C O N F I D E N T I A L

November 5, 1935

REASONS FOR RAISING RESERVE REQUIREMENTS AT THIS TIME

Arguments for immediate action

1. Member bank reserves at the present time are $3,000,000,000 in excess of legal requirements. Further increases in excess reserves through gold imports, silver purchases, and through the ultimate use of the gold in the Stabilization Fund may be expected. Demand deposits of member banks are now higher than they ever were and they can be more than doubled on the basis of existing reserves. This would be injurious credit expansion. It will be necessary at some time to use the Board's powers for absorbing excess reserves. It is, therefore, not a question of whether or not the Federal Reserve System will have to act, but merely a question of the best timing of the action.

2. It would seem best to take measures for absorbing at least a portion of existing excess reserves before the banks have had an opportunity to expand their activities on the basis of these reserves. The banks are being urged by the Government actively to seek opportunities for extending additional credit and thereby to facilitate recovery. To let them proceed and later, when many of them may no longer have excess reserves, to put them in debt by increasing requirements or selling securities may lay the System open to the charge of inconsistency. Action at such a time, furthermore, might cause banks to liquidate loans or investments and might start a deflationary movement. Early action would avoid these difficulties.

3. Gradual advances in reserve requirements started at this time when reserves are ample would be less likely to result in losing members from the Federal Reserve System than would drastic action at a later date.

4. Banks are now in such a position that an advance in reserve requirements would not inconvenience them and would not act as a restraint on business recovery.

5. Action at the present time may have a good psychological effect, indicating that the System is alert to the situation and prepared to take the necessary steps to avoid inflation.

Arguments for raising requirements

6. The preceding arguments would apply equally to selling securities and to raising reserve requirements, but raising reserve requirements would have the advantage of making use of a new method which was not available prior to the passage of the Banking Act of 1935. Previously reserves could not be advanced, except by the declaration of an emergency and with approval of the President. The use of this method now enables the System to say that it could not have acted sooner because of lack of authority.

7. Raising reserve requirements would have the additional advantage over selling Government securities that it would not have any unfavorable effect on the market for these securities.

8. It would also have the advantage of not diminishing the earning assets of the Federal reserve banks, which may become a serious matter if these banks should be put in a position where they would have to go to Congress for appropriations.

9. It may be a good general policy to use changes in reserve requirements as a method of readjusting the banking position to new conditions, such as the present unprecedented reserves, and to use the traditional methods of open market operations and discount rates as the instruments for direct influence on expansion or contraction of credit.

By raising reserve requirements gradually to a point where excess reserves would not be very large, the Reserve banks would be placed in a position to use open-market sales, which are more flexible, to counteract inflationary tendencies.