

Office Correspondence

FEDERAL RESERVE
BOARDDate April 12, 1935To Governor EcclesSubject: The Federal Advisory Council'sFrom Mr. Edmiston *JEH*recommendation on F. R. note collateral.

16-852

Supporting bill

The proposal of the Federal Advisory Council with regard to collateral requirements for Federal Reserve notes indicates a complete lack of understanding of this provision of the pending banking bill. To take the position that the present method of issuing Federal Reserve notes provides an elastic currency that is responsive to the needs of commerce, industry, and agriculture is ludicrous. The United States is primarily a deposit using country and the volume of currency in circulation at any given time is not related to the volume of commercial loans made by commercial banks. Large fluctuations in the volume of notes outstanding have been due to the disposition of the public to hoard or dishoard currency. The Federal Reserve System should be given maximum freedom to aid the banks of the country to meet such emergency situations and thereby prevent the disastrous effects that such movements may have upon the whole banking structure of the country.

I doubt seriously that the Council would argue their position on the basis of experience with movements of note circulation. A more likely explanation of their proposal is that the Council hopes by this indirect method to limit the ability of the Federal Reserve System to purchase government securities by decreasing the volume of excess reserves of the Federal Reserve banks. There is no doubt that this decrease of excess reserves of the Federal Reserve banks would restrict severely the system's potential open-market operations. The exact extent to which it would do so, however, depends upon many factors that cannot be forecast in advance. At the present time if all notes in circulation were legally required to be backed 100% by gold because of the lack of commercial paper, the excess reserves of the Federal Reserve banks would be cut to about \$700 millions. On the assumption that no new gold certificate reserves are received, no gold exports made, and no increase of currency in circulation, the Reserve banks would then be able to purchase government securities and increase member bank deposits only in the amount of about \$2,000 millions before the legal reserve limits would be reached. By paying a 3% tax and putting up a \$1,000 million of government securities behind notes in circulation the potential power to buy governments would be increased to ~~over~~ over \$5,000 millions. Because of the unlikelihood of a large increase of currency in circulation or of large gold exports in the near future the Council's suggestion would not be immediately effective as a brake on government security purchases.

As a long run proposition, however, it would be a highly undesirable provision because it would tend to prove restrictive to the System at the very times when curtailment is undesirable. If member banks were losing reserves by gold exports or currency hoarding the reserves of the Federal Reserve banks would be depleted and the System would, therefore, be unable to engage in open-market operations designed to stem the course

of the deflation that would ensue. Undoubtedly under such circumstances the law would be amended just as it was in 1932 by the Glass-Steagall Act. But the damage would probably already be done before legislative action were taken.

In view of the probable need of conserving our gold stocks in the future in order not to have a continually falling price level it would certainly be unfortunate to have incorporated in the law a provision of this type which wastefully ties up gold to back currency circulation.

The general memorandum on the Council's suggestions contains additional points of opposition to the proposals with regard to note collateral requirements.