COPY

File

333.

THE SECRETARY OF THE TREASURY

WASHINGTON

May 3, 1923.

Dear Mr. Platt:

I received your letter of April 20, 1923, outlining briefly the results of the recent meeting of the new Open Market Investment Committee of the Federal reserve banks held at Philadelphia, and have been glad to note the action of the Committee in recommending that the Federal Reserve banks offer to the Treasury the $35,353,500 of Treasury certificates maturing on September 15th, which they held. As you know, the offer was accepted and the certificates redeemed on April 24th. I also note with much interest the vote of the Committee to raise the open market buying rate on acceptances 1/8 of one per cent. This, I believe, was a step in the right direction, for a number of dealers, I understand, had already marked up the rate on acceptances 1/4 of a point, and a continuance of the lower Federal Reserve buying rate would only have attracted increasing quantities of acceptances into the portfolios of the Federal Reserve banks. The banks have at times carried to extremes the policy of nursing acceptances and providing a market for them at favorable rates, and I hope that the time has now come when the Board, through its supervision over this Committee on Open Market Operations, will see to it that the open market operations of the Federal Reserve banks are kept in line with the general credit policy of the system.

I agree that it is unfortunate for the Federal Reserve banks to be selling their holdings of bonds bearing the circulation privilege, for it results in increasing the circulation of national bank notes at the very time when the circulation ought to remain stable and when consideration should, in fact, be given to measures for reducing this class of circulation. I hope the Federal Reserve banks can be induced to hold the remainder of the bonds bearing the circulation privilege which they now have, and encouraged to buy more, and believe it would be a good thing if the banks would buy each year the full amount of such bonds permitted by the Federal Reserve Act. Such purchases would not have the same effect upon the money market as other open market operations because of the consequent reduction in national bank circulation, but would incidentally give the Federal Reserve banks a source of income.

I do not follow your argument, however, in suggesting that the capital and surplus of the Federal Reserve banks should be continuously invested in Government securities regardless of the demand for discounts, "not only as one of the chief means of supporting the Federal Reserve banks but as investments which cannot possibly affect the money market in the sense of adding new funds to the market." This view, it seems to me, is inconsistent with the whole theory of open market operations. Dealings in Government securities are of major importance in the open market operations of the Federal Reserve banks. The policy with respect to purchases of acceptances has avowedly been determined largely with a view to fostering and encouraging the development of the acceptance market, while operations in Government securities are perhaps even more closely related to general credit conditions and the general credit policy of the system. To control these operations by arbitrarily fixing maximum and minimum amounts to be purchased regardless of credit conditions would destroy in large measure the power and usefulness of the open market operations and tend to defeat the purpose for which the power was included in the Federal Reserve Act. Great latitude of action was permitted in open market operations in order that the Federal Reserve banks might exert a stabilizing influence on credit conditions and money rates, and effectively serve the banking and business interests of the country. So far as I am aware there was never any intent or thought of associating open market operations with the amount of capital and surplus of the Federal Reserve banks or of fixing maximum and minimum limits for such operations, and I cannot see the logic of doing it at this time. Credit extended by the Federal Reserve banks has the same effect upon the market regardless of whether it is through purchases of acceptances, purchases of Government securities, or discounting bills, and I doubt if there is any more reason for fixing arbitrary limits for one type of operation than forthe others. The primary regard, of course, should be for the credit situation.

In this connection I have noted the following statement appearing in the first edition of the Federal Reserve Bulletin for May:

> "The Federal Reserve Board's position in the matter is indicated by the adoption of the following principle with respect to the open-market investment operations of the Federal Reserve banks: 'That the time, manner, character, and volume of open-market investments purchased by Federal Reserve banks is governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation.'
>
> "By providing that open-market investment operations are to be governed 'with primary regard to the accommodation of commerce and business', the principle rests upon the same general conditions as those provided in the Federal Reserve Act for the determination of discount rates. Since in open-market operations the initiative can be taken by the reserve banks rather than the member banks, these operations may be

used as a gauge of the degree of adjustment between the requirements for reserve-bank credit and the volume of it in actual use. In a given market the sale of an investment by a reserve bank is a means of testing the demand for credit and placing the initiative for and the cost of such credit directly upon borrowing member banks."

I heartily agree with this view of open market operations, but find it hard to reconcile with the views stated in your letter.

Your statement that the capital and surplus of the Federal Reserve banks has been taken out of the working funds of the country and locked up unless reinvested should be considered in connection with the total effect of the establishment of the system. It is generally agreed, and I suppose the fact is beyond question, that instead of withdrawing funds from the market the establishment of the system released a large amount of funds as a result of the lower reserve requirements. Computations show, I believe, that the total reserves of country banks at present, plus cash carried in their vaults, are about 8-1/2 per cent of their deposits, or about one-half as large as the reserves maintained before the establishment of the system. Doubtless about the same proportion would hold for reserve city and central reserve city banks. Moreover, every dollar of actual reserves deposited with the Federal Reserve banks has a greatly increased efficiency as a basis of credit expansion. On page 11 of the first annual report of the Federal Reserve Board the statement was made that while the amount of reserves which had been released as a result of the establishment of the Federal Reserve System and the change in reserve requirements had not been accurately estimated, it was "an undoubted fact that the release of actual cash was very large and that the increase of lending power on the part of member banks was correspondingly larger." You are probably familiar with the statement of Governor Strong on the "Elements in Expansion" on pages 521 to 524 of the Hearing before the Joint Commission of Agricultural Inquiry of the 67th Congress, part 13. In this statement it is estimated that the change in reserve requirements when the system was first established released $450,000,000 of funds formerly held as reserves. This amount was greatly increased, of course, by the change in reserve requirements in June, 1917. When a state bank becomes a member of the system the reduction in reserve requirements, as a rule, releases a much larger amount of funds than it invests in the capital of the Federal Reserve bank. In comparison with the release of funds as a result of lower reserve requirements and the increased potential credit expansion on each dollar of reserve, the amount of funds tied up in the capital and surplus of the reserve banks is small, and I do not agree with your statement that investments by the Federal Reserve banks in Government securities (other than bonds bearing the circulation privilege) to the extent of their capital and surplus do not add new funds to the market. It should be noted in this connection that a part of the capital and surplus of the Federal Reserve banks represents investment in banking premises and to this extent the funds were returned to the market.

The heavy imports of gold during the past few years have made it possible for the member banks to maintain a large volume of credit and at the same time liquidate largely their borrowings from the Federal Reserve banks. This has greatly lessened the effectiveness of the discount rate and the power of credit control by the Federal Reserve banks. Continued gold imports will lead to a further increase in the available funds on the market and for the Federal Reserve banks to continue to maintain a large additional volume of credit through open market purchases at rates below the discount rate would only aggravate the situation and practically tend to destroy any attempted exercise of credit control. In view of these conditions a more effective supervision of Federal Reserve Bank open market purchases is, in my opinion, highly desirable.

Very truly yours,

A. W. MELLON.

Secretary of the Treasury.

Honorable Edmund Platt,
Vice-Governor, Federal Reserve Board,
Washington, D. C.