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# Office Correspondence

FEDERAL RESERVE BOARD

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To Governor Eccles

From Mr. Goldenweiser

Subject: Collateral requirements as a limit on Reserve bank purchases of Government obligations

GPO 16—852

The Federal Reserve Act requires that when a Reserve bank obtains currency from the Federal Reserve agent it shall pledge with him an equal amount of collateral consisting of gold or eligible paper, and, under the Glass-Steagall Act of 1932, Government securities are also eligible and will continue to be, under the President's Proclamation, until March 4, 1937. To extend the operation of the Glass-Steagall Act beyond that date, legislation will be required.

In practice the way the issue function operates is that when a member bank's customers apply to it for Federal Reserve notes, either because of seasonal requirements or because of an increase in the volume of trade, or because of a lack of confidence in the banks, the member bank first pays out cash from its vault, but since it never has more cash than it requires from day to day, it soon finds it necessary to obtain additional cash from the Reserve bank. In order to obtain it, the member bank usually has to borrow from the Federal Reserve bank, unless it has excess reserves, which is not the case under ordinary conditions. Ordinarily the Federal Reserve bank can pass the paper received from the member bank to the Reserve agent and obtain the required notes in exchange. In a period of expansion, therefore, collateral requirements do not constitute a restricting influence, because at such a time the banks are likely to be heavily in debt and the evidences of that indebtedness are eligible as collateral for notes.

It should be mentioned that eligible paper includes the member banks' collateral notes secured by Government obligations, so that it is not in any way directly related to trade; it is merely a matter of indebtedness of member banks. The times when collateral requirements become undesirable are when there is a depression and the Federal Reserve System wishes to meet currency demands without necessitating borrowing from the Reserve banks, since heavy indebtedness of banks exerts a deflationary influence. When banks are in debt they become reluctant to make new loans to their customers and, in fact, are inclined to contract credit by calling loans and selling investments.

This is what happened in 1932. There was a heavy demand for currency for hoarding and a heavy drain of gold from abroad. There were still large foreign balances in the United States that were subject to withdrawal in gold on demand. It was a period of terrible deflation and the Reserve banks had purchased up to $800,000,000 of Government securities in an effort to ease conditions. As a consequence, member bank indebtedness was small in relation to the volume of Federal Reserve notes outstanding and the amount of eligible paper available as collateral for notes was limited. The Reserve banks during that period had $1,400,000,000 of reserves in excess of legal requirements. Eligible paper available for collateral, however, was smaller by about $1,000,000,000 than the amount necessary to cover the Federal Reserve notes outstanding. As a consequence, the Federal Reserve banks had to pledge with the Federal Reserve agent $1,000,000,000 of gold, over and above the 40 per cent required as reserves against the notes, and they had only $400,000,000 of so-called "free" gold.

The situation was, therefore, that the Federal Reserve banks had plenty of excess reserves but owing to shortage of collateral could nevertheless not pursue a policy of easing themarket and thus arresting deflation. If the banks had bought more Government securities, this would have resulted in an equivalent decrease of member bank indebtedness, in a further reduction of eligible paper, and, therefore, in the necessity of pledging more gold against Federal Reserve notes. The $400,000,000 of free gold afforded only a very narrow margin and would have been used up in a short time. The Reserve banks were, therefore, in a position that made it necessary to meet any further outflow of gold or of currency by increasing member bank indebtedness and thus aggravating the deflationary process. It is from this condition that the Reserve banks and the country were saved through the passage of the Glass-Steagall Act, which permitted temporarily the use of United States Government obligations as collateral for Federal Reserve notes.

This is what is meant by the statement that collateral requirements limit the amount of Government securities that a Reserve bank may buy. ~~It limits~~ It limits them, furthermore, at the very time when the Reserve banks should pursue a policy of liberal purchases in the open market because of the existence of a deflationary situation. Collateral requirements, therefore, which add nothing to the safety of Federal Reserve notes, as has been explained in other connections, have a perverse influence on Federal Reserve policy. They do not in any way restrain credit expansion at a time when restraint might be desirable, but they do prevent an easing policy at a time when such a policy is necessary in the public interest.

At the present time the Federal Reserve banks have total reserves of $5,900,000,000 and excess reserves, allowing 40 percent against Federal Reserve notes and 35 percent against deposits, of $2,900,000,000. In these circumstances they have enough gold to meet collateral requirements by the use of gold certificates even though there is practically no eligible paper. They can at present cover their entire note issue by gold certificates, and have enough reserves left for the 35 percent required against deposits, and over and above that have $700,000,000 of "free" gold available for the purchase of Government securities or as a basis for expansion. On the basis of this $700,000,000 the Reserve banks could buy about $2,000,000,000 of Government securities so long as the deposits created by the purchases remained as balances with the Reserve banks. This is for the reason that only a 35 percent reserve is required against deposits. Consequently, at the present time, if the Reserve banks were not permitted to use United States Government obligations as collateral against Federal Reserve notes, they could purchase about $2,000,000,000 of additional United States Government obligations and meet the additional reserves necessitated by the creation of additional deposits by using the $700,000,000 of "free" gold.

If, however, a demand for currency should develop and the Reserve banks were not permitted to use United States Government obligations as collateral, they would have to use the $700,000,000 of "free" gold, dollar for dollar, to cover the Federal Reserve notes.

The situation at the present time, therefore, is that the Reserve banks, if they did not have authority to count Government securities as collateral, could buy $2,000,000,000 of additional Government securities, if there were no demand for additional currency, and could buy $700,000,000 of additional Government securities, if there were a demand for additional currency.

The Federal Advisory Council has recommended that under special conditions the Board could authorize the use of a billion dollars of Government securities as collateral on the payment of a 3 percent tax. This would add an additional billion dollars that the Reserve banks could buy in case there was a currency demand, but only upon payment of a penalty tax at the rate of $30,000,000 a year, a larger amount that the System's entire expenditure in a year.

One of the illogical features of the proposal is that it would limit purchases of Government securities much more radically when there is a demand for currency than at a time when the demand is for deposits. This is entirely contrary to what should be, because, when inflation develops, it develops through the creation of deposits, while a currency demand comes much later. When the stage of currency demand has been reached, it is too late to exert a restraining influence, because at that time the Reserve banks must be in a condition to meet the member banks' demand for currency; otherwise the Reserve banks would be declared insolvent. A situation might also arise, as it did in 1932, when the Reserve banks would be confronted with the necessity of selling Government securities in order to put the banks into debt for the purpose of having that debt available as collateral, at a time when indebtedness of member banks might be highly undesirable.

This is a technical matter and fairly complicated in its actual operation. The significance of it, however, may be summarized very simply. Collateral requirements against Federal Reserve notes, which add nothing to the safety of the notes, have a practical significance only to the extent that they limit the volume of United States Government securities that the Reserve banks may buy. The limitation arising from the collateral requirements, furthermore, is very much more drastic when there is a demand for currency than when there is a demand for deposits. Therefore, the limitation comes too late to restrain an inflation, and at a time when the choice is between deflation or modification of the law. It is safe to assume that in these circumstances the law will always be modified, but probabilities are that the modification will be delayed enough to prevent a timely policy of ease by the Reserve banks.

If it were decided to limit the participation of the Federal Reserve banks in Government financing, this should be accomplished by a direct limit of the amountof Government securities that the Reserve banks may own, possibly in some ratio to the Government's revenue, as is done in certain central banks. A round-about limitation through collateral requirements, which operates only at the wrong time and is at all times an expensive and complicated piece of machinery, is not the proper way to limit Government security holdings by the Reserve banks even though such a limitation be considered desirable.