December 17, 1945.

Memorandum to Members of the National Advisory Council

It has occurred to me that the members of the National Advisory Council might desire to be informed concerning the activities of the Federal Reserve Bank of New York in making short-term loans on gold to foreign central banks and governments. I am therefore attaching a memorandum explaining the nature, purposes, and significance of these loans. As will be seen from this memorandum, they have ordinarily been small and infrequent and are of a rather routine character. However, if any member of the Council feels that loans of this type raise, or might in the future raise, problems of a policy nature which the Council should consider, I would welcome any discussion of the subject. In the meanwhile, I shall make it a practice to inform the Council whenever a new loan of this type is granted.

M. S. Eccles.

Loans on Gold made by Federal Reserve Banks

Among the foreign operations engaged in by the Federal Reserve Banks is the granting of short-term loans on gold to foreign central banks and governments maintaining accounts at the Federal Reserve Bank of New York. Authority for such loans is provided in Section 14 of the Federal Reserve Act which states in part, "Every Federal reserve bank shall have power: (a) To deal in gold coin and bullion at home or abroad, and to make loans thereon. . ." As in the case of all relationships and transactions with foreign banks and governments, arrangements entered into by the Federal Reserve Banks to make loans on gold are subject to the prior approval of the Board of Governors of the Federal Reserve System. From the beginning, loans on gold have been made at rates related to the regular discount rate of the Federal Reserve Bank of New York.

Prior to the outbreak of World War II, the loans extended by the Federal Reserve Bank of New York were for the most part made against gold either in transit to the United States or held abroad. The first loans made were to the Czechoslovak central bank in 1924 and to the Polish central bank in 1925, both against the collateral of gold held in other central banks, the control over which was transferred to the Federal Reserve Bank of New York. During the next 13 years, virtually all the loans were made against gold which was in transit; two such loans were made to the Reichsbank, one to the Sveriges Riksbank, one to the National Bank of Belgium, and two to the Bank for International Settlements. All of these loans were of short duration and were paid upon the arrival and sale of the gold in New York.

In the prewar years, the only loans made against gold under earmark in New York were a series of four loans to the National Bank of Nicaragua between 1935 and 1938. Since the outbreak of World War II, however, all loans against gold have been against gold actually held under earmark in the Federal Reserve Bank of New York. Loans against gold held abroad have not been made in recent years because of unsettled conditions and the resumption of such lending will depend upon a return of more stable conditions abroad.

All gold loans made in recent years have had an initial term of three months, but have been renewable for quarterly periods up to a specified date; this date has usually been about one year after the date when the potential borrower was notified of the New York Reserve Bank's willingness, for the time being, to make loans. It has been provided in each loan arrangement that upon the maturity of the loans, unless they are otherwise paid, the bank may sell the gold securing the loan to the United States (acting in connection with such sale as Fiscal Agent of the United States) and apply the proceeds of sale to the repayment of the loan, crediting any surplus to the account of the borrower on the books of the New York Reserve

Bank. Since September 1942 the general policy of the Federal Reserve Bank of New York has been to advance up to a maximum of 98 per cent of the value of the earmarked gold in its vaults pledged as collateral, provided the gold consisted of refined bars of recognized refineries, in contrast with a maximum of about 90 per cent which prevailed for several years prior to that time.

While foreign loans on gold, as well as most of the other foreign transactions of the Federal Reserve Banks are handled by the Federal Reserve Bank of New York, participation in such loans is offered to the other Reserve Banks. All the other Reserve Banks are participating in the loans now outstanding made by the Federal Reserve Bank of New York.

The attached tabulation shows all loans made since, or in effect at, the beginning of 1940.

Loans on gold have been made primarily in order to meet a temporary deficiency of dollar exchange in the current accounts of a country's balance of payments. Furthermore, the loans have usually been related to a specific operation and have therefore been self-liquidating in nature. Virtually all the loans to Uruguay, for example, were made for the purpose of providing dollars to be used for the payment of necessary imports at times when, owing to the wartime shortage of shipping, Uruguay was unable to maintain her schedule of wool and other exports. The recent $35,000,000 loan to the Royal Netherlands Government also exemplifies the short run, self-liquidating nature of these loans. It is understood that the bulk of the proceeds of the loan is to be used for the purchase in the United States of urgently needed goods and that it is contemplated to repay the loan by use of frozen Dutch funds in New York which are expected to be "defrosted" in the near future.

The decision of a foreign central bank or government to borrow against gold may be due to one or a combination of factors. With respect to loans against gold in transit, the loan mechanism makes it possible for the borrower to obtain urgently needed dollars before the arrival of the gold for sale in the United States and to receive credit on more favorable terms than would usually be available under an ordinary bank credit. Other loans against gold are ordinarily requested by the borrower simply to avoid the expense of selling gold in order to meet a temporary stringency and then repurchasing it. Even if the gold is already under earmark in New York so that no shipping costs are incurred, the costs involved in sale and repurchase amount to more than 1/2 per cent (1/4 per cent "handling charge" by the Treasury on the sale, a similar charge on the repurchase, and other minor reimbursable expenses incurred at the Reserve Bank). Hence, with an interest charge of 1 per cent per annum on loans on gold, it is more economical for a foreign central bank or government to borrow against its gold holdings in New York if it expects to gain dollar funds and pay off the loan within six months.

A further motivation which may be present in some cases is that a central bank, for psychological reasons, might desire to avoid showing a decline in gold reserves in its published statement. By borrowing against gold rather than selling it, the bank can maintain the level of its reported reserves although showing a balance sheet liability for the amount of the borrowing.

Borrower	Original date of loan	Maximum authorized	Number of 3 month advances	Maximum out-standing at any one time	Loan as % of gold collat-eral, up to	Rate of inter-est (% per annum)	Date of Final payment
Banque Central de la Republique de Turquie	6-15-39	$ 5,845,000	3	$ 5,500,000	90	1	5-18-40
Banco Central de Reserva de El Salvador	8-31-40	2,000,000	35	947,000	90	1	1-31-41
Banco de la Republica Oriental del Uruguay	5-22-42	5,000,000	9	5,000,000	90*	1	4-17-43
"	8-17-45	18,000,000	2	12,000,000	98	1	(Now outstanding - last possible maturity, Sept. 1,1946)
Royal Netherlands Government	11- 1-45	35,000,000	1	35,000,000	98	1	(Now outstanding - last possible maturity, Nov. 1,1946)

*Up to 98 after August 27, 1944