

*Board*

*Referred to Mr. Miller*

AT BOARD MEETING

MAR 13 1923

*W.D. Houston*  
*Secretary*

March 10, 1923.

Dear Mr. Secretary:

I have read your letter of the 10th, with relation to the open market operations of the Federal Reserve banks particularly their purchases of Government securities, with a great deal of interest and with general agreement. In this connection I enclose copy of a circular letter sent to the Chairmen of all Federal Reserve banks on the 8th stating that the Board is strongly of the opinion that certificates maturing March 15th should be allowed to run off without reinvestment. X-366

I agree with you fully that it is destructive of any credit policy which the Federal Reserve System may be pursuing to permit the Federal Reserve banks to expand credit by purchasing Government securities simply for the purpose of increasing their own earnings and putting themselves in a position to pay expenses and dividends, but I am not entirely clear as to the legal authority of the Federal Reserve Board in the matter. The law gives the directors of the Federal Reserve banks authority to purchase Government securities subject to such regulations as the Federal Reserve Board may prescribe. Up to this time the Board never has made any regulations though at its meeting on March 8th the Board directed a committee to prepare regulations on this subject. I think we have undoubtedly legal authority to prescribe that purchases of Government securities shall be made only through a central committee but whether we can definitely prohibit any Federal Reserve bank from making purchases it seems to me is at least doubtful. \*

I cannot refrain from adding just the personal statement that when the Federal Reserve Act was under debate in the 63rd Congress in the summer of 1913 some of us foresaw and predicted the difficulties of the maintenance of so many regional reserve banks in normal times or in times when demand for credit was light. Of course no one then supposed any great volume of Government securities would be available and no such open market investments as have been made were expected. On the other hand it was expected that something like \$25,000,000 of Consols bearing the circulation privilege would be absorbed by the Federal Reserve banks each year and if it had been possible to carry that policy out I think it would have gone far towards solving the difficulties of maintenance in some of the Reserve banks. \*

Yours very truly,

Acting Governor.

Hon. A. W. Mellon,  
Secretary of the Treasury.



THE SECRETARY OF THE TREASURY  
WASHINGTON

333.-6  
AT BOARD MEETING

MARCH 10, 1923.

Dear Sirs:

Recent developments indicate that it is again necessary to bring to your attention the importance of establishing a definite policy as to the open market operations of the Federal Reserve Banks, including particularly their purchases of Government securities. The only policy now recognized by most of the Federal Reserve Banks apparently rests on the theory that earning assets must always be large enough to be sure to cover expenses and dividends for the year, and when the earning assets of a given Federal Reserve Bank fall below the assumed amount necessary for this purpose, the Bank usually goes into the market and buys Government securities, or bills, in order to assure larger earnings. Within the past few weeks, for example, the Federal Reserve Banks of Atlanta, Dallas, Boston, Cleveland, Chicago, Kansas City, and perhaps others, have been placing with the Central Committee of Governors located in New York orders for the purchase of Government securities in amounts ranging from \$1,000,000 to a possible \$20,000,000, and while it has been possible, as I understand, to execute most of these orders by shifting investments from one Federal Reserve Bank to another, several situations have arisen in which the execution of the orders would require purchases outside of the system. At least one bank, I understand, has



bought about \$2,000,000 of certificates without paying any attention to the Central Committee.

It is hardly necessary to point out that purchases of Government securities by the Federal Reserve Banks put Federal Reserve funds into the market, thereby increasing the supply of available funds, and that it is destructive of any credit policy which the Federal Reserve System may be pursuing to permit the Federal Reserve Banks to expand credit in this way simply for the purpose of increasing their own earnings and putting themselves in a position to pay expenses and dividends. Such an attitude on the part of the Federal Reserve Banks subordinates the major question of credit policy to a purely incidental question of Federal Reserve Bank house-keeping and is wholly at variance with the views expressed from time to time by the Federal Advisory Council as to the policy which should be followed by the Federal Reserve Banks in respect to earnings. It would be peculiarly unfortunate for the Federal Reserve Banks at this time, when three banks have recently raised their discount rates and the problem of credit control is causing some concern, for Federal Reserve Banks again to set out upon a program of increasing their earning assets by making further purchases of Government securities. It seems to me clearly necessary, therefore, that the Federal Reserve Board, acting under its general powers, should prescribe regulations governing the open market operations of the Federal Reserve Banks, and require in these regulations

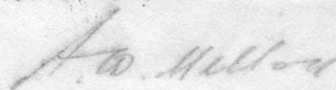
that the Federal Reserve Banks shall not make any further purchases of Government securities, or bills, for the purpose of increasing their earning assets without first getting the express approval of the Federal Reserve Board, and that generally speaking the Federal Reserve Banks shall not in the future make investments simply for the purpose of increasing earning assets. It should also be definitely understood that under any circumstances all purchases and sales of Government securities for account of the Federal Reserve Banks are to be handled through the Central Committee of Governors which is now functioning.

The Treasury, I may add, has a peculiar interest in any Federal Reserve Bank operations in Government securities, for as I pointed out last year uncontrolled purchases and sales by the Federal Reserve Banks frequently conflict with Treasury operations and always make it difficult for the Treasury to determine the basis upon which its own new offerings of securities should be sold in the market. It should not be forgotten, moreover, that the Federal Reserve Banks are still holding a very substantial amount of Government securities acquired chiefly within the past year or so and that with rising interest and discount rates the Federal Reserve Banks ought to be endeavouring to liquidate the investments they already have rather than to accumulate larger holdings. The most satisfactory form of liquidation is to collect the short-term certificates at maturity without reinvesting the proceeds, and this leads me to suggest that



the Federal Reserve Board should specifically advise the banks not to proceed with the reinvestment of the funds resulting from the redemption of their holdings of certificates maturing March 15, 1923, without further authority from the Board. As I understand it, there is a considerable volume of certificates of the series maturing March 15th in the hands of the Federal Reserve Banks and the redemption of those holdings of certificates, without reinvestment of the proceeds, offers a good opportunity to reduce by a substantial amount the investments of the Federal Reserve Banks in Government securities without at the same time putting any extraordinary pressure on the market.

Very truly yours,



Secretary of the Treasury.

The Federal Reserve Board,  
Washington, D. C.