Memorandum regarding proposed plan for dealing with foreign balances, drafted for the purpose of incorporation in the minutes as containing the reasons for a motion favoring the enactment of legislation granting the Board additional power to absorb excess reserves.

Since the end of January, 1934, the inflow of gold to this country has amounted to about $5,000,000,000, which represents a large scale movement of funds from foreign countries and may be withdrawn at any time. A large portion of these funds has been placed in liquid investments in this country. In recent months the inflow has resulted in a large growth in idle balances which at present are at an exceptionally high level, and may be withdrawn or placed in liquid investments in this country. Sudden liquidation of such foreign investments or sudden withdrawal of such foreign balances would have serious repercussions on the security markets and the domestic credit situation. The inflow of such foreign funds was reflected in excess bank reserves in this country until the Board increased reserve requirements of member banks and the Treasury took steps to sterilize additions to the gold stock.

Under the Treasury policy adopted in December, 1936, the effects on reserves of additions to the gold stock either from imports or from new production are offset by the sale to the public of equivalent amounts of United States Government obligations and the setting aside of such additions to the gold stock in an inactive account in the Treasury, in this way keeping the gold out of the

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country's credit base. Under this policy, an outward movement of gold acquired through sales of bills would be similarly offset by the purchase or redemption of United States Government obligations in the market, thus restoring to the market the funds lost through the export of gold. To this extent, therefore, the volume of member bank reserves would neither increase nor decrease as the result of changes in the supply of gold.

In January, 1937, the Board of Governors took action utilizing to the full extent its authority under the law to raise the requirements as to reserves against deposits in member banks of the Federal reserve system. This action became finally effective on May 1, 1937. The Board having exhausted its power to raise the requirements as to reserves against deposits, the System has no means of absorbing further excess reserves except through disposal of securities, held in the System open market account, by direction of the Federal Open Market Committee. Such action would involve not only the question of effect upon general credit conditions but also the advisability of dissipating this power of control by the System over credit in case an inflationary development should occur at a later time.

At the same time the Treasury is confronted with a serious problem. It is understood that when it adopted the policy of sterilizing further gold acquisitions, it was contemplated that the amount that it would have to borrow in order to carry out this

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policy should not exceed a billion dollars, but this limit has already been passed and serious objections have been raised to further increasing the public debt or the expenditure necessitated by the payment of interest upon the additional obligations which would be issued in order to continue this policy.

It is understood that serious consideration is being given to the question of discontinuing this policy and to the possibility of depositing in the Federal reserve banks gold certificates for all or a large part of the amount of gold which has been sterilized pursuant to such policy.

If either action should be taken, the question would immediately arise for determination what could be done by the Federal reserve system to meet the situation. In these circumstances, it has been suggested that a direct approach to the problem would be to obtain legislation granting the Board additional power to absorb excess reserves resulting from gold imports, by increasing reserve requirements on deposit balances maintained by foreigners in this country.

The Board is advised that at present there are approximately $1,800,000,000 of such balances which are held for the most part by banks in New York City, against which the reserves required to be held under existing law are in the neighborhood of $500,000,000, so that the portion of these balances not covered by required reserves would amount to between $1,000,000,000 and $1,500,000,000.

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It would therefore be helpful for the Board to have power to deal with the situation created by these excess reserves by raising reserve requirements against foreign balances to such extent as may be found necessary up to the full amount of such balances. In all probability a certain amount of these deposits will remain in this country as minimum working balances, and the possibility of interference with the ordinary requirements of foreign trade could be met by providing in the legislation for exemptions to be determined by the Board of Governors within some prescribed limits. Such exemptions could be different for savings accounts, for time deposits other than savings accounts, and for demand deposits. By making these exemptions there could be eliminated from the operation of the higher reserve requirements such proportion of the balances as would be necessary in order to make it practicable for the banks to comply with the requirements without interfering with the accomplishment of the purpose in view.

In order for such a plan to be effective, however, the power of the Board to increase reserve requirements against foreign balances should be coupled with legislation to discourage foreign capital from coming to this country, and the Treasury should continue to maintain in its inactive gold account an amount approximately equal to the balance which has already been accumulated. Otherwise, the System might find itself without adequate means for coping with the situation.

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Even if the Board should obtain and exercise the authority to require higher reserves against deposits of foreigners, this method of absorbing excess reserves would be ineffective to the extent that foreigners withdrew their deposits and invested them in this country. If gold should continue to come in undiminished volume and take the form of investment in securities, the System might find itself swamped with excess reserves.

The proposed legislation should be applicable to nonmember banks as well as to member banks. If it were confined to member banks foreign balances could be transferred to private bankers and thereby escape the reserve requirements. There is precedent for such a proposal in the fact that Congress has heretofore granted the Board authority to impose margin requirements on security loans made by nonmember banks.

The proposed power to raise reserve requirements would be in the interest of safeguarding the country's monetary system and protecting international trade, both of which are subjects of concern to the Federal Government.

The Treasury should continue to maintain in its inactive gold account approximately the balance which has already been accumulated for the following reasons: If the Treasury were to desterilize at once the balance which it now holds in that account, the expenditure of the proceeds would create excess reserves and the Federal reserve system would be confronted with the necessity

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not only of absorbing the additional reserves which might be created by further gold imports but also of absorbing the billion dollars of excess reserves created by the desterilization of the amount now held in the account. Such a result would be undesirable. The power under the proposed legislation would not meet the situation and serious repercussions in the money market might result. While the increase in reserves required to be held against foreign balances would be operative against the banks in the money markets, the expenditures of the proceeds of the desterilization operation would be scattered over the country and the banks in the money markets would be under the necessity of disposing of earning assets—at least temporarily—with possible adverse effects upon credit conditions.

In connection with any legislation authorizing the Board to absorb excess reserves resulting from importations of gold, by raising reserve requirements on deposits of foreigners, it is also desirable that the Board be authorized to prevent domestic banks, other than Federal reserve banks, from accepting deposits from foreign central banks; otherwise foreign central banks, on their own volition, could seriously affect conditions in the domestic money market by shifting large balances from Federal reserve banks to commercial banks or vice versa, thereby adding to or reducing the amount of excess reserves.

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