

Original held by Secy

December 10, 1936.

My dear Mr. Secretary:

In response to your request, I am transmitting herewith a memorandum which raises a number of points that I feel sure I should bring fully to your attention in connection with the proposal with reference to sterilization of bank reserves.

We have canvassed the subject as thoroughly as time would permit. Inasmuch as in our preliminary discussions you requested us to bring to your notice whatever comments or views we felt were pertinent, I have noted down here briefly some of the considerations which it seems to me should be carefully weighed before you take a position or announce a step which has such far-reaching importance. As you know, I am fully aware of your legal responsibilities and freedom of action, and I would not venture to put forth these considerations except for the fact that in a spirit of unreserved co-operation, you had asked me to make known fully to you the views that naturally arise from the standpoint of the Federal Reserve System, nor do I need to emphasize my appreciation of your desire to do whatever is appropriate toward our common objective.

Sincerely yours,

M. S. Eccles,
Chairman.

Honorable Henry Morgenthau, Jr.,
Secretary of the Treasury,
Washington, D. C.

enclosure

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December 10, 1936

TREASURY PROPOSAL FOR STERILIZING GOLD

The substance of the Treasury's proposal is that it will offset the effects on member bank reserves of any further additions to the gold supply either through imports or through domestic production. It proposes to offset such additions by selling bills to the market, so that in effect it will pay for the gold by bills rather than by ~~reserve~~ funds, *that create member bank reserves.*

The purpose of this proposal, which is to make our credit base independent of gold movements, is highly desirable and the method proposed would accomplish the result.

There are certain questions, however, which appear to call for further consideration. In the first place, the policy should be extended to cover silver purchases, which have the same effect on deposits and reserves as gold purchases. This would emphasize the fact that from the point of view of monetary policy the silver purchase plan, under conditions now prevailing, serves no useful purpose and makes the problem of monetary control more difficult.

Other questions relate primarily to the timing of the adoption of the policy. There appears to be no immediate urgency for this action. Gold imports have recently been small and are not likely to be large in the near future; the stock market is not as buoyant as it was immediately after the election; and excess reserves are likely to decline substantially from now until the Christmas holidays. There is time, therefore, to give this important matter further careful consideration.

One question, which of course is entirely the responsibility of the Treasury, is whether it would be best to inaugurate the new policy prior to obtaining renewal of the Stabilization Fund from Congress. This renewal may possibly be delayed or complicated if a new issue is introduced, particularly one that involves increasing the public debt for the purpose of sterilizing gold. At the time when the Stabilization Fund is renewed authority may be obtained for the issuance of obligations by the Fund itself, with interest payments out of the fund's assets rather than out of taxes. This would obviate the necessity of increasing the public debt figure.

Another question is whether this step ought to be taken before the Board of Governors has had an opportunity to use the full authority to raise reserve requirements. Congress is likely to ask why the Government should pay interest out of taxes for offsetting gold imports and provide earning assets for member banks, when the Board of Governors has authority to absorb these reserves by raising reserve requirements, which would not cost the Government anything. This argument might be potent with Congress.

The question might also be raised whether the adoption of this policy would not diminish the pressure for legislation to discourage the inflow of capital from abroad. It may be felt that, since the future damage of such inflow will be taken care of by the Treasury action, there is less need for legislation. But the Treasury policy would only eliminate the effects of a gold inflow on excess reserves. An inward movement of foreign funds would still have the effect of increasing deposits and stimulating the ^{security and} ~~stock~~ commodity markets with possible serious consequences to our economy. Furthermore, off-

setting gold imports is a method of neutralizing some of the effects of capital movements, but would do nothing to restrain the movements themselves, which are undesirable not only from our domestic point of view but from the point of view of world trade and the maintenance of exchange stability. Legislation providing for taxation of foreign funds or foreign profits would remove some of the incentive for the inflow of capital and would make the offsetting operations less urgent. It would be unfortunate if the adoption of the Treasury policy at this time should diminish the chances of dealing with the matter in a more fundamental way through taxation.

It is also worth while to inquire whether the same results might not be obtained in an equally satisfactory or even a more satisfactory manner by permitting the Federal Reserve banks to issue debentures. If they could do this the Federal Reserve authorities would be in a position to offset or not to offset gold movements, depending on the prevailing credit situation. This procedure would have the advantage of placing the entire matter of the domestic effects of gold movements in the hands of the Federal Reserve authorities which are supposed to give their entire attention to the domestic position of the dollar. It would also relieve the Government of the need of incurring interest-bearing debt to offset the gold movements.

There is also this problem. If the Treasury should sell bills to offset the gold inflow, and if a situation should arise in which the Federal Reserve authorities felt it important in the interests of domestic economy to tighten money rates, this would not only make it more expensive for the Treasury to sell the bills, but might result in attracting additional gold from abroad with the consequence of making it necessary for the Treasury to sell more bills, and thus incur still more ^{Government debt and} expense.

December 10, 1936

MONETARY PRINCIPLES TO BE OBSERVED IN
OPERATION OF TREASURY PLAN

In case the Treasury decides to adopt now its plan for offsetting additions to the gold supply, Chairman Eccles will approve of it provided it will be operated in accordance with the following principles:

(1) Treasury operations in this matter will be automatic and not discretionary, unless conditions should arise that would cause the Board of Governors to request a departure from this policy. All increases in the gold stock from the present level will be offset shortly after they occur. Otherwise the Federal Reserve authorities will have no way of controlling an important factor operating on the domestic credit situation for which they have to bear the brunt of responsibility.

(2) The Treasury will sell bills up to the full amount of additions to the present gold stock and buy bills to offset all decreases in the gold acquired from now on, but not decreases from the now existing stock. Beyond that point the determination whether or not to offset gold exports will remain in the hands of the Federal Reserve authorities.

STERILIZING FUTURE ACQUISITIONS OF GOLD

The most practical and satisfactory device for neutralizing gold imports through Stabilization Fund operations under existing law would be as follows:

- A. The Fund would buy all imported gold.
- B. To pay for this gold it would use funds obtained from the General Fund of the Treasury in exchange for its gold transferred to the Treasury.
- C. The Treasury would obtain such funds by increasing the amount of Treasury bills sold to the market.

An illustrative example of the detailed operation of a transaction is as follows:

- (a) X, in New York, imports \$50,000,000 worth of gold.
- (b) Delivers the gold to assay office for account of Stabilization Fund (Secretary's special account).
- (c) Federal Reserve Bank of New York, as fiscal agent (for Stabilization Fund), pays X for gold by issuing its cashier's check.
- (d) X deposits check in its member bank.
- (e) Member bank deposits check with Federal Reserve bank, receiving credit in its reserve account, thus increasing excess reserves.
- (f) Amount of Federal Reserve bank's check is charged to account of Stabilization Fund (Secretary's special account).
- (g) This account is replenished by transfer from account of Treasurer of United States (General Fund) on books of Federal Reserve bank.
- (h) Stabilization Fund turns over to Treasurer gold equivalent to transfer, which gold will be impounded in General Fund.
- (i) At selected dates the Treasurer's account with the Federal Reserve bank will be replenished by the sale of Treasury bills to the market in amounts sufficient to compensate for the purchases of gold during a given period.
- (j) Bills will be paid for, directly or indirectly, by a drawing on a member bank's reserve account with Federal Reserve bank, the increase in reserves mentioned in "(e)" above being thus neutralized.

Note 1: Since any purchase of gold increases bank deposits and hence changes the ratio of deposits to reserves, this plan slightly more than neutralizes the increase in excess reserves. Should it be desired exactly to equate this, slightly less than \$50,000,000 in bills could be sold.

Note 2: Any purchase of gold increases bank deposits. If it is desired to neutralize such increase, a corresponding amount of Government deposits could be transferred from member banks to Federal Reserve banks to the extent of such deposits.

December 7, 1936