquisitions into gold.

In the second half of 1960, foreign private short-term dollar holdings declined at an annual rate of $1 billion, while they had increased in the first half of 1960 and in 1959. The movement of private dollar holdings therefore reduced the impact of the U.S. deficit on gold movements in the previous periods, but increased that impact in the second half of 1960. In fact, if Germany had not taken most of its reserve gains in dollars, the decline in the U.S. gold stock in the second half of 1960 would have exceeded the balance-of-payments deficit, in spite of the U.S. purchase of gold from the International Monetary Fund.

As it was, the U.S. gold stock declined in that period at an unprecedented annual rate of $3 billion, as compared to a negligible decline in the first half of 1960, and a decline of $1 billion in 1959.

Causes of the short-term capital movements

The outflow of U.S. short-term and of unrecorded capital and the withdrawal of foreign dollar holdings was in part certainly due to the emergence of considerable differences between interest rates in the United States and in other financial centers, particularly the United Kingdom and Germany.

It is equally certain, however, that differences in interest rates did not account for all of the movements. First, there were large outflows to countries where interest rates were not higher than in the United States, such as the Netherlands and Switzerland. Second, part of the outflow to the United Kingdom resulted in private purchases of gold in the London free market; these purchases reached a record level in the second half of 1960.

Third, a large part of the funds moving to Germany were attracted by the expectation of an appreciation of the German mark instead of mere interest rate differentials; Germany prohibited interest payments to foreigners on short-term assets.

Fourth, movements of capital out of the United States in response to short-term interest-rate differentials were encouraged by developments in forward rates. The large outflow of capital from the United States forced the exchange rate of the dollar against the leading European currencies virtually to the floor represented by the "gold points", approximately 3/4 of 1 per cent below par. Under these conditions, the premium on forward dollars would have been expected to rise sharply, and largely to offset the attraction of higher interest rates abroad. It failed to do so as, for the first time since the war, some capital moved uncovered into foreign currencies.

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Fifth, some capital apparently moved not into short-term but into long-term assets, obviously in the expectation of capital gains, which would result in the case of bonds from an expected decline in foreign interest rates and in the case of equities from the expectation of a continuing boom abroad, as contrasted with the expected recession in the United States. The importance of this factor is indicated by a reflux of capital to the United States in early 1961 to take advantage of expected advances in quotations at the New York Stock Exchange.

Sixth, some expansion of U.S. bank credit to foreigners and some repatriation of dollar holdings of foreign commercial banks were probably influenced by changes in relative credit demands and availabilities, and especially by a tightening of commercial bank reserve requirements in some foreign countries, independently of relative levels of money-market rates.

While there can be no doubt that all these factors played an appreciable role, it is virtually impossible at this time to make a reasonable quantitative estimate of their relative importance.

Avoidance of excessive capital movements

Large movements from dollars into gold or other currencies can basically be attributed to an excessive supply of dollars abroad. In the 2-1/2 years preceding the start of that movement in mid-1960, official and private liquid dollar holdings (short-term claims and holdings of U.S. Government bonds and notes) of foreign countries rose $4 billion. If it had not been for this increase, foreigners presumably would have been glad, in the aggregate, to keep not only existing assets but also moderate further receipts in the form of dollars: before 1958, foreigners used to complain about an international scarcity rather than an international glut of dollars.

As long as the "basic" balance of payments of the United States remains in long-term equilibrium, and the supply of dollars to foreigners therefore remains limited, even relatively large capital movements would be unlikely to result in a general "flight from the dollar." In principle, therefore, the best way to avoid excessive volatile capital movements will be to restore and preserve equilibrium in the "basic" balance of international payments of the United States.

Apart from this general consideration, excessive capital movements may be avoided by eliminating their specific causes.

(a) Those capital movements that are caused by uncertainty as to the future value of the dollar (reflected in movements into gold and in the failure of forward exchange rates to rise) can best (or only) be avoided by restoring confidence in the stability of the U.S. economy in general and of the U.S. dollar in particular.

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Insofar as capital movements are due to attractive yields and expected capital gains connected with rapid rates of growth abroad, the best remedy is to make sure that economic growth in the U.S. provides similar attractions for capital investment at home.

(b) Capital movements exclusively caused by differences in short-term interest rates not offset by forward-exchange costs may be divided into two groups.

Some capital movements may result from "structural" differences in short-term interest rates, due to differences in the pattern of supply of and demand for funds in various money markets. It would be unrealistic to expect market interest rates to be as low in Japan as in the United States, and there is no economic need to prevent funds from moving out of countries in which the supply of short-term capital is ample to countries in which it is scarce.

The second (and more important) type of differences results from variations in the pattern of cyclical fluctuations. A country suffering from a recession does not (all other things being equal) have the same market rate of interest as a country experiencing a rapid upswing. Such movements, however, will not affect the long-term equilibrium in the balance of payments of the countries involved as long as it can be expected that the flows will be reversed when the relative cyclical positions of the countries are reversed.

Problems arise only when these structural and cyclical flows become so large as to impair confidence in the smooth working of the international payments system. In this case, several different methods of approach may be used.

The country suffering from a speculative outflow may try to keep its interest rates higher than the current structural or cyclical situation would warrant. It may do so by trying to keep all rates high, reducing the supply of funds throughout the economy. Such an attempt would obviously be economically and politically dangerous since it would almost certainly reduce economic activity, employment, and "real" national income.

The country may, instead, try to raise only those rates which appear to be particularly attractive to international capital. Assuming that such capital is primarily interested in short-term rates, this would mean an attempt to raise short-term rates while not raising, or actually lowering, medium or long-term rates. The success of such an operation depends not only on the power of the monetary and fiscal authorities to influence the supply of and demand for both long and short-term funds, but also on the flexibility of the money market, and especially the size and speed of arbitrage operations among different maturities.

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Whenever arbitrage is effective, the success of the authorities in decisively changing interest-rate patterns is likely to be short-lived.

These difficulties may invite attempts at insulating interest rates for international transactions from the domestic level, either for all foreigners or only for foreign official accounts. It would be possible to issue special Treasury securities and to induce banks to offer special deposit rates, available only to foreigners, but to all foreigners. The main shortcoming of such a policy would be the difficulty of preventing domestic investors from transferring their funds to foreign institutions and thereby increasing almost infinitely the amount of "foreign" funds at the expense of "domestic" funds. If this happened, the attempt at insulation would break down, and domestic rates would tend to rise to the level offered to "foreign" holders.

This danger could be avoided if the special rates were restricted to foreign monetary authorities, especially if these authorities undertook not to make the advantage indirectly available to private holders. On the other hand, such a restricted measure would probably not have an appreciable effect on international capital movements, since major central banks do not decide on the division of their reserves among gold, sterling, and dollars on the basis of interest yields. Some of them, including those of the United Kingdom, Belgium, the Netherlands, and Switzerland, keep all their reserves, except for working balances, in the form of gold; in the second half of 1960 these four banks were responsible for two-thirds of all the gold purchases from the U.S. Treasury. Even small central banks do not seem usually to determine their gold policy on the basis of interest rates. At most, some of those banks might move funds from London to New York in response to higher interest rates. Competition between London and New York for central bank funds, through special rates offered regardless of market levels, might, however, threaten friendly cooperation between the two major central banking institutions of the free world. Moreover, the structural level of interest rates is usually higher in London than in New York and it would, therefore, be easier for London than for New York to offer particularly attractive discriminatory rates to foreign central banks.

The bulk of the funds invested by foreign central banks in the special securities or deposits, would presumably not be shifted out of gold or sterling, but out of other dollar assets. In this case the final effect of the special rates would again be felt in the domestic money market; moreover, the main result of the attempt at insulating the market for foreign monetary authorities would merely be to burden the balance of payments with higher interest payments to foreigners.

In any case, facilities for foreigners should be terminable whenever a change in the international or domestic financial position of the United States would make a continuing inflow of foreign funds no longer desirable or positively undesirable.

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Avoidance of harmful effects of capital movements

If it were impossible or inconvenient to avoid large speculative capital movements, it still would be possible to prevent such movements from disturbing the international payments system and thus the U.S. domestic economy.

If the main capital movements are restricted to some major countries (as in the second half of 1960), it may be possible to conclude bilateral agreements under which these countries keep the inflowing private funds invested in dollars; in this case, the only effect of the capital movements would be to increase foreign official holdings at the expense of foreign or domestic private holdings of dollars, leaving the U.S. gold stock unchanged.

If such bilateral agreements are considered impractical, or if the foreign countries involved insist on conditions that would seem unacceptable, the same result may be achieved by means of existing international institutions, and in particular by utilizing present and perhaps also increased future resources of the International Monetary Fund.

Two types of proposals to increase the effectiveness of the Fund in this matter are currently under consideration. The first would use the Fund's existing power to borrow currencies of its member countries and to lend them to other members, regardless of quota limitations. For instance, if the United States wanted to offset a movement of capital to Germany, the Fund would borrow the corresponding amount of German currency and lend it to the United States; the United States would use that currency to repurchase the dollar funds that had been transferred to the German central bank. Germany would thus end up with increased claims against the Fund rather than increased holdings of either dollars or gold.

Such an operation might be more acceptable to Germany than a direct loan of German marks or dollars to the United States, because under the Articles of Agreement of the International Monetary Fund all sums made available to the Fund, as well as all sums owed to the Fund, are guaranteed against changes in their gold value. Sums loaned to the Fund would therefore be as free from the risk of depreciation as would physical holdings of gold, and they would have the advantage of yielding a return.

While the United States could borrow from the Fund without the need for special legislation, it is prevented from making loans to the Fund without Congressional action (Bretton Woods Agreement Act, Section 5). Obviously, foreign countries would be reluctant to make loans to the Fund for relending to the United States unless they could be assured that if they needed dollars in the future in excess of their Fund quota, the United States would be prepared to make similar loans to the Fund. For this reason, this proposal is likely to remain impractical unless the Congress authorizes U.S. loans to the Fund.

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The second proposal envisages the deposit with the Fund of currencies other than its own which a country acquires over and above the amounts it wishes to hold. For instance, if there were a flow of capital from the United States to Germany and the German central bank did not want to keep the resulting reserves invested in dollars, it could deposit them (against interest) with the Fund. Again, the benefit for Germany would lie in the automatic guarantee of these deposits against any risk of depreciation in terms of gold.

In comparison with the first proposal, the second would seem to have the disadvantage that the amounts involved would not be under the control of the United States. Under the first proposal, it would always be up to the United States to decide whether or not to borrow foreign currencies from the Fund, and thus how far to permit funds to be subjected to the automatic gold value guarantee. Under the second proposal, the decision on the amount involved would initially be up to the creditor countries and to the management of the Fund.

Actually, however, the United States would be able, under the Articles of Agreement of the International Monetary Fund, to limit the amount of dollars deposited with the Fund by redeeming any excess in gold -- just as the United States would be able to avoid borrowing foreign currencies from the Fund under the first proposal by making gold payments to the foreign countries holding dollars.

Another disadvantage of the second proposal might be that deposits with the Fund, with their combination of gold value guarantee and yield, could prove so attractive to foreign central banks presently holding dollar reserves that larger amounts would be deposited with the Fund than otherwise would be presented to the United States for conversion into gold. This danger might be avoided by keeping interest rates on these deposits low in relation to the yields of investments in U.S. money markets.

At present, most experts within United States Government agencies and most Executive Directors of the Fund favor the plan of borrowing through the Fund over the plan of permitting foreign countries to deposit dollars with the Fund. Their preference is presumably based less on the economic differences between these proposals (which are small) than on the fear that the second proposal might lead to the fundamental change in the free world's system of international payments proposed by Professor Triffin.

Professor Triffin, who at present is Consultant to the Council of Economic Advisers, has urged the replacement of sterling and dollars as international reserve currencies by a newly created monetary unit to be administered by the International Monetary Fund, and has advocated the voluntary deposits of dollars (and sterling) by foreign countries with the Fund as a first step toward a realization of his plan. To those who believe that the Triffin plan is either premature or unworkable, or outright harmful to the interests of the United States, the deposit proposal would be acceptable only on the understanding that it was not to be interpreted as an endorsement of further moves in the direction of that plan.

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CAPITAL MOVEMENTS AND GOLD TRANSFERS, 1959-60

	1960 1/		1959 2/
	2nd half p/	1st half	
	(Billions of dollars)		
1. "Basic" U.S. balance of payments deficit 3/	1.3	2.2	4.5
2. Plus: Outflow of recorded U.S. private short-term capital and unrecorded transactions (inflow: -)	3.4	0.7	-0.8
3. Equals "conventional" deficit	4.7	2.9	3.7
4. Plus: Outflow of foreign private short-term capital (inflow: -)	1.0	-0.9	-1.1
5. Equals: Change in gold and in dollar liabilities to foreign authorities 4/	5.7	2.0	2.6
6. Minus: Increase in foreign official dollar holdings 4/	2.6	1.7	2.0
7. Equals: net gold sales	3.1	0.3	0.7

1/ At annual rates (without seasonal adjustment)

2/ Excluding U.S. subscription to International Monetary Fund.

3/ Imports of goods and services, military expenditures, pensions and remittances, outflow of private long-term capital, and U.S. economic aid, minus exports of goods and services.

4/ Includes international institutions.

p/ preliminary.

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