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Governor Black

Mr. Smead

Devaluation of the dollar and the Federal Reserve System

In view of the authority possessed by the President to reduce the gold content of the dollar at any time by as much as 50 percent and the growing probability that the dollar will be devalued by the exercise of that authority, perhaps in the near future, the subject of the effect thereof upon the Federal Reserve System has come to be of vital concern.

At the present time our monetary gold stock amounts to $4,322,000,000, which would be increased to $7,203,000,000 if the gold content of the dollar were reduced to 60 percent of the present statutory weight, corresponding roughly to the present exchange value of the dollar. At this valuation our gold stock would exceed by about $1,960,000,000 the amount of money in circulation at the present time, exclusive of subsidiary silver and minor coin. In other words, we could retire all the Federal Reserve notes, Federal Reserve Bank notes, national bank notes, United States notes, gold certificates, silver certificates, gold coin and silver dollars in circulation, replace them with gold coin of the new weight or with gold certificates based on the devalued gold dollar and have a reserve stock of gold remaining in the amount of $1,960,000,000.

Bearing in mind also the fact that our gold stock at its present valuation is equal to more than 80 percent of our total circulation, exclusive of subsidiary silver and minor coin, it is evident that the addition of $2,880,000,000 to the value of our gold stock, that would result from a 40 percent devaluation of the dollar, would give this country an additional fund of gold in that amount not needed for monetary purposes and which would have to be held by someone as a nonproductive asset. The possible holders of this gold are three, i.e., (1) the United States Treasury, (2) the Federal Reserve

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Banks, and (3) member and nonmember banks.

That the Treasury would hold any substantial portion of this immense sum of idle gold is, of course, quite inconceivable, especially in view of the current heavy requirements of the Treasury for funds to finance unusual Governmental activities. The Treasury might, however, it would seem be willing to carry a 100 percent gold reserve against United States notes, which would absorb about $190,000,000 of gold.

If the Reserve Banks were permitted to retain the profit realized from the revaluation of their own gold holdings (which it is taken for granted they will not, unless perhaps in connection with the adoption of a "commodity dollar"), they could carry the increased gold reserves with no other embarrassment than that of a striking increase in their surplus accounts; but if the Reserve Banks do not share in the profit derived from the revaluation of the gold stock, the thrusting upon them of such an amount of unproductive gold would have very serious consequences. Assuming that the Treasury deposited with the Federal Reserve Banks its profits of $2,880,000,000 or so resulting from the devaluation of gold it would then be in position to draw on the balances thus created in meeting its obligations.

The paying out of these funds by the government in ordinary course in defraying current expenses or redeeming government securities held by the public would transfer them to member bank reserve account, since the government checks would be deposited with member banks who in turn would deposit them with the Reserve Banks. This would expand excess reserves of member banks from the present unprecedented level of $850,000,000, to the fantastic total of something like $3,700,000,000. The inevitable result would be tremendous pressure upon the Reserve Banks to dispose of their government securities and thereby enable member banks to reduce their excess reserves to more normal proportions. If the Reserve

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Banks complied they would be virtually, if not completely, bereft of earning assets, as they would also be if the Treasury instead used the funds in the direct purchase from the Reserve Banks of the government securities held by them. Earnings of the Reserve Banks would naturally decline almost, if not quite to the point of extinction and the continued existence of the Federal Reserve System would be endangered through inability to cover expenses. But there would also be the even more serious result of depriving the Reserve Banks of any means of credit control, whether or not they retained a substantial volume of government securities, unless there was an export movement of gold on such a tremendous scale as to wipe out excess reserves of member banks and put member banks in debt for substantial amounts to the Federal Reserve Banks. The existence of excess reserves of member banks in such amount as would result from the paying out by the government of the profit (approximately $2,880,000,000) realized from the revaluation of gold would tend to cheapen credit in this country and consequently to produce an export movement of gold. Any gold exports due to this cause would, of course, cease when excess reserves of member banks were reduced to a normal level.

Member and nonmember banks cannot be expected to hold in their vaults as a nonproductive asset any substantial portion of the increase in the country's monetary gold stock resulting from the revaluation of gold, even if they were not deterred from doing so by the risk of loss by robbery or otherwise. There are, however, a number of means whereby member and nonmember banks could be forced to assume at least a part of the burden that would otherwise fall on the Reserve Banks. Among these is the building up of excess reserves of member banks, and some increase in even the present large excess reserves obviously would not be dangerous under existing conditions. To force member banks to carry large excess reserves

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under any and all conditions, however, would be to surrender any possibility of exercising any restrictive influence on credit expansion and to furnish member banks a powerful incentive to launch into credit expansion on an unprecedented scale at the very time, perhaps, when changed conditions called for restraint. Another means of shifting a part of the burden to the banks would be to induce all, or substantially all, nonmember banks to join the Federal Reserve System. All nonmember banks, other than mutual savings banks, in the country have about $6,000,000,000 of deposits, which would call for reserve balances of about $300,000,000 with the Reserve Banks if they became member banks. Mutual savings banks have deposits of about $9,600,000,000, which at the rate of 3 percent applicable to time deposits would call for reserve balances with the Reserve Banks in the amount of $288,000,000. Accordingly, bringing all nonmember banks into the System would take care of perhaps $600,000,000 of the around $2,880,000,000 of excess gold. The most prompt and effective means, though one that perhaps could not be resorted to without arousing a considerable amount of opposition, would be to increase member bank reserve requirements. For example, a 40 percent increase in the reserve requirements would result in increasing required reserves for present membership by about $720,000,000. There remains the possibility of retiring the about $750,000,000 of national bank notes in circulation.

If all of the above suggestions, which are tabulated below, were adopted the System would no doubt be able to function measurably satisfactorily even with a 40 percent devaluation of the dollar.

Increase the gold reserve against U. S. notes to 100 percent	$190,000,000
Retire national bank notes	750,000,000
Increase required reserves:	
(a) By admission to membership of nonmember banks (75 percent of the estimated maximum)	450,000,000
(b) By increase of 40 percent in legal reserve requirements of new and present membership	900,000,000
Decrease earning assets of the Reserve Banks	590,000,000
Total	$2,880,000,000

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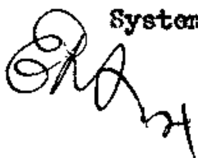
If, however, excess reserves of member banks were allowed to fall to the normal level of around $150,000,000, there would be a further decrease in earning assets of the Reserve Banks of about $700,000,000 in addition to the $590,000,000 indicated above, which would thereby reduce earning assets from $2,500,000,000 as at present to about $1,200,000,000, or to approximately the amount required at 3 percent to cover operating expenses, losses, and dividends. The immediate effect upon the Federal Reserve Banks, even without any decrease in excess reserves of member banks, could scarcely fail to be a reduction in earning assets of much greater magnitude than the $590,000,000 assumed in the above illustration, and the Reserve Banks might find it necessary to make up for the consequent reduction in their earnings, so far as possible, by discontinuing the printing of Federal Reserve currency with a gradual substitution for Federal Reserve notes in circulation of gold certificates, by obtaining full reimbursement, so far as practicable, for all services rendered the Government, and by charging member banks for some of the free services now performed for them. In the above illustration no allowance is made for a possible reduction in money in circulation, (money in circulation now amounts to $5,666,000,000, compared with $4,929,000,000 at the end of November 1929), or for the importation of gold either of which, other things being equal, would result in a corresponding further decrease in Reserve Bank earning assets.

Of course, if the dollar were devalued less than 40 percent or if there were a substantial export of gold, perhaps partly as the result of an agreement with one or more foreign countries in connection with the stabilization of the dollar, the situation would be more favorable from the standpoint of the Federal Reserve System.



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