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International Relations of the Federal Reserve System 17 pages

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This Review is intended primarily for internal circulation and should in no case be cited or quoted. It consists of personal and informal contributions by the author, which in many cases represent tentative analyses of the subject considered.

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J. H. F.

January 28, 1958.

International Relations of the Federal Reserve System

J. Herbert Furth

Introduction: International functions of the Federal Reserve System

The Federal Reserve System is concerned with international problems, first because of the interrelation between these problems and the problems of domestic monetary policy, and second, because of the specific functions in the international field with which the System has been entrusted by the Congress.[1]

In the United States, international trade and finance form a smaller part of economic activity than in most foreign countries.[2] Nevertheless, foreign developments exert a powerful influence on many branches of industry and agriculture in which exports account for a large part, and occasionally for the bulk, of total output. They also decisively affect the federal budget by determining the requirements of national security expenditures, including those involved in assistance to foreign nations. Finally, they determine the movements in foreign-held dollar balances and other short-term assets, which affect the liquidity of the member banks and the money market.[3]

In addition to this general concern, the Federal Reserve System has special responsibilities in the following matters:

(1) The Federal Reserve Banks act as correspondents for foreign central banks and governments and as fiscal agents for international institutions; they also are authorized, subject to supervision by the Board of Governors, to undertake certain financial operations abroad, and to make loans on gold collateral to foreign central banks and governments.

(2) The Board of Governors regulates certain foreign operations of member banks (bankers' acceptances and foreign branches), and all operations of certain other corporations (the so-called "Edge" and "Agreement" Corporations) that are engaged in international financial activities.

1/ cf. Reply of the Chairman of the Board of Governors to Subcommittee on General Credit Control and Debt Management. Joint Committee on the Economic Report. Washington, 1952, Part 1, pp. 273-275.

2/ In 1956, international receipts and payments of the United States were each equal to $26 billion, or about 6 per cent of the gross national product.

3/ There are special Divisions at the Board of Governors and at the Federal Reserve Bank of New York which deal with the analysis of international developments of interest to the System.

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(3) In spite of the transfer of the ownership of the monetary gold of the United States to the Treasury, the Federal Reserve System remains vitally concerned with gold problems, including the international movement of gold, since gold continues to function as the reserve basis of Federal Reserve notes and deposits.

(4) The Chairman of the Board of Governors is a member of the National Advisory Council on International Monetary and Financial Problems; in this way, the Federal Reserve System exerts a direct influence on the institutions with which the Council is concerned; these institutions include three international organizations (the International Monetary Fund, the International Bank for Reconstruction and Development, and the International Finance Corporation) and such United States government agencies as the Export-Import Bank of Washington, the International Cooperation Administration, and the Treasury's Stabilization Fund.

This enumeration shows that the Federal Reserve System plays an important role in the international financial policies and operations of the United States; nevertheless, its role is more explicitly circumscribed than in the case of many other central banks. Central banks of many foreign countries are empowered to "transact any banking business with foreign countries" (e.g., most recently, German Federal Bank law, Art. 19, para. 9). In contrast, the Federal Reserve Act defines in detail the powers of the System in regard to transactions abroad, and under the Gold Reserve Act of 1934 the Secretary of the Treasury, rather than the Federal Reserve System, has the power of ultimate decision as to gold and Stabilization Fund transactions.

Within the Federal Reserve System, the ultimate responsibility for international financial policies and operations is vested in the Board of Governors, which "shall exercise special supervision over all relationships and transactions of any kind entered by any Federal Reserve Bank with any foreign bank or bankers . . . and all such relationships and transactions shall be subject to such regulations, conditions, and limitations as the Board may prescribe" (Sec. 14, para. 8, of the Federal Reserve Act, added by the Banking Act of 1933).[4]

The following sections discuss the specific functions of the Federal Reserve System in the international field.

4/ cf. E. A. Goldenweiser, American Monetary Policy, New York, 1951, pp. 274-278.

1. International financial operations of the Federal Reserve Banks

Virtually all international operations of the Federal Reserve System are conducted by the Federal Reserve Bank of New York.5/ However, the other Federal Reserve Banks are given the opportunity of participating in these transactions, and they regularly make use of that opportunity.

Correspondent relations -- In December 1957, the Federal Reserve Bank of New York held accounts for the central banks or governments of 72 foreign countries (Federal Reserve Act, Sec. 14, para. 6) as well as for such international institutions as the International Monetary Fund, the International Bank for Reconstruction and Development, and the International Finance Corporation (Bretton Woods Agreements Act, Sec. 6; International Finance Corporation Act, Sec. 6). 6/

The Bank offers to its foreign correspondents most but not all the facilities of a commercial bank.7/ For their account, it purchases and sells bankers' acceptances,8/ and United States Government securities; earmarks, holds, and sells (to the United States Treasury or to foreign purchasers) gold that is the property of a foreign central bank or a foreign government; purchases and sells foreign exchange; receives and holds in custody securities; and collects and pays checks, notes, bills, and other items payable within the United States. However, it cannot accept any interest-bearing (time or savings) deposits, and it has only limited authority to make advances.

In its international operations, no less than in its domestic activities, the Federal Reserve System has to take account of its monetary policy as a whole (cf. Federal Reserve Act, Sec. 12A, para. 3). Therefore, the Federal Reserve Banks reserve the right to decline the execution of an order of a foreign correspondent if its effects would be contrary to Federal Reserve policy, and to offset foreign operations in bankers' acceptances and U. S. Government securities that would be inconsistent with the open-market activities of the System, by executing the transactions directly through the System's Open Market Account rather than through the market.

5/ A very small number of transactions is executed by the Federal Reserve Bank of San Francisco.

6/ The Hague Agreement of 1930 envisaged the official participation of the United States in the Bank for International Settlements, including the appointment of a representative of the Federal Reserve System as ex-officio Governor (Statutes of the B.I.S., Art. 6, 9, 15, and 28). This official participation has not materialized; however, the Federal Reserve Bank of New York acts as the Bank's "sole correspondent in America" (E.L. Dulles, The Bank for International Settlements at Work, New York, 1932, p. 84), the Federal Reserve System has the right to object to any of the Bank's dealings in the United States market or in United States currency (Art. 20), and representatives of the Federal Reserve System frequently attend meetings of the B.I.S. as guests.

7/ Upon request, the System also makes staff members available to foreign central banks for consultation and advice.

8/ It also guarantees the payment of acceptances purchased for foreign account.

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The Federal Reserve Banks do not insist that their foreign correspondents hold all their accounts with them.9/ Many foreign monetary authorities hold part of their foreign exchange as working balances for commercial transactions, rather than as monetary reserves, and the Federal Reserve Banks do not compete with commercial banks for those balances. The fact that the Federal Reserve Banks cannot pay interest on deposits, offers an inducement to foreign monetary authorities to maintain balances with commercial banks.10/

Transactions abroad -- In contrast to the large-scale activities of the Federal Reserve Banks in the United States as correspondents and fiscal agents for foreign and international monetary institutions, their own operations abroad have virtually ceased.

Under the Federal Reserve Act, the Federal Reserve Banks may purchase and sell in the open market abroad (from or to foreign banks, enterprises, and individuals) cable transfers and bills of exchange; they may deal abroad in gold and make loans on gold collateral;11/ they may buy and sell abroad securities of the United States or its agencies; and they may establish and maintain accounts in foreign countries, and appoint correspondents and agencies abroad (Sec. 14, para. 1, 2, 3, and 6). Actually, the last transactions abroad were undertaken in 1931, when the Federal Reserve Banks participated in international central bank credits to the United Kingdom, Austria, Germany, and Hungary; the largest such transactions was a credit of $125 million to the Bank of England. In previous years, the Federal Reserve Banks had participated in numerous credits (apart from loans on gold collateral), including one to the United Kingdom ($200 million in 1925); of these credits, only one to Hungary ($2 million in 1929) was ever utilized. All the agreements provided for credit extension in the form of a purchase of bills, with the notable exceptions of the agreements with the United Kingdom (1925) and Hungary (1929), which provided for the sale of gold against

9/ On December 31, 1957, holdings of foreign countries and international institutions with the Federal Reserve Banks included $6,023 million of earmarked gold, $5,762 million of dollar deposits and Government securities, and $76 million of bankers' acceptances. The gold holdings exceeded one-third of all reported gold holdings of foreign countries and central institutions; the dollar holdings were equal to nearly two-thirds of all liquid dollar assets of foreign monetary authorities and international institutions.

10/ This inducement is reinforced by legal provisions (Internal Revenue Code, Sec. 861a, 1, c, and 881) which exempt foreign holders from income tax on the revenue from bankers' acceptances and time deposits, but subject them to taxation in regard to the yield of Government securities. While some central banks are completely tax-exempt under tax treaties or as government agencies, many of them are taxable, and these banks find it often more profitable to invest in time deposits with commercial banks than in Treasury bills; the market for bankers' acceptances (see below) is too narrow to afford scope for large-scale investment.

11/ The Banks are also authorized to make advances "secured by direct obligations of the United States" (Federal Reserve Act, Sec. 13, para. 13, added by Banking Act of 1933). However, such advances bear interest rates that are higher than the discount rate, and are therefore unattractive to potential borrowers.

foreign exchange (sterling and pengö, respectively), with the foreign currency accounts in turn to be used for the purchase of commercial bills.12/

In contrast to most foreign central banks, the Federal Reserve Banks do not operate in the foreign exchange market for their own account, although they do so for the accounts of the United States Treasury and of their foreign correspondents.13/ One reason for this difference is the fact that the par value of the United States dollar is expressed exclusively in terms of gold while the par values of other currencies are also expressed in terms of the United States dollar; other countries therefore see to it that the market rate of exchange of their currencies does not depart from the par value.14/

The Federal Reserve Banks maintain nominal accounts with three foreign central banks; at the end of 1957, these accounts totaled only $15,000 and had no economic significance.

Gold loans -- The most important international transactions executed by the Federal Reserve Banks for their own account are loans to foreign central banks on gold collateral. In contrast to unsecured credits, or to drawings upon the International Monetary Fund, these loans do not add to the total amount of international means of payments available to the borrowing country, but merely transform one type of such means of payments, namely gold, into another, namely dollars. Under the policy of the Federal Reserve, such loans are made only on gold held under earmark at the Federal Reserve Bank of New York and only for temporary needs; they usually have a maturity of not more than three months and usually carry an interest rate equal to the discount rate at the Federal Reserve Bank of New York. For a country that needs dollars for longer periods, it is better to sell gold than to borrow on gold collateral since the interest rate burden would exceed the cost of selling and repurchasing the amount of gold in question.

Gold loans usually involve relatively small amounts: in 1957 new gold loan arrangements totaled $16.5 million, of which $5 million were outstanding at the year-end; the largest amount outstanding at any one time was $185 million in October 1954.

12/ The President's Commission on Foreign Economic Policy recommended in January 1954 "that the Federal Reserve System explore with foreign central banks the possibilities of standby credits or line of credit arrangements" as a means "of strengthening foreign reserves and . . . to assist in the gradual attainment of general convertibility" (Report, pp. 74-75).

13/ The Federal Reserve Bank of New York certifies daily to the Secretary of the Treasury the buying rates in the New York market for cable transfers of certain foreign currencies; however, this certification is exclusively for the purpose of determining the basis of assessment and collection of import duties (Tariff Act of 1930, Title IV, Sec. 522).

14/ Federal Reserve Bank of New York, Monthly Review, December 1957, p. 166.

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2. Supervision of foreign operations of member banks and of operations of corporations doing foreign banking

The Board of Governors supervises foreign operations of member banks in two respects, namely as to the acceptance of bills of exchange and the establishment of branches abroad.

Bankers' acceptances -- Any member bank may accept, within specified limits, bills of exchange growing out of the importation and exportation of goods, the shipment of goods within the United States, and the storage of readily marketable staples in the United States or in a foreign country (Federal Reserve Act, Sec. 13, para. 7; Regulation C, Sec. 1). Moreover, the Board of Governors may grant a member bank permission to accept bills of exchange drawn by banks in foreign countries or insular possessions of the United States "for the purpose of furnishing dollar exchange as required by the usages of trade in the respective countries" (Federal Reserve Act, Sec. 13, para. 12; Regulation C, Sec. 2).[15]

Bankers' acceptances have been playing an increasing role in United States banking since the revival of foreign trade following the end of the Second World War. In December 1957, there were $1.3 billion of accepted commercial bills in circulation, all but a negligible amount arising out of imports into and exports from the United States or the storage of staples in foreign countries. The volume of "dollar exchange" acceptances has been consistently even smaller than that of commercial acceptances based on domestic shipments.

Foreign branches -- Member banks having capital and surplus of $1 million or more may receive permission from the Board of Governors to establish branches in foreign countries or insular possessions of the United States "for the furtherance of the foreign commerce of the United States" (Federal Reserve Act, Sec. 25, para. 1, and Sec. 9, para. 3). These branches are not restricted to transactions involving the foreign commerce of the United States, but are authorized to engage in any banking business in which their home office could engage.[16]

15/ Under a ruling of the Board of Governors, "dollar exchange" bills are required by the usages of trade only in Australia, New Zealand, Indonesia, and Latin America excepting Haiti, Mexico, and the Netherlands Antilles. Such bills, in contrast to commercial bills, are based on expected future rather than on present commercial transactions; they must not be mere "finance bills", drawn to provide working capital rather than dollar exchange (Regulation C, Sec. 2. c).

16/ Restrictions upon banking activities in the United States apply also to foreign branches, although such activities may be customary in the foreign country involved. Since this restriction sometimes hampers the competitive position of a foreign branch, the pending Financial Institutions bill would grant the Board of Governors authority to permit foreign branches to conduct activities customary in the foreign country.

As compared with banks of other major foreign countries, banks in the United States have few foreign branches. In December 1957, 12 United States banks (including "Edge" and "Agreement" Corporations; see below) had a total of 110 foreign branches (excluding those in United States offshore areas), of which 62 were in Latin America.

Corporations engaged in foreign banking -- The Federal Reserve System is concerned with two types of U. S. corporations that, without being member banks themselves, conduct an international or foreign banking business; the so-called Edge Corporations,17/ which are chartered by the Board of Governors; and corporations formed under State law, in which member banks participate as shareholders and which operate under agreement with the Board of Governors. 18/

Edge Corporations (Section 25 A of the Federal Reserve Act) may be formed either by member banks or by other corporations or individuals. They must have a capital of not less than $2 million; all their directors must be U. S. citizens, and the holders of a majority of their shares must be U. S. citizens or corporations controlled by citizens and chartered under United States federal or State laws.

Edge Corporations are of two kinds: Banking Corporations, which are engaged in deposit banking, and Financing Corporations, which are engaged in other types of financial activities. Banking Corporations may not engage in the security business, and Financing Corporations may not engage in deposit banking (Regulation K, Sec. 4). Edge Corporations may not carry on any part of their business in the United States except such as is incidental to their international or foreign business. In particular, Banking Corporations may receive only such deposits within the United States as are incidental to or for the purpose of carrying out transactions abroad; and Financing Corporations may not engage or participate in the underwriting, sale, or distribution of securities in the United States (Regulation K, Sec. 6). Banking Corporations, but not Financing Corporations, are permitted to accept bills of exchange growing out of foreign or international transactions, within limits similar to those imposed on member banks (Regulation K, Sec. 7).

17/ Named after Senator Edge of New Jersey who in 1919 was instrumental in having the Federal Reserve Act amended so as to permit the establishment of such corporations.

18/ In addition, there are corporations doing banking business abroad which have no connection with the Federal Reserve System because no member banks are shareholders; the most important corporation of this kind is the American Express Company, which does not operate a banking business in the United States, but whose subsidiaries conduct extensive banking operations in many foreign countries.

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Edge Corporations may establish branches abroad, but not within the United States, and may purchase and hold stock in other corporations, subject to the consent of the Board of Governors. However, the Board of Governors ordinarily will not grant consent for a Banking Corporation to purchase and hold stock in a corporation not engaged in banking or closely related activities, or for Financing Corporations to purchase and hold stock in a corporation engaged in banking; in no case may a subsidiary corporation be engaged in transacting business in the United States, except such as in the judgment of the Board of Governors is incidental to its international or foreign business (Regulation K, Sec. 9).

Corporations other than Edge Corporations, in which member banks participate as shareholders, must restrict their operations by agreement with the Board of Governors (Federal Reserve Act, Sec. 25, para. 7, and Sec. 9, para. 20); these corporations are generally subject to the same limitations as Edge Banking Corporations (Regulation K, Sec. 11). Both Edge and "Agreement" Corporations are subject to examination by the Board of Governors.

At present there are two Edge Banking Corporations: the Bank of America, New York, a subsidiary of the largest commercial bank in the United States, the Bank of America National Trust and Savings Association of San Francisco, California; and the First Bank of Boston (International), New York, a subsidiary of the First National Bank of Boston. The Bank of America, New York, is the largest Edge Corporation, with total assets of $450 million; in addition to having a number of foreign branches and participations in some other foreign banking corporations, it controls the Banca d'America e d'Italia, the ninth-largest Italian bank. There are two Edge Financing Corporations, and three "Agreement" Corporations of which two conduct a significant banking business abroad. 19/

Edge Banking Corporations and "Agreement" Corporations have the advantage over foreign branches that their authority to do business abroad can be expanded by consent of the Board of Governors so as to include some activities which are customary abroad though beyond the power of United States commercial banks at home. They also enjoy some flexibility in acquiring stock in other foreign financial institutions. Even more important, the establishment of an Edge Corporation or an "Agreement" Corporation enables a member bank to establish in effect an office in the United States outside of its home State; this is an important exception from the general rule prohibiting banks from having branches in the United States outside of their home State. 20/

Edge Financing Corporations make it possible for a member bank to engage indirectly in investment banking activities abroad, although it could not do so domestically (Banking Act of 1933, Sec. 20). 21/

19/ One of them is affiliated with J. P. Morgan and Co. Inc. and in effect serves as the Paris branch of that bank; the other is affiliated with the First National City Bank of New York and owns the only bank operating in Liberia.

20/ Thus neither of the two Edge Banking Corporations could have been established as a branch of its parent company.

21/ The fact that Edge Corporations and "Agreement" Corporations thus have rather exceptional features explains the strict limitations upon the domestic business of such corporations included in Regulation K.

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3. Gold

Gold forms the basis of the American currency system: the dollar is defined as 1-35th of a troy ounce of fine gold. Moreover, each Federal Reserve Bank "shall maintain reserves in gold certificates of not less than 25 per centum against its Federal Reserve notes in actual circulation" and against its deposits (Federal Reserve Act, Sec. 16, para. 3). 22/ The United States fulfills its obligation under the Articles of Agreement of the International Monetary Fund to maintain the par value of the dollar (Art. IV, Sec. 4) by freely selling and buying gold in transactions with foreign monetary authorities for all legitimate monetary purposes at the rate of $35 per ounce of fine gold (plus or minus a charge of one-fourth of one per cent). 23/ Finally, the Federal Reserve Banks are authorized to hold gold for their foreign correspondents, and to use gold to settle international balances and "to maintain the equal purchasing power of every kind of currency in the United States" (Gold Regulations of the United States Treasury, Sec. 54.28, 54.29).

International role of gold -- Gold remains the ultimate means of international payments.24/ In practice, dollar and sterling are used more frequently than gold in settling balances; however, gold is generally accepted by all monetary authorities, and it is freely convertible into any currency, including the dollar and the pound sterling.25/ In particular, the International Monetary Fund is prepared to sell the currencies of any member in exchange for gold (Articles of Agreement, Art. V, Sec. 2 and 7,a). The members of the European Payments Union may and frequently do settle in gold that part of their monthly payments positions for which credit is not automatically extended.

22/ Gold also must be held in reserve by the Treasury against some older United States paper money still in circulation, including United States notes, Treasury notes of 1890, and pre-1933 gold certificates. At the end of December 1957, the United States gold stock stood at $22.9 billion. Gold held against the gold certificate reserves of the Federal Reserve amounted to $22.1 billion and covered 46.3 per cent (instead of the legal minimum of 25 per cent) of total Federal Reserve note and deposit liabilities; gold held as reserve against other money in circulation amounted to $0.2 billion. The rest of the gold stock were "free" holdings of the Stabilization Fund and the Treasury's General Fund.

23/ Statement of the Secretary of the Treasury, October 4, 1949.

24/ Under Article IV, Sec. 1, of the Articles of Agreement of the International Monetary Fund, either gold or the U. S. dollar as defined above forms the common denominator of the par values of the currencies of all Fund members.

25/ It might well be argued that the international acceptability of gold at present depends more on the willingness of the U. S. Treasury freely to convert gold into dollars at a fixed rate, than *vice versa*.

Monetary gold held in the free world on December 30, 1957, amounted to $39 billion, of which the United States held nearly 59 per cent. Nevertheless, it is sometimes suggested that the United States gold reserves are inadequate because of the size of dollar balances held by foreign authorities, corporations, and individuals, and international institutions; on December 31, 1957, these balances (including short-term holdings and long-term U. S. government securities) amounted to $16.5 billion. It is true that, if this entire sum were deducted from the United States gold holdings, the rest would not suffice to satisfy the legal reserve requirements for Federal Reserve notes and deposits. However, it would not make sense to consider all foreign dollar holdings a lien on the United States gold stock. First, under present policies only official holdings of foreign countries -- which in December 1957 amounted to about one-half of all foreign and international holdings -- can expect to be redeemed in gold. Second, a good part of these official holdings, as well as the great bulk of other foreign and international holdings, are needed as working balances for transactions with and in the United States, and their conversion into gold would be inconsistent with that purpose. Third, and most important, a large-scale demand for conversion of dollar balances into gold could be imagined only in the case of a political or financial catastrophe in the United States; however, in such a case not only foreigners but also domestic investors would presumably wish to withdraw their funds from the United States, and the problems created by large-scale domestic capital flight would dwarf those caused by requests for the redemption of foreign dollar holdings.[26]

Gold movements and the monetary system of the United States -- Under the Gold Reserve Act of 1934, (Sec. 10), the Secretary of the Treasury is authorized, for the account of the Exchange Stabilization Fund, to deal in gold "for the purpose of stabilizing the exchange value of the dollar". However, the Administration may not change the gold par value of the dollar without act of Congress (Bretton Woods Agreements Act, Sec. 5), and under the Articles of Agreement of the International Monetary Fund (Art. IV, Sec. 2; Fund Rules and Regulations, F-4) may not sell or purchase gold at prices deviating from that value by more than one-fourth of one per cent.

The Treasury's gold transactions affect the monetary policy of the Federal Reserve System. When the Stabilization Fund purchases gold from a foreign monetary authority, it usually pays for it out of its account with the Federal Reserve Bank of New York and immediately transfers the gold to the General Fund of the Treasury, replenishing its Bank account by drawing on the account of the General Fund; the Treasury in turn usually issues an equal amount of gold certificates to the Federal Reserve Banks, using the

26/ If an abnormal demand for redemption of foreign dollar balances into gold were due to a short-lived panic, it could always be met, even at the cost of impairing the legal gold reserve, since the Board of Governors is authorized to suspend all reserve requirements for a period not exceeding 30 days and to renew such suspension for periods not exceeding 15 days (Federal Reserve Act, Sec. 11, para. 4).

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proceeds to replenish its General Fund account with the Federal Reserve Banks. The ultimate effects of the purchase of gold from abroad are thus as follows: the Treasury has increased both its gold holdings and its liabilities to the Federal Reserve Banks (in the form of gold certificates) by the amount involved, leaving its dollar balance unchanged; the Federal Reserve Banks have increased both their holdings of gold certificates (and thus the power to expand their liabilities in the form of notes or deposits up to four times the amount involved) and their liabilities in the form of Federal Reserve notes or deposits (held by the foreign seller of gold) by the same amount; finally, the foreign seller of gold has increased its dollar holdings by the amount in question. In other words, not only the lending power of the Federal Reserve Banks has been expanded -- this would be important only if the actual reserve ratio were close to the legal limit of 25 per cent -- but also the actual circulation of money (in the form of holdings of the gold seller) has been increased. If the Federal Reserve System wishes to avoid an increase in circulation, it has to counteract the purchase of gold by the Treasury by means of an open-market sale of securities out of its portfolio by the same amount. A sale of gold by the Treasury obviously has exactly the opposite effect on the circulation of money.[27]

The monetary impact of the changes in the gold stock of the United States is by no means academic: in the postwar period, annual gold flows varied between a record net inflow of $2.2 billion in 1947 and a record net outflow of $1.7 billion in 1950, and the United States gold stock fluctuated between a year-end low of $20.1 billion in 1945 and a year-end high of $24.6 billion in 1949.

Domestic circulation of gold, and in fact domestic possession of gold coins or bullion by anybody but the Treasury (apart from economically insignificant amounts for industrial and artistic use) have been prohibited and also *de facto* prevented since 1933. Some observers, and especially the gold producers, have argued that it would be advisable to lift the prohibition on domestic gold coin circulation or at least on domestic trading in gold bullion. Their opponents have argued that in normal times the free-market price of gold would not depart from the legal par value and thus

27/ If the Federal Reserve System wished to let the "automatism of the gold standard" operate, it would refrain from counteracting the expansionary effects of gold purchases and the contracting effects of gold sales by the Treasury. According to gold standard theory, the inflow of gold is a sympton of deflationary, and the outflow of gold a symptom of inflationary, departures from international financial equilibrium, and these departures need to be corrected by expansionary and contracting monetary measures, respectively. However, this theory is valid only if the gold movements reflect exclusively the state of the balance of current international payments, and it cannot be applied when these movements, as at present, are largely influenced by capital transactions, and especially those of a governmental nature.

would not have any economic importance, while during a crisis a sudden increase in the demand for gold would draw gold from the monetary reserve into private hoards and thereby force a restriction in monetary circulation just at a time when the preservation of domestic liquidity and international solvency would be of the utmost importance. 28/ Actually the clamor for freeing the trade in gold, which was rather loud at the time when gold in some foreign free markets showed a significant premium over and above its par value, has died down since in the most important markets gold is now traded at the equivalent of the United States par value. 29/

4. Federal Reserve participation in the National Advisory Council on International Monetary and Financial Problems

The Chairman of the Board of Governors is a member of the National Advisory Council on International Monetary and Financial Problems, together with the Secretary of the Treasury, the Secretary of State, the Secretary of Commerce, and the President of the Export-Import Bank of Washington. The Council was established by the Bretton Woods Agreements Act of 1945 "to coordinate the policies and operations of the representatives of the United States on the Fund and the Bank and of all agencies of the Government which make or participate in making foreign loans or which engage in foreign financial exchange on monetary transactions" (Sec. 4).

The Council obviously cannot try to coordinate the policies and operations of the International Monetary Fund and the International Bank for Reconstruction and Development themselves, but only those of the United States representatives on these institutions. 30/ However, since the United States has the largest single vote in each of these institutions (26.6 per cent in the Fund, 29.7 per cent in the Bank) its representatives have a strong influence on the policies and operations of the institutions themselves even though -- contrary to the opinion sometimes expressed by critics of these institutions -- their views do not always prevail.

28/ A domestic free market in which the Treasury would not intervene, could not directly withdraw gold from the U. S. monetary reserves. However, a divergence between U. S. official and market prices for gold might undermine confidence in the ability of the United States effectively to maintain the "par value" of the dollar.

29/ In those markets in which gold still commands a significant premium, the premium reflects either restrictions on the free importation of gold (e.g., in India), or a *de facto* depreciation of the local currency. The most important free gold market is in London (re-established in 1954); however, gold can be bought in that market only for dollars (and for certain types of sterling held by foreigners and freely convertible into dollars).

30/ The United States representatives on the Bank are also its representatives on the International Finance Corporation.

Under the Bretton Woods Agreements Act, the Council has primarily the duty to "recommend to the President general policy directives" and to "advise and to consult with the President"; in practice, it generally acts by means of direct consultation with the United States executive directors and their alternates on the Fund and the Bank and with the policy making officials of the United States Government agencies involved.

Every six months the Council transmits to the President and to the Congress a report on its activities and especially on the participation of the United States in the Fund and the Bank; every two years it also transmits a special report on the Fund and the Bank, including recommendations as to the policies and operations of these institutions and changes in their Articles of Agreement.

The Council has no staff of its own; all the work preparatory to Council decisions is done by its Staff Committee, consisting of staff representatives of the member agencies and such other Government agencies as may be involved in the problem under discussion. The Staff Committee meets usually about once a week. Formal Council meetings are held only in matters of special importance or in case of disagreement among the member agencies; on all routine matters, the vote of the Council members is taken informally on the basis of the staff recommendations. In this way a continuous and thorough coordination between the staffs of the member agencies is achieved without consuming a great deal of the time of the high officials that form the Council itself.

Within the Council and its Staff Committee, the Federal Reserve representatives attempt primarily to advise the other members on the relations of the matters under discussion to monetary and credit problems and policies of the United States and the rest of the world. Just because the Federal Reserve has less operational responsibilities in the international field than other member agencies, its representatives may be able to view matters with greater detachment and objectivity.

The Council deals primarily with the following policies and operations of the international institutions and United States government agencies involved.

International Monetary Fund -- The Fund's main purposes are to promote international monetary cooperation; to promote exchange stability, maintain orderly exchange arrangements, and avoid competitive exchange depreciation; to assist in the establishment of a multilateral system of international payments and in the elimination of foreign exchange restrictions; and to make its resources available to members in order to enable them to correct maladjustments in their balance of payments (Articles of Agreement, Art. I).

The National Advisory Council is particularly concerned with the vote of the United States representative on proposals of member countries to establish or change the par values of their currencies, which are expressed in gold and in United States dollars (Art. IV, Sec. 1 and 5); on requests of member countries for approval of the maintenance or modification of exchange regulations and restrictions (Art. VIII, Sec. 2, and Art. XIV, Sec. 4); and on requests of member countries for drawings on the Fund's resources (Art. V, Sec. 3-5).

A country is entitled to a drawing only if it needs foreign exchange for a relatively short period. Drawings restricted to the country's "gold tranche" i.e., that part of its quota that has been paid by the country in gold,31/ are given the "overwhelming benefit of doubt" (International Monetary Fund, Executive Board decision, February 13, 1952; Annual Report 1952, p. 89); in practice they are granted without question. Drawings exceeding the gold tranche, but not exceeding one-half of the country's quota, are granted liberally, though not without question (Annual Report 1957, p. 119). Drawings of further amounts are granted only under exceptional circumstances, e.g., if a country that had been in difficulties has given evidence of executing in good faith a stabilization program approved by the Fund (Annual Report 1957, p. 120). Most but by no means all drawings are made in U. S. dollars.

In order to give Fund members an opportunity to secure drawings without delay when needed, the Fund is prepared to enter into "standby arrangements", giving a member the right to draw an agreed amount within an agreed period without further examination (Executive Board decision, October 1, 1952; Annual Report 1953, pp. 95-96). Such standby arrangements have become increasingly important and now are a part of virtually every stabilization program approved by the Fund.32/

31/ Each country is assigned a quota, ranging from $2,750 million for the United States to $500,000 for Panama. In general, a country pays one-fourth of its quota in gold and the rest in non-negotiable non-interest bearing government securities denominated in its own currency; these notes are presented for redemption by the Fund whenever the Fund needs the currency in question, primarily in connection with a drawing of that currency by another member.

32/ In the 12 months ending December 31, 1957, the Fund entered into new standby arrangements totaling $179 million, permitted actual drawings of $978 million, and received repayments ("repurchases") of $64 million. By far the largest individual transaction in the Fund's history was concluded in December 1956 with the United Kingdom; it consisted of a drawing of $561.5 million and an additional standby arrangement of $738.5 million, constituting together 100 per cent of the country's quota. This transaction was motivated by the exceptional position of the pound sterling as an international currency. On December 31, 1957, the Fund had $1.7 billion in drawings outstanding and $0.9 billion in standby arrangements still available for drawings of its members. Its uncommitted funds in currencies freely convertible into gold or dollars amounted to $1.6 billion; the rest of its total assets of $9 billion consisted primarily of inconvertible currencies, many of which are of little use for its purposes.

International Bank for Reconstruction and Development -- The Bank's main purposes are to assist in the economic development of its members; to promote private foreign investment by means of guarantees or participations; and to supplement private investment by loans out of its own resources. In practice, the most important function of the Bank is to aid underdeveloped countries, both by cooperating in the formulation of suitable development plans and individual development projects, and by providing credits, whereever possible in conjunction with other public or private investors (Articles of Agreement, Art. I).

All loans granted by the Bank must be either made to, or fully guaranteed by, the Government or the Central Bank of the borrowing country (Art. III, Sec. 4)33/. In general, the loans are to cover foreign exchange rather than local currency costs of the project involved; but in exceptional cases, the Bank may also provide funds for local expenditures, especially if a development project is likely to give rise indirectly to increased foreign exchange outlays (Art. IV, Sec. 3). In some instances, the United States Government has made available local currency funds arising from aid or agricultural surplus transactions (see below) to cover local expenditures connected with projects, the foreign exchange costs of which were financed by the Bank. It is one of the purposes of the National Advisory Council to encourage such cooperation between the Bank and United States Government agencies.

International Finance Corporation -- The International Finance Corporation was established in 1956 to supplement the activities of the International Bank by making investments in underdeveloped countries in a form resembling equity investments rather than fixed-interest loans. In contrast to Bank loans, its investments are available only to private enterprises, without Government guarantee. The Corporation is a frankly experimental institution with small resources.34/

Export-Import Bank of Washington -- The Export-Import Bank is fully owned by the United States Government; its purpose is "to aid in financing . . .exports and imports and the exchange of commodities between the United States . . . and foreign countries . . . or nationals thereof" (Export-Import Bank Act of 1954, Sec. 2).35/ In contrast to the International Bank, the

33/ During 1957, the Bank disbursed loans amounting to $439 million and received repayments of $72 million. At the end of the year, it had loans outstanding of $2.6 billion, and undisbursed loans of $0.6 billion. Its liquid assets available for lending include members' subscriptions, proceeds of bond issues, and net receipts from repayment or sale of loans to other investors and current income; its total lending capacity is limited to the amount of its subscribed capital and its surplus totaling $9.3 billion.

34/ In December 1957 the Corporation had a capital stock of $93 million; by that time it had authorized 5 investments averaging about $1 million each, all in Latin American countries.

35/ When the Bank was first established in 1934, its main purpose was to finance United States trade with Soviet Russia; this fact is no longer mentioned in polite conversation.

Export-Import Bank has to insist that its funds be spent primarily in the United States. In practice, it gives credits (or, to a very small extent, guarantees) to domestic exporters or foreign importers of United States goods; in both instances it generally relieves the United States exporter of a large part of the risk involved in the transactions. The Bank, like the International Bank and the International Finance Corporation, is not supposed to compete with private lending institutions, but to supplement and encourage private credits; and most of its credits, like those of the two international institutions, are medium or long-term. About 40 per cent of its loans usually go to Latin America.36/

It is an important function of the National Advisory Council to encourage a proper division of functions between, and a similarity of credit terms and conditions of, the Export-Import Bank and the international lending institutions; otherwise prospective borrowers might be encourage to "shop around" and to play off one institutions against the other. In general, the Export-Import Bank is preferred as a source of dollar funds whenever a transaction is in the particular interest of the United States, either for political or for economic reasons.

International Cooperation Administration -- The National Advisory Council is concerned with the operations of the International Cooperation Administration, which administers the United States aid programs, in regard to the choice between loan and grant aid, the terms and conditions of loans, and the disposal of the so-called counterpart funds, i.e., local currency balances deposited abroad by foreign governments as counterpart for the receipt of grant aid, which these governments may use only with the consent of the United States.37/ The Development Loan Fund established in 1957 also is "administered subject to the applicable provisions of Sec. 4 of the Bretton Woods Agreement Act . . . with respect to the function of the National Advisory Council" (Mutual Security Act of 1954, as amended, Sec. 206).

36/ On December 31, 1957, the Bank had a lending authority of $5 billion, outstanding loans of $3.0 billion, and undisbursed lending commitments of $1.4 billion; taking into consideration a small amount of outstanding guarantees, it thus had an uncommitted lending authority of $0.5 billion. In 1957, it disbursed credits of $663 million and received repayments of $315 million. The transactions of the Bank do not in general constitute a drain on Treasury funds; in fact the Bank has proved profitable, and regularly pays to the Treasury an annual dividend of 2-1/4 per cent. In 1957, disbursements were exceptionally large because of the payment of $250 million to the United Kingdom on the basis of a credit authorized during the Suez crisis of 1956.

37/ Sec. 111 (c) 1-2, and 115 (b) 6 of the Foreign Assistance Act of 1948; Sec. 522 and 523 of the Mutual Security Act of 1951; Sec. 142 (b) and 502 of the Mutual Security Act of 1954 (as amended) in conjunction with Sec. 101 (b) of the President's Executive Order of November 6, 1954.

The International Cooperation Administration also administers funds in local currencies resulting from the United States agricultural surplus disposal program (P.L. 480, 83rd Congress, as amended). Under the so-called Cooley Amendment of 1957, up to one-fourth of these funds is to be lent to private enterprises (primarily United States enterprises) in the countries to which the agricultural surplus commodities are supplied. Most of the balance, as well as a large part of the funds arising from non-military foreign aid, are lent to the public authorities of the countries involved, usually for purposes of development.

These loan transactions involve very large sums, but they can only rarely be considered strictly from the point of view of the creditworthiness of the borrowing country.38/ In recent years most of the funds have gone to the Near East and Far East, often to countries whose financial situation is such that the loans must be regarded as grants in disguise. Should all borrowing countries indeed service and repay the loans in their local currencies, such currencies in the hands of the United States Government would in due time reach astronomical figures.

Exchange Stabilization Fund -- The United States Treasury, through its Stabilization Fund established by the Gold Reserve Act of 1934, concludes from time to time "exchange agreements" with foreign countries, often supplementing stabilization programs approved by the International Monetary Fund, and sometimes in turn supplemented by credits of commercial banks. Such agreements are in force with Mexico, Peru, Chile, Bolivia, Paraguay, and Nicaragua; with the exception of the agreement with Mexico, they involve relatively small sums varying between $5 million and $12.5 million. So far, no disbursements under these agreements have been made. It is one of the functions of the National Advisory Council to coordinate these activities of the Stabilization Fund with those of the International Monetary Fund.

38/ Some assistance legislation required that a specified minimum of aid be granted in the form of loans rather than grants. These requirements were repealed in 1955, but the Congress made it clear that it continued to expect "a maximum use of loans" (Report of the Senate Committee on Foreign Relations, Mutual Security Act of 1955, p. 22). By December 31, 1957, the Administration had concluded loan agreements totaling the equivalent of $2.4 billion under aid programs and $0.8 billion under the agricultural surplus disposal programs; about $2.2 billion had actually been disbursed. The Development Loan Fund is not authorized to give grants, but it is expected that a large part of its loans will be repaid in local currencies rather than in dollars.

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