333.-b-1

May 11, 1927.

5/9/27

The Open Market Committee, after considering the attached memorandum, and after discussion with the Federal Reserve Board, submits the following recommendations of policy for the period ending August 1 next:

(1) That $\boxed{\text{no}}$ further sales of system securities be made in order to offset arrivals of gold from abroad now known or anticipated.

(2) That it shall be the policy of the committee between now and August 1 next, gradually to acquire, if possible to do so without undue effect upon the money market, sufficient additional short-time government obligations to bring the total of the committee's investment account up to $250,000,000. In interpreting the expression "undue effect upon the money market," the committee would expect to keep in mind any changes which might occur in the general level of money rates, as well as the extent to which these purchases might effect a reduction in the amount of borrowings by member banks.

While this policy is not directed towards bringing about a reduction in discount rates by any Federal reserve bank, nor is that immediately anticipated, it is recognized that some lowering of market rates for money might nevertheless justify such a reduction later in the year, especially at the principal financial centers. The recommendation in paragraph two is also made after consideration of the fact that somewhat lower interest rates ordinarily operate to check gold imports; in fact, that was one of the effects of purchases of securities made in 1924.

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The committee further expects to continue studies of those methods set out in the preliminary memorandum by which increases in the System's portfolio might be brought about without increasing the amount of Federal reserve credit in the market. It expects to discuss with the Treasury Department those methods with which the Treasury is concerned, and requests that the Federal Reserve Board give consideration to those particular items, such as reserves on time deposits, which relate to the regulations of the Federal Reserve Board.

333.-6-1

May 9, 1927.

Revised Copy May 17

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PRELIMINARY MEMORANDUM RELATIVE TO OPEN MARKET POLICY

The principal transactions in the Special Investment Account since the last Governors Conference were reviewed in the chairman's report to the committee on March 21, and copies of this report were sent to all Governors. In accordance with the action taken at that meeting, purchases of 25 million dollars of securities were made in the market to replace March 15 maturities, and the Special Investment Account was thus restored to 200 million dollars, which is approximately the same amount as has been maintained for the past two years. Recent transactions resulting from large purchases of gold, are described hereafter.

General Credit Situation

For many months business has been active and has continued to maintain, and in some directions even to exceed, the rate of production and consumption of immediately preceding years, although a number of recent developments have been of a character which might have had a widespread unfavorable effect had the general business and financial situation not been fundamentally sound. These developments are, of course, the extensive floods in the lower Mississippi Valley, some overproduction and price declines in the oil industry, disturbing financial developments in Japan, reduced production and consequently reduced working time for labor in two or three large automobile concerns, and not so recently the collapse of a number of real estate and building speculations and of one or two large installment finance companies.

The total volume of credit in use, estimated from the reports of the reporting member banks, is now about a billion and a half dollars larger than a year ago. The considerable expansion of the last two

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months has been distributed between increases in commercial loans, security loans and investments. On the other hand, the total amount of credit extended by the Reserve banks is about one hundred million dollars less than this time last year. As the net gold imports (excluding the movement now under way) within this period were about 105 millions, the reduction of Reserve bank credit has about offset gold imports.

The figures for Reserve System earning assets are as follows:

(in millions)

	April 27,1927	April 28,1926.
Bills discounted - - - - - - - - - - - - - -	444	514
Bills bought in open market - - - - - - - -	242	199
U. S. Securities - - - - - - - - - - - - - -	318	389
Total bills and securities - - - - - - - -	1006	1114

While total discounts at the Reserve banks are smaller than a year ago, the difference is largely due to reduced borrowings by country banks as reporting banks in principal centers are borrowing nearly as much as they did a year ago. Money rates are about 1/2 per cent. above this time last year, as shown by the following table. The present tendency is for higher rates than last year. For example, time money is 3/8 higher than last year, 90-day bills are 1/2 higher, and Treasury certificates and notes show an even larger increase. The New York discount rate is 1/2 per cent. higher.

Money rates at New York

	April 28, 1927	April 28, 1926
Call money - - - - - - - - - - - - - - - - - -	* 4	* 3 1/2
Time money - 90-day - - - - - - - - - - - - - -	4 3/8	4
Prime commercial paper - - - - - - - - - - - -	4-4 1/4	4 4 1/4
Bills - 90-day unendorsed - - - - - - - - - -	3 5/8	3 1/8
Treasury certificates and notes -		
maturing June 15 - - - - - - - - - - -	3.46	2.51
maturing September 15 - - - - - - -	3.51	3.07
Federal Reserve Bank of New York -		
rediscount rate - - - - - - - - - - -	4	3 1/2
Federal Reserve Bank of New York -		
buying rate for 90-day bills - - -	3 3/4	3 1/2

* Prevailing rate for preceding week.

A review of the general credit situation, of rates and business, brings out the following striking facts:

(1) That the general level of interest rates in New York, where changes of rates generally originate, is about 1/2 of one per cent, above last year, the discount rate of the Federal reserve bank also being 1/2 of one per cent. higher.

(2) The amount of bank credit employed for conducting the country's business, at a volume certainly much above the average of the last few years, is only $1,500,000,000 above what it was last year.

(3) While irregularly distributed between the classes of goods, the general level of commodity prices has experienced a considerable fall, and over the greater part of the past year the decline in prices has been in both agricultural and non-agricultural commodities. Considering the reluctance of member banks to borrow from the Reserve banks, coupled with the considerable decline in interest rates which is occurring in Europe, the question is raised as to whether the somewhat greater restraint now being applied to the extension of credit at the money center (New York), coupled with the reduction of the total of the open market investment account over the past 18 months or two years from $500,000,000 to less than $200,000,000, has not gradually had the effect of exercising some pressure, imperceptible in any change over a short period, but now becoming apparent when examined as to its effects over a longer period.

Gold Movements

Between January 1 and May 1 of this year, gold imports into the United States have amounted to about $110,000,000, including $8,000,000 from Japan, and exports during the same period were $26,000,000. Net imports during this period were therefore $84,000,000. Inasmuch as approximately $14,000,000 of the gold exported was gold which had been earmarked before the period under discussion, about $98,000,000 was the net amount added to the monetary gold supply of the country during the first four months of the year. This gold movement, together with the imports of 1926, account largely for the fact that the System's earning assets show a decline during the past year, in spite of an increase of some billion and a half dollars in bank credit.

Entirely apart from the movement of gold referred to above, there have been some significant developments since May 1, not included in the above figures. During the last part of April, the Bank of France recovered approximately $90,000,000 of gold from the Bank of England by the repayment of its credit to the Bank of England. Of this $90,000,000, $12,000,000 arrived in New York last week, $18,000,000 is still on the water, and $60,000,000 was purchased by the Federal Reserve Bank of New York on May 6 and is now held by the Bank of England under earmark for account of the New York bank. In addition to this Bank of France gold, $2,500,000 has recently been imported from Australia, and another $2,500,000 more is now on the water from Australia and expected to arrive in this country this week.

A somewhat disturbing factor arose in the probability of the importation and sale to the Federal Reserve Bank of New York of the $90,000,000 of gold, negotiations for the purchase of which had been concluded by one of the New York member banks from the Bank of France. It was learned that space had been reserved on the steamers and arrangements had been made for shipping the entire amount of gold; in fact, one shipment was about to arrive in New York, and others were being loaded. In view of this situation, after consulting with all the members of the Open Market Investment Committee and with the Federal Reserve Board by telephone, it was arranged to purchase from the Bank of France all of the gold - nearly $60,000,000 - which had not been shipped, and to sell the

Bank of France a like amount of the September maturity of certificates of indebtedness held in the Open Market Investment account. By this arrangement, the money market status remained unchanged, except as to the gold which had already been shipped, leaving the committee in position to determine later at its meeting whether these securities should be replaced or not. Securities were sold to offset $9,000,000 of the $12,000,000 already arrived, but no arrangements have been made for sales to offset the balance of the gold which will arrive from London and from Australia, amounting in all to about $20,000,000. With the sale already made and further sales, if made to offset forther gold arrivals, the securities remaining in the System's portfolio account will be a little over $100,000,000, too small an amount to afford security against possible future developments. This will be appreciated, for example, if the $90,000,000 now purchased had arrived at a time when we had no portfolio of government securities available. It is clear, therefore, that the committee must from now on give careful attention to meeting this gold problem, either by increasing its portfolio in anticipation of future developments, or by adopting other measures. The method of doing so should be determined with regard to whether the time has or has not arrived when the Federal Reserve System can afford to put new funds in the market, the effect of which would be to reduce the borrowings of member banks, principally in New York, and possibly to reduce the System's holdings of bills. There are various possibilities for dealing with the gold problem as a whole which have never heretofore been discussed in the committee's report and which are now submitted simply for discussion. None of them are recommended at this time, but are intended simply as a summary of all possibilities. They are:

(1) The committee could replace the securities sold to the Bank of France. The immediate effect would be to reduce the amount of member

bank borrowings in New York, which are now running on the average at from $100,000,000 to $150,000,000.

(2) Those Federal reserve banks which have considerable holdings of long time bonds could dispose of those bonds, realize their profit and repurchase through the committee as a part of the committee's account, an equivalent amount of short time securities. These, with other short term government securities owned by individual Reserve banks, could be added to the System holdings without reducing the total earning assets of the individual Reserve banks, and thus increase the committee's account to over $200,000,000.

(3) Arrangements might be made with the Secretary of the Treasury for somewhat increasing balances carried with the Federal reserve banks, and reducing the amount carried with special depository banks.

(4) Some or all of the $75,000,000 of 2 per cent. Panama Canal bonds could be called and the national bank notes issued against them retired. Further purchases of the 2 per cent. Consols of 1930 could be made in anticipation of their possible retirement in 1930, as contemplated by the Secretary of the Treasury in his report of 1924.

(5) By gradual stages, or all at once, the time schedule of the Par Collection System could be adjusted so as to increase the volume of uncollected checks and correspondingly reduce the reserve of members.

(6) Plans could be undertaken for retiring the greenbacks, which however would require legislation.

(7) Further amounts of the capital of the Federal reserve banks could be called.

(8) The reclassification of reserve cities could be gradually undertaken so as to increase reserve requirements.

(9) A readjustment of the relations of the Reserve banks to the market for gold could be effected if the Secretary of the Treasury saw fit

as authorized by law, to discontinue paying cash up to 98 per cent. of the value of imported gold, thus throwing the market for gold entirely upon the Federal reserve banks and enabling them to reduce the gold point for imported gold by the equivalent of a loss of interest for the period during which payment would be delayed. By reason of our Treasury practice, the United States is today paying the highest price of any world market for gold.

(10) The Federal Reserve Board, of course, after adequate study, could revise the definition of what constitutes a time deposit, thus raising the reserve requirements. This is probably justified by the fact that something like 60 per cent. of the increase in bank deposits in the United States over the past ten years consists of that class of deposits which require only 3 per cent. reserve.

(11) A revision of the regulations of the Federal Reserve Board in relation to the maintenance of reserves, by averaging reserves for a period of a week in Federal reserve bank cities, and two weeks in the rest of the country, could have the practical effect of somewhat increasing the amount which member banks must borrow.

(12) The Federal Reserve Board could revise its ruling relative to currency in transit, which in effect reduces reserve requirements in those districts where the ruling is now applied.

The above comprehend most, if not all, of the possible measures available for dealing with the problem of gold imports in view of our reduced portfolio. They are submitted for consideration and study.

The possibility of gold imports must not be overlooked, and may indeed be imminent. The underlying causes of such a movement would be:

(1) The continued maintenance of our present level of interest

rates, somewhat higher than a year ago, in the face of declining interest rates and reducing bank rates in Europe.

(2) The fact that our technical practice in dealing with gold makes this the best market in which to sell it and one of the most difficult from which to export it.

(3) The possibility, regarded by some as the probability, that within the next two years Germany will be forced to ship us large amounts of gold in order to meet reparation payments in the standard year.

(4) Heavy foreign payments to meet the service on all foreign loans.

Nor must the possibility be overlooked that conditions may change rapidly and instead of experiencing a large addition to our gold reserve, there is indeed a possibility, although more remote, that within the next few years we may sustain a large loss of gold.

Gold exports from this country can arise from two causes:

(1) The first is the perfectly normal movement resulting from exchange rates reaching a level at which it is cheaper to make payments abroad by shipping gold than by buying exchange.

(2) The other, however, can occur irrespective of the gold shipping point, because of large balances held in this country for account of foreign governments and foreign banks of issue, which, as in the case of Germany, may decide to take gold for reserve purposes, irrespective of the gold point.

No danger need bp apprehended as to a normal export of gold, but we might sustain a large loss of gold under the second category at any time, and that we are now prepared to deal with successfully because of the large proportion of such balances held by the Federal reserve bank, the export of which could easily be provided for by our purchasing the securities now held for account of our foreign correspondents. The only embarrassment likely to occur as a result of such a demand will be due to the lack of an adequate supply of American gold coin, concerning which discussion has been had from time to time with the Treasury.

Looking, therefore, to the future, that is, say for the next three years, the committee is of the opinion that the policy of the Federal Reserve System should be to prepare itself to deal with either a large import movement of gold or a large export movement of gold. Any other position would expose the System to the charge of lack of foresight.

In view of the many alternatives to be considered, and especially in view of the fact that whatever may be the policy of the System it will involve taking a definite position as to the money market, the committee prefers to defer any recommendation until after discussion with the Federal Reserve Board and a definite expression of their views.