

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 2, 1937.

To Chairman Eccles

Subject: Proposal to give the Board
discretionary power over reserve require-
ments against foreign deposits.

From Lauchlin Currie

LAC.

Attached is a memorandum on the proposal to give the Board discretionary power over the reserve requirements against foreign deposits, together with a statement by Mr. Vest on the legal aspects of the proposal.

June 2, 1937.

DISCRETIONARY POWER OVER RESERVE REQUIREMENTS AGAINST FOREIGN DEPOSITS

IN AMERICAN BANKS

The following arguments can be urged in favor of a grant of broad discretionary power to the Board of Governors to determine reserve requirements against deposits held by or on behalf of non-resident aliens in American banks:

1. Such power could be used as a deterrent to the inflow of short-term capital. If reserve requirements were raised sufficiently, banks would be reluctant to accept foreign deposits and would certainly not solicit them.

2. In so far as capital inflows take the form of deposits, and to the extent to which reserves were required against such deposits, the Treasury would be relieved of the necessity of increasing the public debt and sterilizing incoming gold. From the end of 1933 to May of this year foreign deposits increased by nearly a billion dollars.

3. If high reserve requirements were in force against foreign deposits, this would minimize the extent to which banks would be forced to liquidate their loans or to borrow from the Federal Reserve in the event of a sudden withdrawal. From the end of 1929 to the end of 1933 foreign deposits were drawn down by \$1.3 billion. In addition, other short-term balances declined \$1.3 billion. The worst period of bank deflation, that of late 1931, was associated with withdrawal of foreign-held deposits in this country. Conditions have changed since then but a large withdrawal of foreign-held deposits would still result in some liquidation.

4. Discrimination could be exercised as between a net increase in foreign deposits arising from an inflow of capital and a net increase arising from stock market liquidation. In the latter case reserve requirements need not be raised and might actually be lowered or the increased requirements might be supplied by open market purchases.

5. Ability to vary reserve requirements against foreign deposits would afford a valuable additional power to operate on the volume of reserves of the New York banks.

6. Such a grant of power would constitute the strongest grounds for testing our authority to determine reserve requirements for non-member banks. The main non-member bank affected would be J. P. Morgan and Company. The addition of this power to our existing power to determine margin requirements for non-member banks would constitute another step toward bank unification.

As against these advantages may be contrasted the following disadvantages:

1. Raising reserve requirements against existing foreign deposits would tend to absorb excess reserves, force liquidation or cause borrowing from the Federal Reserve, and would therefore be restrictive in nature. (This disadvantage could be met by confining an increase in requirements to a future increase in deposits until such time as it is desired to exercise some general measure of restraint).

2. New York banks would be exposed to an element of uncertainty with respect to reserve requirements against their foreign deposits.

3. Foreigners could evade service charges, if any were imposed, by withdrawing cash or by investing in Treasury bills and acceptances. If invested in Treasury bills, there would be a tendency to convert inactive deposits into active deposits, which at times may not be desirable on general monetary grounds. (The withdrawal of cash would be equivalent to the imposition of 100 percent reserves and the purchase of Treasury bills could be met by the imposition of moderate transfer taxes. In any case, it is doubtful if service charges would be imposed and an increase in the withholding tax rate would diminish the attractiveness of Treasury bills).

4. If higher reserve requirements were in force against foreign deposits and such deposits were drawn down for the purpose of buying securities, reserve requirements of banks as a whole would be reduced and an expansion of loans and deposits made possible. (This could be counteracted by open-market sales of securities or by Treasury absorption of excess reserves).

5. If the Treasury did not sterilize gold that resulted in an increase in foreign-held deposits on the grounds that the high reserve requirements constituted the sterilization, excess reserves would be increased when, as, and if these deposits were drawn down for the purchase of securities. (The Treasury might undertake to absorb excess reserves arising from this source.)

A grant of power should be broadly discretionary, so as to permit of discrimination as between ordinary working balances and other deposits.

Reserves for foreign-held deposits in non-member banks should take the form of deposits in the Federal Reserve banks.

For the particular purpose at hand it appears proper to require high reserve requirements against foreign-held time deposits as well as demand deposits.

The problem of enforcement should not prove unduly difficult. The bulk of foreign-held deposits are now known to and reported by banks. A general notice to the effect that all deposits held by or on behalf of non-resident aliens must be reported to the banks, with penalties provided for failure to report, should be all that is needed. There will be very little inducement not to report such deposits, as the service charges, if any are imposed, would be small relative to the penalties.