BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date December 12, 1947

To Chairman Eccles

From Mr. Knapp

JBK

MESSAGE:

Attached are some notes on the proposal to increase Federal Reserve Bank reserve requirements. I am circulating these comments to Messrs. Thurston, Thomas, and Young as representing the reactions of an independent "guinea pig".

Attachment

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Message delivered by ______________

F.R. 468
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The following comments relate to the proposal that the reserves, in the form of gold certificates, required to be held by Federal Reserve Banks against their outstanding notes and demand liabilities should be increased from the present straight 25 per cent to 40 per cent for notes and 35 per cent for demand liabilities. This proposal has been put forward as a contribution to the fight against inflation, it being now generally recognized that inflationary pressures represent a grave threat to the health and stability of our economy.

In the light of this avowed purpose, the proposed measure reflects a bankruptcy of ideas; in fact it simply amounts to a confession of failure. It would be too complimentary to call the proposal woefully inadequate; rather it is almost completely irrelevant. If it is put forward as in any sense a substitute for effective action in the control of bank credit, it amounts to a fraud on the American public and an insult to the intelligence of the electorate. At the same time, the adoption of the proposed measure, innocuous enough at the moment, would carry with it the danger that at some future time control in this manner over Federal Reserve System operations would lead to disastrous consequences.

These points are further developed below:

(1) The two principal functions which have traditionally been discharged by gold reserves are (a) a reserve against demands by the public for gold coin, and (b) a reserve against international payments. The first function has disappeared in the United States as well as in the rest of the world as a result of the abandonment of free gold coin circulation. The second purpose remains, but in the case of the United States, our present gold stock is more than ample to cover any conceivable requirements of this country for international payments.

(2) It remains true that the legal reserve requirements applicable to the Federal Reserve Banks might theoretically be manipulated by the Congress with a view to controlling the potential amount of Federal Reserve credit. However, in practice the reserve requirements must either remain fictitious and academic as at the present time, or become a dangerous threat to the integrity of the Federal Reserve System.

(3) From this point of view, it is fortunate that under present circumstances the proposed increase in the reserve requirements of the Federal Reserve Banks would be completely ineffective. The new proposed ratios, although substantially higher than the existing ratio, would nonetheless leave the Federal Reserve Banks with holdings of gold certificates substantially in excess of the required amount. But since their operations and freedom of action would not therefore be significantly affected, it is apparent that the proposed measure makes absolutely no genuine contribution to the control of inflation.

(4) On the other hand, if as a result of such factors as the expansion of currency in circulation, the established reserve ratio did come to be restrictive upon the freedom of action of the Federal Reserve Banks, it would obviously have to be changed. It is unthinkable that Congress would allow a situation to develop in which the System would be powerless to provide credit and to stabilize the Government bond market merely for the sake of maintaining a completely artificial legal reserve ratio. In this respect, this measure is fully comparable to the futile attempts to legislate ceilings on the amount of the public debt.

(5) It may be claimed that enactment of the proposed measure will have beneficial "psychological effects". It is extremely difficult to conceive, however, why such effects should be induced in any part of the American people aside from the lunatic fringe of "hard-money" economic antiquarians. Even if such individuals are psychologically stimulated, it is far from clear how they can take any action which will have the least counter-inflationary influence. This is certainly sweeping back the ocean with a broom.

(6) On the other hand, even from the psychological point of view, there are dangers in the course which has been advocated. If conceivably the time ever should be reached when the higher requirements became effective, it would be at a moment of serious inflationary pressures. At such a time of crisis, with the current already running strongly toward inflation, the inevitable reduction in reserve requirements might well serve to strengthen such tendencies and to undermine public confidence in the currency.