

Hon. A. E. McLaughlin

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April 30, 1923.

represents a pretty drastic deflation of Government securities and it seems to the committee that the banks have about as far in this matter as they should be expected to go. I don't say that the \$10,471,000 of Treasury certificates held April 4th on sales contracts represent a low stage of that item. On October 25, 1922 the amount held was \$27,331,000 and on January 31, 1923, \$25,301,000. Mr. Case told me that this item would fluctuate from about \$10,000,000 to \$30,000,000. It may be considered practically negligible but an increase or decrease of five or ten millions in any weekly statement might be.

Dear Mr. Secretary:

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I might add that in their efforts to reduce the investment accounts of the banks. On Friday of last week I attended a meeting of the new Open Market or Investment Committee of the Federal Reserve banks held at Philadelphia. The committee is made up of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland and Chicago, and there were present Governor Harding, Acting Governor Case, Governor Norris, Governor Fancher and Governor McDougal.

After preliminary discussion the committee organized by electing Mr. Case as Chairman and then ensued a full discussion of the whole open market policy of the Federal Reserve System. I will state briefly the results of the meeting and then take up some of the facts brought out by the Governors present and some matters of the discussion. The Governors voted to recommend to their own boards and to the other Federal Reserve banks that the Treasury certificates maturing on September 15th, amounting to \$35,953,500, be tendered to the Treasury at par and interest if and when the Treasury is willing to take them. The committee also voted to raise the open market purchasing rate on acceptances 1/8 which will make the rate at New York for purchasing short bills 4 per cent, for sixty-day bills 4-1/8, ninety-day bills 4-1/4 and longer bills 4-3/8. This action has already had its effect upon the brokers offerings in New York City.

Furthermore it was understood that the banks buying bills would buy each day a little less in value than the amounts maturing.

Mr. Case presented a schedule of the holdings of all Federal Reserve banks in United States securities and other earning assets from May 17, 1922, to April 4, 1923, inclusive. The holdings of Government securities were at their peak as you know in May 1922, being at \$594,975,000 on May 17th, and \$603,419,000 on May 31st. From that time they began rapidly to decline and on April 4th had been reduced to \$239,149,000 while other earning assets had increased to \$955,109,000. Government securities therefore have been reduced no less than \$355,826,000.

When you consider that of the \$239,149,000 held on April 4th last \$10,471,000 were held on repurchase agreement there remain only \$228,678,000 of investment securities in the Federal Reserve System, and of these \$39,083,000 are Government bonds, nearly all of them bonds bought before the war in conformity with Section 18 of the Federal Reserve Act. Some of them are bonds or still bearing the circulation privilege and others are conversions of such bonds into 3 per cents. When these are subtracted it will be found that there remain in the Federal Reserve System only \$189,595,000 of bonds and notes and certificates of which \$34,011,000 are December 1923 maturities, \$2,062,500 March 15, 1924 maturities and the balance \$117,550,000 are Treasury notes.

This represents a pretty drastic deflation of Government securities and it seemed to the committee that the banks have gone about as far in this matter as they should be expected to go. I ought to say that the \$10,471,000 of Treasury certificates held April 4th on sales contracts represent a low stage of that item. On October 25, 1922 the amount held was \$27,231,000 and on January 31, 1923, \$25,301,000. Mr. Case told me that this item would fluctuate from about \$10,000,000 to \$30,000,000. It may be considered practically negligible but an increase or decrease of five or ten millions in any weekly statement might be shown without any actual increase in the investment accounts of the banks. I might add that in their efforts to reduce their holdings of Government securities Federal Reserve banks since May 17, 1922 have actually sold nearly \$14,000,000 of bonds bearing the circulation privilege which I believe was a very bad policy and it simply puts that amount of national bank notes back into circulation. I have protested vigorously against this and hope I have succeeded in producing some impression. ✓

When you consider that the Federal Reserve banks have a capital and surplus of \$327,000,000 which was actually taken out of the working funds of the banks which joined the System and represents that much deflation unless it is invested I think you must admit that the holdings of Government securities at the present time are very low. Counting out the bonds which represent subtraction from the national bank circulation and counting out the \$10,000,000 held on sales contracts the Reserve banks have \$137,400,000 less invested in Government securities than their capital and surplus. Every time a new bank joins the System and every time the capital and surplus of any present member bank are increased something is added to the capital of the Federal Reserve banks which is taken out of the working funds of the country and locked up unless reinvested. During the past year, that is between April 5, 1922 and April 4, 1923, the capital of the Federal Reserve banks increased \$4,064,000 while the surplus increased \$3,000,000. The capital increases a few thousand dollars almost every week. ✓

It would seem to me, therefore, that the capital and surplus of the Federal Reserve banks should be continuously invested regardless of the demand for discounts, not only as one of the chief means of supporting the Federal Reserve banks but as investments which can not possibly effect the money market in the sense of adding new funds to the market because such investments simply return to the market what have previously been subtracted from it and leave the conditions as before. This was substantially the view of the committee and is also the opinion of Mr. Warburg with whom we talked over the open market investment policy of the Federal Reserve banks when he was last here something more than a week ago. My own feeling has always been that a considerably larger proportion of this fund might be invested in long time bonds. ✱

Since the Federal Reserve banks now have \$137,400,000 less than their capital and surplus invested in Treasury certificates and notes it seems to me that we may fairly be said to have deflated to that extent. I believe that when the investments of the Reserve banks in Treasury certificates and notes or in bonds other than bonds bearing the circulation privilege reach \$350,000,000 they may be said to be excessive and to be influencing the market in the direction of easy money, but when they fall below \$200,000,000 it seems to me the influence is distinctly in the direction of deflation. I understand from Mr. Case that arrangements are to be made to take up the September 15th maturities which will

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actually leave the Federal Reserve banks only a little more than \$153,000,000 of Treasury certificates and notes.

Why should not the Treasury consider that about the minimum with \$350,000,000 as a maximum.

Perhaps it may be said that the holdings of acceptances or "bills bought in the open market" ought to be considered in the same category with Treasury certificates and notes, but there is this difference - the acceptances represent actual business transactions and are self-liquidating. Furthermore unless the Federal Reserve banks make some investments in acceptances the acceptance business will be entirely destroyed or driven to London as it will be just as cheap to sell open market one named paper as to arrange for the accepting of drafts in banks or acceptance houses paying the 1/4 of 1 per cent commission. Mr. Case seemed to think it doubtful whether the market could stand a further raise of 1/8 unless the rediscount rate was raised.

Yours very truly,

Acting Governor.

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

Mr. Case presented the following statement of the Federal Reserve banks in United States and possessions, to April 4, 1923, 1924, and \$593,410,000 on May 31, 1924. The statement on April 4th had been reduced had increased to \$593,410,000. The current liabilities therefor have been reduced to less than \$350,000,000.

When you consider that of the \$339,140,000 held on April 4th last \$10,471,000 were held in the open market there remain only \$328,670,000 of investment securities in the Federal Reserve System, and of these \$39,023,000 are Government bonds, nearly all of them bought before the war in conformity with Section 14 of the Federal Reserve Act. Some of them are bonds still bearing the circulation privilege and others are conversions of such bonds into 3 per cents. When these are subtracted it will be found that there remain in the Federal Reserve System only \$189,647,000 of bonds and notes and certificates of which \$34,011,000 are December 1923 maturities, \$3,023,500 March 15, 1924 maturities and the balance \$152,612,500 are Treasury notes.