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WORKING ARRANGEMENTS WITH REFERENCE TO GOLD DE-STERILIZATION

Possibilities

There appear to be three main possible working arrangements:

1. We could raise reserve requirements against foreign deposits by one or two big jumps and the Treasury could simultaneously de-sterilize a corresponding amount of its inactive gold.

2. In exchange for the power to raise reserve requirements against foreign deposits we could undertake to sterilize the next billion dollars of inflowing gold in whatever way and at whatever time we saw fit.

3. A compromise between these two positions would be for us to raise requirements by, say, $250 million immediately and for the Treasury simultaneously to de-sterilize that amount. When $250 million more gold had come in and been added to the inactive gold account the operation could be repeated. No commitment as to the aggregate amount need be given and the situation could be kept continually under review.

The present memorandum is an argument for the third arrangement.

Guiding principles

Our choice of these possible arrangements should be governed by their differing probable effects on (a) a permanent satisfactory solution of the gold problem, (b) the interests of the Federal Reserve System, and (c) domestic monetary policy.

(a) Permanent solution. From the point of view of securing a satisfactory solution of the gold problem it is essential that drastic tax measures be adopted to deter the inflow of gold which, in turn, would make conditions favorable for joint action with England. The only development strong enough to overrule the objections of the State Department, of Congress, and of some persons in the Treasury to a vigorous tax program is the necessity for continued sterilization. From this point of view it appears essential that we neither take over the present billion dollars of inactive gold nor make any commitments to sterilize the next billion. Our best course of action would be to afford temporary relief from time to time when it could be done to keep down the inactive account without disturbing the money market. If we take over responsibility for the next one billion dollars the problem will cease to be urgent or pressing for perhaps a year and it will be difficult to secure effective action.

(b) Interests of the Federal Reserve System. From the point of view of the independence of the System it is vitally important that we maintain a substantial volume of earning assets. Even as matters now stand there is a possibility of having to use some $500 or $800 million in absorbing excess reserves. The adoption by the Treasury of the responsibility for sterilizing gold was very much in our interests, though there may have been some question as to the timing, as at least it established the precedent that it was the Treasury's responsibility to sterilize inflowing gold and offset outflowing gold, permitting us to regulate the domestic money supply as though we were off the gold standard. We should resist any course that would weaken or destroy this precedent. For us to take over responsibility for handling the next billion dollar inflow at our discretion would do, however, precisely this. It would appear the better course to afford temporary relief from time to time by shifting some of the burden on commercial banks, and, for the rest, to have the Treasury feel a continuing and uninterrupted responsibility for handling gold movements.

There is another point in this connection worth bearing in mind. We do not contemplate using the power to raise reserve requirements against foreign deposits as one of our general control mechanisms. The primary purpose is to afford some relief for the Treasury. While we should not hesitate to do anything unpopular if we feel that it is also in the public interest, it appears that in this particular instance the exercise of power would be in the nature of an accommodation for the Treasury and that, therefore, the Treasury should receive its share of credit or discredit that may be attached to the action. From this point of view it is desirable that raised reserve requirements and the release of inactive gold be intimately connected and occur simultaneously. For us to handle a billion dollars of inflowing gold at our discretion would be to obscure the fundamental nature of the operation.

(c) Domestic monetary policy. In the field of domestic monetary policy it is said that to allow flexibility to the Board in handling gold inflows has advantages over an automatic policy of raising reserve requirements in substantial steps. This point, however, is debatable. It is said, for instance, that at certain times it may prove desirable to have excess reserves increase and that, therefore, it may not always prove desirable to sterilize gold inflows. This point, however, can be met by pointing out that if the Board feels that additional excess reserves are desirable it need not, and, indeed, should not wait for such reserves to be created by gold inflows. It can create them itself through its acceptance or open-market policy.

Similarly, it has been said that sometimes it may prove desirable to sterilize gold inflows by open-market operations, rather than by increased reserve requirements. The danger of this course, however, is that we would be parting with earning assets with no assurance that we could get them back again. We would find ourselves eventually in the position of bearing part of the burden of gold sterilization.

If inflowing gold were permitted to add to member bank reserves instead of being automatically sterilized by the Treasury there is a distinct possibility that the reserves would become diffused. It would then prove difficult to raise reserve requirements in the New York banks without at the same time buying securities. The result would be a net addition to member bank reserves.

A further point that has been made in favor of handling gold inflows at our discretion is that otherwise the Treasury would be in the position of adding to its debt one month and retiring its debt the next month, which would be ridiculous and unnecessary. This, however, does not follow. The Treasury pays for the gold by checking against its balance with the Federal Reserve bank. Its balance, in turn, is built up through tax collections and borrowings and is reduced by expenditures. Its borrowing policy, therefore, is governed by the outcome of a number of forces. During the coming year a substantial portion of any gold inflows can be sterilized out of the excess of cash collections over cash disbursements.

Finally, there is a real danger in making a commitment to sterilize one billion dollars, inasmuch as the power to raise reserve requirements against foreign deposits may not prove adequate to accomplish this. A substantial shift from foreign to domestic accounts would have this result. We would then be in the position of having to use our open market portfolio.

Conclusion

In view of all these considerations it would appear that the desirable course would be not to disturb the present gold sterilization arrangement, to secure the new power and to use it gradually after consultation with the Treasury to lighten the cost of sterilization. It should, however, be used only for this purpose and the operations of raising reserve requirements and de-sterilizing gold should as far as possible be simultaneous. Any growth of excess reserves that results from a subsequent shift of deposits from foreign to domestic account should be regarded as resulting from inflowing gold and be sterilized in the same way by the Treasury. On the other hand, any subsequent shift of deposits from domestic to foreign account not compensated by inflowing gold should be regarded as permitting of further de-sterilization by the Treasury.