

July 20, 1935

Mr. Hamlin
Mr. Wyatt
Mr. Thurston
Mr. Clayton ✓
Miss Burr

The attached comments were written as a mental exercise and are offered to you as light reading over the week-end.

E. A. Goldenweiser

July 20, 1935

NINETEEN--THIRTEEN IDEAS OF THE FEDERAL RESERVE IN
THE LIGHT OF EXPERIENCE

Senator Glass and his school have failed to learn three fundamental facts about the Federal Reserve System which were not clear at the time the act was passed and which make their approach to Federal Reserve problems unrealistic. The first is that a dollar borrowed from a Federal Reserve bank may become the basis of bank credit of several times that amount. The second is the idea that the purposes for which a piece of rediscounted paper has been drawn have no relationship to the uses to which the proceeds of the rediscount are put. The third is that the elasticity of currency does not depend on the nature of the paper back of Federal Reserve notes.

The difference between a Federal Reserve bank dollar and a member bank dollar arises from the fact that this country's business is done largely by check rather than through the payment of cash and from the fact that member banks are required to keep as reserves a specified fraction of their deposits. If all payments were made in cash there would be no difference between the two kinds of dollars. If the public needed more means of payment, it would borrow from the banks and the banks would have to give it Federal Reserve notes. In order to obtain the Federal Reserve notes they would ordinarily have to borrow from the member banks, possibly using the original borrowers' paper as a basis of borrowing. When the original borrower paid back his loan, the member bank would be in funds to pay back the Federal Reserve bank, and that much currency might conceivably be retired unless someone else borrowed an equivalent amount. That is the way Senator Glass thinks the Federal Reserve System works. But that is not the way it works in reality. What happens is

that if a bank is loaned up, which means in effect that it has no more reserves with the Federal Reserve bank than the law requires, and if it creates an additional deposit, the bank, or more accurately the entire banking system, borrows from the Reserve bank, not the full amount of the new deposit, but only enough to furnish the additional reserve required to support the additional deposit. In other words, the banking system must borrow from the Federal Reserve banks on the average only about one-fifteenth of what it creates in new deposits.

This upsets the entire Glass conception of the nature of Federal Reserve bank credit. Contrary to Mr. Glass, if a small merchant borrows a thousand dollars from a member bank and the member bank rediscounts the merchant's note with the Federal Reserve bank, the reserve money that is made available to the member banks by this operation, amounting to a thousand dollars, in ordinary times places into use not a thousand dollars of additional means of payment, but about fifteen times that amount, because the additional reserve created with the Federal Reserve bank after passing from hand to hand in the end will support deposits of \$15,000. There is, therefore, a real distinction between a Reserve bank dollar and a member bank dollar: the Reserve bank dollar is fifteen times as powerful as the member bank dollar. This distinction must be kept in mind whenever the question of open market policy or of rediscounting is under consideration.

The second misconception is closely related to the first. It is clear that our merchant's note for a thousand dollars when rediscounted with the Federal Reserve bank becomes the basis of \$15,000 of deposits, that the note itself is responsible for only the first thousand of deposits, and that the other \$14,000 could be created through any other kind of loan or investment.

But even if the multiple expansion did not prevail, the Glass conception would still be untenable. There is no reason why a bank which wants to have a thousand dollars to lend on the stock market would need to borrow the money by rediscounting a broker's loan, which it could not do. There is no reason why it could not borrow the money either on a collateral note secured by any available eligible asset or by rediscounting commercial, agricultural, or industrial paper in its portfolio and then use the thousand dollars it obtains for any purpose it wishes, including lending on the stock exchange. It would be very difficult for the Federal Reserve bank to trace the transaction, unless the bank in question were expanding its security loans at an unusual rate. So that even without the multiple expansion there would be no direct relation between the character of the paper that reaches the Reserve bank and the use to which the borrowed funds are put. This is infinitely more true for the reason that reserves created support a credit structure that is fifteen times as large as the original borrowing.

In other words, the Senator Glass conception of the function of the Federal Reserve banks in accommodating commerce and business whereby the Reserve banks step in and supply the needed amount of additional emergency money, provided the money is wanted by industry, does not work as a matter of practical operation. The funds obtained not only go wherever directed by the member bank regardless of the paper on which they have been obtained, but they also create a basis for a fifteen-fold expansion of credit. The idea of automatic expansion and contraction under the Federal Reserve of loans on self-liquidating paper in which Senator Glass believes does not correspond to the facts in actual banking operations.

The third misconception that prevails among the original proponents of the Federal Reserve System is that there is a close relationship between the collateral back of Federal Reserve notes and the elasticity of the currency. They believe that this elasticity rests on the fact that demand for currency arises when commercial borrowing increases and diminishes when borrowing decreases. The fact is that except for a long-time downward trend for currency, which has recently been reversed, and unusual circumstances when currency is being hoarded because of lack of confidence in the banks, fluctuations in currency demand are seasonal in character. There is little increase or decrease in currency in circulation from year to year and the seasonal changes in the volume of currency merely represent changes in the volume of retail trade and of payrolls.

Elasticity of our currency depends on an entirely different set of circumstances than the collateral back of the notes. It is rooted in the fundamental fact which the old-fashioned theorists always forget—that the great bulk of our payments is made by check and that currency is merely the small change of business, ~~which has few, if any, cyclical fluctuations.~~

It also rests on the fact that the public does not care to carry in its pockets any more cash than it needs for the day-to-day transactions that it is accustomed to pay for in cash, mostly retail trade, car fares, gas for cars, and, among employers, payrolls. Cash in excess of these needs is deposited at the banks, except when there is a lack of confidence in the banks. Since cash in the banks' vaults does not count as reserves and is completely idle, as well as expensive to keep, it is deposited at the Reserve bank to the credit of the member bank, where it counts as reserves of the bank and constitutes the basis of a multiple expansion.

The elasticity of our currency, therefore, depends on the fact that currency is a minor item in our medium of exchange; that ordinarily there is no advantage in keeping out more than is needed, and that there is ample facility for issuing all that is needed. In the final analysis the elasticity of our currency rests on the one side on the fact that redundant currency automatically returns to the Reserve banks, and, on the other side, on the fact that the Federal Reserve banks are always in a position to issue additional currency when the need arises. Throughout our period of serious banking and financial difficulties our system of issue and retirement of currency worked satisfactorily, although the clumsy and obsolete technical collateral requirements interfered with the System's open-market policy in 1931 and early 1932 and had to be corrected by the emergency Glass-Steagall Act. The currency system was subjected to a terrific strain, particularly in 1933 when \$2,000,000,000 of cash, much of it in gold, was withdrawn within a very short time. The banks, however, were able to meet this demand and the currency returned very rapidly when the banks were reopened after the holiday.

In the matter of currency the Federal Reserve banks are in fact about in the position that Senator Glass visualizes as their ideal position for all their operations. They do accommodate commerce, industry, and agriculture with as much cash as is required and they do reabsorb all excess cash.

In this field the Reserve banks are passive, as Senator Glass would have them be in all respects.

The main gap in his understanding of the system is his lack of realization that this is only an incidental and minor function of the Federal Reserve banks, despite the fact that currency difficulties were conspicuous

among the defects in our financial organization that led to the establishment of the Federal Reserve System. These difficulties have been overcome, and new problems of greater complexity and import have arisen. It is the function of the Federal Reserve System to grapple with these problems, and in doing so it must rely principally, not on its note issuing and currency-supplying function, but on its power, through its influence on member bank reserves, to influence the total volume of bank deposits that is available for the use of the people.