The Gold Cover

In the past gold has been held by the United States Treasury for two purposes. One purpose has been to provide international reserves, i.e., a means of international payment. The United States Government agrees to sell gold for United States dollars held by foreign governments and foreign central banks. Another purpose was to provide a reserve backing for our money. This has generally been referred to as the gold cover.

On March 19, 1968, President Johnson signed a bill eliminating the gold cover for Federal Reserve notes and for United States notes and Treasury notes of 1890. All of these types of currency have been, or are, part of our money.

The removal of the gold cover was somewhat obscured in various news media by headlines surrounding the international financial crisis of mid-March. On the weekend of March 16-17, the members of the London Gold Pool, meeting in Washington, had established the two-market gold system, and on the day before this meeting the Federal Reserve System had raised the discount rate by one-half percentage point to 5%. Furthermore, the much-awaited British budget was presented on the same day the gold cover was removed.

Prior to the removal of the gold cover each Federal Reserve Bank was required to hold a gold certificate reserve of not less than 25% against its Federal Reserve note liability, i.e., each Bank's Federal Reserve notes outstanding minus those of its own notes held by the issuing Bank. Before March 19, the Treasury was also required by law to hold a gold reserve of $156 million against United States notes and Treasury notes of 1890. By far the most important of these reserves in terms of size was the reserve behind Federal Reserve notes. The total Federal Reserve note liability for all Federal Reserve Banks combined was over $41 billion at the end of February. United States notes outstanding, on the other hand, totaled only $323 million. Treasury notes of 1890 are no longer issued and less than $500 thousand are estimated to be in circulation.

History The earliest legal recognition of the necessity of a gold reserve in the United States occurred in the Bank Act of July 12, 1882. This law provided that the issue of gold certificates, which were authorized in the same law, would be suspended whenever the gold coin and gold bullion reserved in the Treasury for the redemption of United States notes, or greenbacks, fell below $100 million.

The Gold Standard Act of March 14, 1900, increased the gold reserves held for redemption of United States notes and Treasury notes of 1890. Under this Act, the Secretary of the Treasury was required to hold a gold reserve of $150 million for the redemption of such notes.

The percentage reserve requirements of recent years were inaugurated as part of the Federal Reserve Act of 1913. The twelve District Banks were required to maintain a 40% gold reserve behind Federal Reserve notes and were also required to hold a 35% reserve in gold or lawful money behind member bank deposits at Federal Reserve Banks (member banks hold the larger part of their required reserves as deposits at Federal Reserve Banks).

Through the same Act and through another Act in 1923, the Secretary of the Treasury was authorized to apply earnings of Federal Reserve Banks and Federal Intermediate Credit Banks to the reserve for United States notes and Treasury notes of 1890. About $6 million was added to the reserve in this way, making the total of $156 million which was held in reserve until March of this year.

Prior to 1933, United States citizens could redeem currency for gold. The Emergency Banking Act of that year in effect prohibited persons subject to United States jurisdiction from holding gold. In 1934, the Gold Reserve Act provided, among other things, for the gold held by Federal Reserve Banks to be replaced by gold certificates. The gold was transferred to the Treasury which then issued gold certificates to the Federal Reserve Banks against its gold stock.

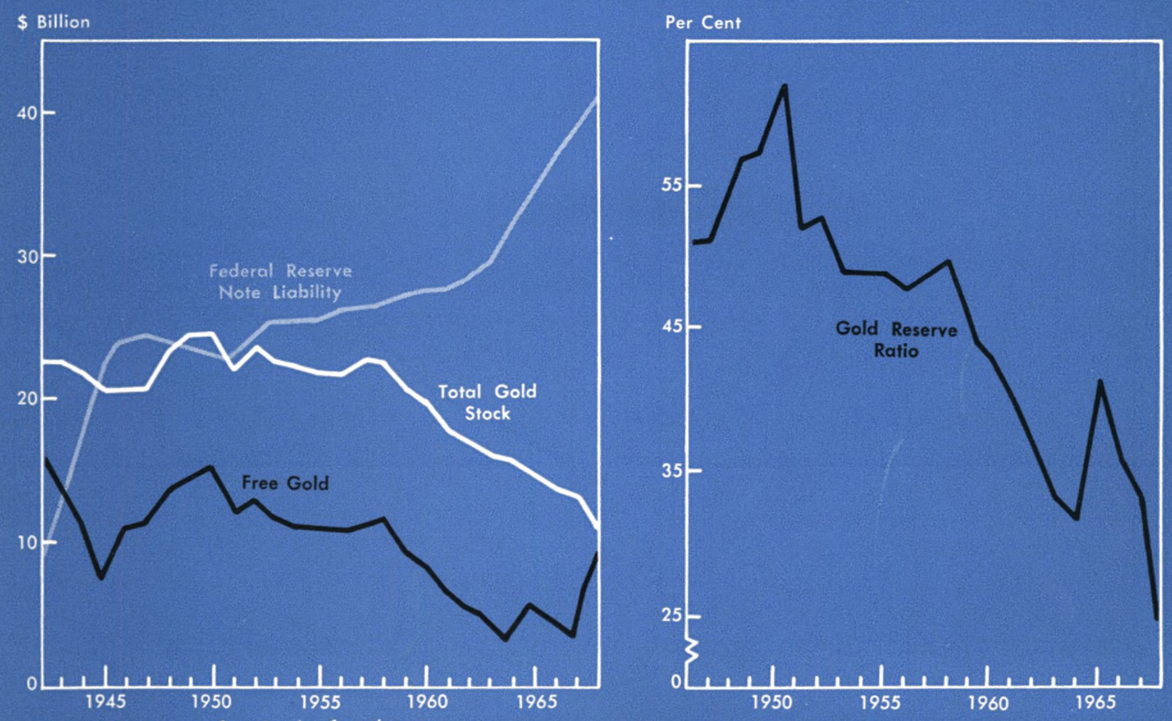
In 1945 the gold reserve requirement was reduced to 25% for both Federal Reserve notes and the reserve deposits of member banks. At the same time, the law was also changed to exclude legal tender such as silver certificates and greenbacks as legally acceptable reserves against deposits of member banks with Federal Reserve Banks. Due to the reserve requirement change, the amount of free gold in the United States at that time, i.e., gold not required to be held for reserve purposes, rose substantially, as may be seen in the accompanying chart. Before March of this year, the amount of free gold was used by many persons to indicate the ability of this country to settle foreign dollar claims in gold.

Following 1950, the volume of free gold in the United States started to decline. The increase in total Federal Reserve note liabilities and in member bank deposits, and the outflow of gold from the United States to redeem dollars presented by foreign official institutions accounted for the decline. The level of free gold continued to drop until the reserve requirements established in 1945 were changed in 1965. In March of that year the reserve requirement against deposits was eliminated. Just prior to this change, the level of free gold had declined to less than \$2 billion, over \$1 billion below the \$3 billion level shown in the chart for March 1964. The 1965 Act freed over \$4 billion of gold and the free gold supply accordingly jumped up to nearly \$6 billion.

From 1950 to 1965 the gold reserve ratio curve, comparing the total gold stock with the Federal Reserve note liability plus deposits of member banks with Federal Reserve Banks, dropped sharply. In February 1965 the ratio of gold to notes and deposits had fallen to nearly 28%. The sharp rise in the curve in 1965 reflects the change in the law. The gold stock is then compared only with the Federal Reserve note liability and consequently the gold reserve ratio rose markedly in 1965 before plummeting again over the next three years. When the gold cover requirement was removed in March, the ratio of our gold stock to the total Federal Reserve note liability stood at 25.0084%.

Foreign Countries Gold reserve requirements in most countries were either repealed or suspended quite some time ago. During the pre-World War I period of the gold standard, most major countries of the world had a gold reserve requirement at one time or another. During World War I, however, all of the belligerent countries except the United States went off the gold standard. Most of them returned to some form of gold standard after the War, only to abandon it in the 1930's.

GOLD RESERVE AND FEDERAL RESERVE NOTE LIABILITY



Note: Figures are for March of each year.
Source: Board of Governors of the Federal Reserve System.

Among the countries which still have gold reserve requirements for their currency are Belgium, Mexico, the Netherlands, South Africa, and Switzerland. Some countries that still have reserve requirements allow these requirements to be met in part by foreign exchange in lieu of gold, e.g., Mexico and the Netherlands.

Rationale for Removal Various pros and cons surrounded the removal of the gold cover. International and domestic confidence in the dollar, and the related issues of inflation and controlling the growth of the money supply were focal points of discussion.

In Congressional testimony, William McChesney Martin, Chairman of the Board of Governors of the Federal Reserve System, stated that removal of the gold cover "would make absolutely clear that the United States' gold stock is fully available to serve its primary purpose as an international reserve." At the same time, however, he emphasized that domestic developments would necessitate some change in the gold cover requirement in the relatively near future even if there were no further net sales of gold to foreigners. As the volume of our currency grew in response to the growth in our economy, the amount of gold required as a backing for the currency would have soon outstripped our supply. The increase in Federal Reserve notes in 1967 was about $2 billion, which added $500 million to the amount of gold required to be held as reserves under the old law. In addition to the growth in Federal Reserve notes, our free gold was being reduced by industrial and artistic uses for gold over and above domestic production. This excess amounted to $160 million last year.

Despite the obvious need to remove the gold cover for the aforementioned reasons, there was concern for the possible detrimental affect of such a move on confidence in the dollar. Fears were expressed that the international and domestic communities would lose a measure of faith in the dollar as a universal, stable means of exchange. Qualms about international confidence were answered by Chairman Martin's testimony. As he stated, "the primary function performed by gold today is not as a reserve against domestic currency but as a monetary reserve for use internationally." Removing the gold cover should improve foreign confidence in the dollar by clarifying our ability and intention to convert foreign-held dollars for gold. No longer should our international reserve position in gold be understated or misunderstood. It should be absolutely clear that the United States' gold stock is fully available to meet foreign-held dollar claims.

The matter of domestic confidence in the dollar primarily involved the question of control over the money supply. Removal of the gold cover would, it was thought, abolish an effective limitation on the supply of money in the country. The argument continued that this would promote inflation and degrade the value of the dollar.

As originally set up, the gold reserve requirements were intended to place an upper limit on the expansion of the domestic money supply (the money supply is most often defined as currency plus demand deposits at commercial banks, and in April totaled nearly $185 billion, of which $41 billion was currency). The gold reserve requirements were a reflection of the gold standard philosophy which was prevalent at the time the Federal Reserve Act was passed. According to this philosophy, domestic monetary conditions were to be determined largely by fluctuations in the gold stock. Thus, the Federal Reserve Act attempted to tie the money supply to the gold stock. Even at the time the Federal Reserve Act was passed, however, the gold standard philosophy was on the way out. Like a number of other provisions of the original legislation, the attempt to tie the money supply to the gold stock became more and more anachronistic as time passed.

Certainly the gold reserve requirements have not limited the expansion of the money supply in recent decades, if ever. The United States has had enough gold in excess of required gold so that the reserve requirements imposed no limitation on monetary expansion. And when the reserve requirements threatened to become a limiting factor in 1945 and 1965, the law was changed. Thus, the growth of the domestic money supply has, in reality, been determined by the Federal Reserve, which attempts to achieve a rate of growth which will contribute to maintenance of orderly economic growth, full employment, price stability, and balance of payments equilibrium. The most recent change in the law, therefore, represents no change from past practices.

Conclusion Reaction since the removal of the gold cover in March has been negligible, as was the case in 1965 when the gold reserve behind deposits was removed. Hopefully, the parallel will end there. Subsequent to that change our stock of gold continued to fall sharply. To prevent the continuation of that decline, fiscal and monetary policy must work together to put our international accounts in order and maintain stable economic conditions in this country.

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