June 16, 1937

A plan for giving the Board authority to raise reserve requirements on foreign balances apparently can be worked out. The question is raised, however, whether such a plan in and of itself is worth undertaking, even though it might be a good feature of a general plan to handle the situation. Foreign balances are now at an exceptionally high level because of a large dishoarding movement, a renewed critical situation in France, and a temporary unattractiveness of our stock market. It is reasonable to suppose that without any action of any kind, a considerable portion of the deposits will be converted into investments of some sort. This proposal might make that movement come sooner and on a larger scale. In that case, the problem would not be solved because as the deposits were spent here for any purpose they would become domestic deposits and would no longer be subject to the high requirements.

There has been discussion of a transfer tax to be levied at the time these foreign balances are used for the purchase of investments. This plan appears to involve great administrative difficulties because of identification of purchasers and identification of investments. Most obligations are in bearer form and can be bought without identifying the purchaser. We are all in general impressed by the desirability of requiring as much as 100 percent reserve against short-term foreign balances, certainly short-term balances that are not normally working balances in connection with international trade. Doing this internationally would be helpful, both as a means of absorbing gold and as a means of protecting the countries against sudden raids on short-term funds.

As far as our situation is concerned, however, we feel that it is important that this be a part of a general measure for handling the exceptional inflow of gold and of capital, including a withholding tax and a capital gains tax. It may be that this is not an opportune time for that kind of legislation because of the fact that the stock market is now weak.

The question may be raised whether this proposal would greatly disturb the banks which are generally scared of the spectre of a 100 percent reserve applied to all deposits and may in general resent any further increase in their reserve requirements. We need not be too much concerned about the banks' reaction unless it leads to renewed liquidation of Government securities. The possibility of such a development should be kept in mind and our course of action in case it should eventuate should be clearly thought out.

If a plan of this sort is adopted, it must be coupled with some arrangement by which the Treasury would undertake to resterilize gold if the foreign balances are withdrawn for use in the United States.

The initial purchase of bills, for instance, at the time reserve requirements are raised could be handled by the System. Such a handling of the developing situation would save the Treasury the embarrassment of constantly shifting its financing operations. It would have the added virtue of leaving operations intimately affecting the domestic credit situation in the hands of the Federal Reserve System.

In view of the possible necessity for two-way action on the part of the Treasury -- i.e., first buying, then selling bills in order to eliminate the effects upon excess reserves of member banks -- it is possible that the task could best be performed currently by Federal Reserve open-market operations with periodic clearings with the Treasury. Such a handling of the developing situation would save the Treasury the embarrassment of constantly shifting its financing operations. It would have the added virtue of leaving operations intimately affecting the domestic credit situation in the hands of the Federal Reserve System.

The question is bound to be raised whether this proposal can be so framed as not to have an unfavorable effect on the country's foreign trade. The question arises whether there is a feasible way of exempting balances required in connection with foreign trade. It seems difficult to apply any exemption other than a flat amount, which probably would not accomplish the purpose.

The question would also arise about the application of these reservex requirements to nonmember banks.