Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 19, 1936

To Chairman Eccles

Subject: The Stabilization Fund as an open-market power

From Mr. Gardner W.R.G.

GPO 16—852

1. Since Mr. Goldenweiser and I talked with you on November 4 about the imminence of a move by the Stabilization Fund to increase its dollar resources, the Fund has been extremely active. The movement of foreign capital into American securities in the ten days following the election made it necessary for the Fund to purchase large amounts of gold and foreign exchange. The dollars with which to make these purchases were drawn in part from sources outside the Federal Reserve deposit. Apparently the Fund now commands resources somewhat greater than the original \$2,000,000,000; for the \$1,800,000,000 of gold with the Treasury has not been touched and the working balance now appears to be in excess of \$200,000,000. There may be some error in this conclusion, for we are not getting direct reports from the Treasury, and we are not yet in position to obtain explanations of the Fund's transactions. There is, furthermore, a possibility that the excess represents accumulation of profits, though it appears to be too large for that. If the Treasury has some new device for adding to the resources of the Fund, we should know about it in order that we may consider its effects on member bank reserves.

2. It is probable, however, that the Fund can now acquire additional dollar resources with which to purchase

gold abroad only by selling gold to the Federal Reserve in the form of gold certificates. A transaction of this character amounting to $21,000,000 occurred on November 9. The dollar proceeds were mostly used, however, in further purchases of gold, and the special deposit with the Federal Reserve Bank of New York, instead of increasing, is now down to about $5,000,000. If the inward movement of capital continues, further transfers of gold certificates to the Federal Reserve will be necessary. The public will presently catch on to the fact that the frequent unexplained increases in reported monetary gold stock represent the operations of the Stabilization Fund. The Treasury may then want to cover up.

3. There is danger that at this point the Treasury may suggest a major operation such as the investment of $1,000,000,000 of gold in U. S. Treasury bills. This operation would immediately be reflected in a corresponding growth of reported monetary gold stock and member bank reserves. The public would know that overnight the Fund had completely altered its status. But thereafter, the public would know nothing of what the Fund was doing, for the Fund would then be in a position to purchase gold without leaving any trace in reported figures. The purchase of the gold would put cash at the disposition of the market; but this cash could be simultaneously taken away by the sale of securities, leaving reported monetary gold stock and bank reserves unaffected. If gold had to be sold abroad to support the dollar, securities could be purchased to offset the sale, and again there would be in the published figures no trace of what had happened.

4. Although this would solve the Treasury's problem of secrecy, it would be a most unfortunate development from the standpoint of the Federal Reserve. The major objections are two:

1) It would add $1,000,000,000 to excess reserves of the member banks.
2) It would constitute the Stabilization Fund a rival central bank engaging in open-market operations at home.

On the first point it might be argued that the $1,000,000,000 added to member bank reserves by the purchase of Treasury bills would be added to member bank reserves anyway if that much gold came in. But in fact that much gold might not come in. Half a billion dollars or more might unnecessarily be added to the excess reserve problem by such a move.

On the second point it might be argued that the Fund would not be playing a rival central bank rôle if it exercised no discretion, but always just cancelled the effect of gold movements by offsetting open-market operations. If the Fund is to engage in open-market operations at all, this policy of offsetting gold movements is undoubtedly the most satisfactory from the standpoint of the Federal Reserve; for it would render the operations of the Fund automatic and predictable, leaving the field of discretionary action on the domestic money market to the Federal Reserve.

There is grave danger, however, that if the Fund once began to engage in open-market operations on a large scale, it would not confine itself to automatic offsetting operations. The temptation to use its great powers to support the Government bond market or adjust the credit situation to the financing needs of the Treasury would be always present and powerful. Sooner or later it would probably be found that a major open-market instrument was being wielded by an agency other than our Open Market Committee and with objectives different from those of the Federal Reserve.

Even if this outcome could be prevented and the Fund confined to offsetting operations, the first objection would stand -- namely, that the initial purchase of Treasury bills would accentuate by perhaps a half a billion dollars or more the problem of excess reserves.

5. These objections will not arise if the Fund keeps its dollar resources with the Federal Reserve banks. If it does so, it will keep clear of open-market operations, and it will add to member bank reserves only as it purchases gold.

Gold purchased will be held unreported by the Fund. The public will know nothing about it. But to make the purchases the Fund must draw on its account with the Federal Reserve bank, and the drafts will be deposited to the credit of member bank reserves. In other words, an inward gold movement will, without changing reported monetary gold stock, have its usual effect of increasing the reserves of the member banks. While there are several ways in which the Fund's current operations and changes in its account with the Federal Reserve bank can be concealed from the public for weeks or months at a time, any major inward gold movement must, in the course of time, be reflected in the persistent growth of member bank reserves. This amount of disclosure of international movements the Treasury should be prepared to face.