FEDERAL RESERVE BOARD

WASHINGTON

CONFIDENTIAL

August 7, 1918.
X-1113

Dear Sir:

The Board has given special attention of late to the question of reserves, which for some time past have shown a downward tendency. A decline in reserve percentages is inevitable as long as the Treasury is forced to draw upon the financial resources of the country more rapidly than deposits based upon earnings can accumulate. However, we should not forget that $90,000,000 silver has been withdrawn from circulation since April, and when the Federal reserve bank notes, which we are assured will be available about August 15th, can be put into circulation in an amount equivalent to the silver certificates which have been withdrawn, we will be able to strengthen our gold reserves by approximately $45,000,000. In addition to this, the Treasury will be able in the near future to turn over to the Federal reserve banks ten or twenty million dollars more of gold, and we should thus be able to maintain our reserves for awhile in the neighborhood of 58%.

The Board has reached the conclusion that before any steps looking to the suspension of reserve requirements are seriously considered, the Federal reserve banks should make an arbitrary computation of their reserves against deposits on a basis of 35%, thereby increasing in a corresponding degree the reserves against note issues, which, for the time being, on the basis of 35% for reserves on deposits, would be above 75%.

The position of the twelve Federal reserve banks on August 2, 1918, was as follows:

Total cash reserve........................	$2,034,918,000
Net deposit liabilities..................	1,558,839,000
35% thereof................................	545,594,000
Federal reserve notes in circulation.....	1,906,465,000
Note reserve available....................	1,489,324,000
Per cent..................................	78.1

Whenever the reserve against notes shall fall to 40%, the deposits reserve having been maintained at 35%, it will then be the policy of the Board to maintain the note issue reserve at the 40% level, and, if necessary, begin to reduce the reserve against deposits until it reaches a figure materially below normal - say 20%.

Section 11 requires that the Board "shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the amount hereinafter specified". The Board is authorized, therefore, to establish a very moderate graduated tax upon deficiencies in deposit reserves, but in suspending the requirements on note issue reserves, the Board would be bound by the tax imposed by the Act, as follows:

"When the reserve falls below forty per centum, until it reaches thirty two and one half per centum, a tax of not more than one per centum."

Down to $32\frac{1}{2}\%$, therefore, the Board has the discretion of imposing a moderate tax upon the deficiencies in note issue reserves in the same manner as it can deal with deposit reserve deficiencies. Whenever the Federal reserve note issue reserve falls below $32\frac{1}{2}\%$, however, it will become the Board's duty to impose a tax of not less than $1\frac{1}{2}\%$ upon each $2\frac{1}{2}\%$ deficiency or fraction thereof.

There seems to be no reason, however, to apprehend in the near future, if ever, a fall in our reserves to this point, and we can do a great deal in the manner above indicated to delay any such development. When confronted with such a condition, we can then consider the advisability of asking Congress to modify the terms of the Act.

Before any action is taken looking to the suspension of reserve requirements, we should exert every effort to complete the concentration of gold in the Federal reserve banks. There are still in the vaults of member and non-member banks, in circulation, and in hoarding, - entirely outside of the vaults of the Federal reserve banks - about \$800,000,000. of gold and gold certificates. As much of this gold as possible should be brought into the banks while our note reserves are still high and before there is any tendency upon the part of the public to become alarmed.

In view of the foregoing the Federal Reserve Board desires that the Federal reserve banks adopt a dual method of calculating their reserves, as follows:

1: As heretofore, (a) gold reserve and (b) cash reserve on combined deposits and note issues;

2: Fixed reserve on deposits of 35%, in gold and lawful money, 5% on Federal reserve bank notes, leaving a fluctuating reserve on the Federal reserve note issue, which would receive the benefit of the entire excess above 35%, and 5% respectively.

These reserve percentages will be published in the weekly statement of the Federal Reserve Board, and in this way the public will gradually become accustomed to a reserve of 35% against deposits, while Federal reserve note issues will, for a considerable time show a very strong gold cover.

The Federal reserve banks are not expected to publish their percentages in their own statements, and this letter is confidential and not for publication.

Very truly yours,

Governor.