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HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING AND CURRENCY

WASHINGTON

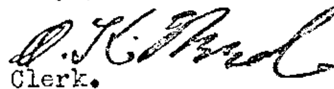
February 25, 1937.

Hon. Marriner S. Eccles,
Chairman, Board of Governors,
Federal Reserve System,
Washington, D. C.

Dear Sir:

I am enclosing copy of letter addressed to Chairman Steagall relative to S. 417, recently reported out of Committee, and other data which you left with the committee stenographer.

Sincerely yours,



Clerk.

Enclosures.

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Clerk - Banking & Currency Committee.

The attached documents are to be returned personally to Mr. Eccles per his request.

Committee Stenographers.

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Honorable Henry B. Steagall, Chairman,
Banking and Currency Committee,
House of Representatives,
Washington, D. C.

My dear Mr. Chairman:

In accordance with the discussion held this morning, I inclose herewith a proposed bill to extend until June 30, 1939 the authority to use direct obligations of the United States as collateral security for Federal Reserve notes. I also inclose a statement explaining the necessity for this amendment to the law and this statement is in such form that it may be utilized as a basis for the preparation of a Committee report on the bill if it is so desired.

Sincerely yours,

M. S. Eccles,
Chairman.

Inclosures

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A BILL

To extend the period during which direct obligations of the United States may be used as collateral security for Federal Reserve notes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the second paragraph of section 16 of the Federal Reserve Act, as amended, is amended to read as follows:

> Any Federal Reserve bank may make application to the local Federal Reserve agent for such amount of the Federal Reserve notes hereinbefore provided for as it may require. Such application shall be accompanied with a tender to the local Federal Reserve agent of collateral in amount equal to the sum of the Federal Reserve notes thus applied for and issued pursuant to such application. The collateral security thus offered shall be notes, drafts, bills of exchange, or acceptances acquired under the provisions of section 13 of this Act, or bills of exchange indorsed by a member bank of any Federal Reserve district and purchased under the provisions of section 14 of this Act, or bankers' acceptances purchased under the provisions of said section 14, or gold certificates: Provided, however, That until June 30, 1939, the Board of Governors of the Federal Reserve System may, should it deem it in the public interest, upon the affirmative vote of not less than a majority of its members, authorize the Federal Reserve banks to offer, and the Federal Reserve agents to accept, as such collateral security, direct obligations of the United States. At the close of business on such date, or sooner should the Board of Governors of the Federal Reserve System so decide, such authorization shall terminate and such obligations of the United States be retired as security for Federal Reserve notes. In no event shall such collateral security be less than the amount of Federal Reserve notes applied for. The Federal Reserve agent shall each day notify the Board of Governors of the Federal Reserve System of all issues and withdrawals of Federal Reserve notes to and by the Federal Reserve bank to which he is accredited. The said Board of Governors of the Federal Reserve System may at any time call upon a Federal Reserve bank for additional security to protect the Federal Reserve notes issued to it.

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Extension of Authority for the Use of Direct Obligations of the United States as Collateral Security for Federal Reserve Notes

Section 16 of the Federal Reserve Act was amended by the Act of February 27, 1932, so as to provide that until March 3, 1933, the Federal Reserve Board (now the Board of Governors of the Federal Reserve System), if it deems it in the public interest, shall have authority, by an affirmative vote of not less than a majority of its members, to authorize the Federal Reserve banks to offer, and the Federal Reserve agents to accept, direct obligations of the United States as collateral security for Federal Reserve notes. The Act was again amended by the Act of February 3, 1933, so as to extend the period of this authority until March 3, 1934, and was further amended by the Act of March 6, 1934, so as to extend the authorization to March 3, 1935, or until the expiration of such additional period not exceeding two years as the President may prescribe. The President has extended the authority until March 3, 1937, when it will expire unless it is renewed by the Congress.

At the time the Act was first amended in this respect, February 27, 1932, it was deemed necessary in the public interest

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for the Federal Reserve System to maintain an easy money policy and thus to encourage the extension of credit by member banks for all legitimate commercial, industrial, and agricultural purposes. The maintenance of an easy money policy required the purchase by the Federal Reserve banks of large amounts of United States Government securities in order to put member banks of the Federal Reserve System in funds with which to pay off existing indebtedness to the Federal Reserve banks and to build up excess reserves. It was the expectation that member banks in possession of excess reserves (idle funds) would become more active in seeking out opportunities for employing these funds in order to increase their earnings, and that these endeavors of the banks would tend to stimulate business and to reduce unemployment. Another result would be the lowering of money rates, both in the open market and on loans to customers, which would encourage enterprise and reduce the burden of debt service. The Board has continued to maintain an easy money policy since that time, and it is believed that this policy has been an important factor in bringing about the broad recovery in business which is now under way.

In order to enable the Federal Reserve banks to purchase United States Government obligations, in accordance with the System's easy money policy, the Board, on May 5, 1932, authorized

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the Federal Reserve banks to pledge direct obligations of the United States as collateral for Federal Reserve notes within certain limitations. Since that date such obligations have been pledged continuously as collateral for Federal Reserve notes, the maximum amount pledged at any one time being $1,098,000,000 on March 20, 1933. On December 2, 1936, Federal Reserve notes were outstanding in the amount of $4,497,999,000, and there was pledged as collateral against them $4,695,000 of eligible paper, $88,000,000 of United States Government securities, and $4,464,838,000 of gold certificates.

As a consequence of large gold imports in recent years there are now enough gold certificates held by the twelve Federal Reserve banks combined to enable them to provide a 100 per cent cover for all outstanding Federal Reserve notes. While this is true in the aggregate for the twelve banks, however, it is not true in the case of some of the individual Reserve banks. More important is the fact that in case gold should leave the country in large amounts, as it has on previous occasions, notably in 1931 and 1932, the Federal Reserve System, in the absence of authority to pledge United States Government obligations for Federal Reserve notes, might find itself compelled to adopt a restrictive credit policy at a time when such a policy might start a disastrous deflationary

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development, or aggravate one that was under way. In 1931 the System had the experience of being unable, owing to lack of authority to pledge Government obligations against Federal Reserve notes, to adopt an active policy of combatting a deflation. A large outward movement of gold might reduce the gold certificate holdings of the Federal Reserve banks below the amount necessary to provide cover for outstanding Federal Reserve notes and, without authority to pledge Government securities for this purpose, the Federal Reserve banks, in order to get the necessary collateral to take the place of gold certificates held against outstanding Federal Reserve notes, would have to sell Government obligations to the point where member banks would be forced to borrow from the Federal Reserve banks. Such borrowings, in turn, might cause member banks to tighten their lending policies and to contract credit, with a consequent rise in money rates and serious restraint on business activity. It is clearly not in the public interest to run the risk of such a development by permitting the authority to pledge Government securities against Federal Reserve notes to lapse.

For these reasons it is proposed in the bill under consideration that the authority to issue Federal Reserve notes against United States Government obligations be extended until June 30, 1939, with the same safeguards against undue use of the authority as were incorporated in the original legislation.

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There is set forth below the second paragraph of section 16 of the Federal Reserve Act, as amended, with the part thereof to be stricken out in brackets and the proposed new matter underscored, as follows:

> Any Federal Reserve bank may make application to the local Federal Reserve agent for such amount of the Federal Reserve notes hereinbefore provided for as it may require. Such application shall be accompanied with a tender to the local Federal Reserve agent of collateral in amount equal to the sum of the Federal Reserve notes thus applied for and issued pursuant to such application. The collateral security thus offered shall be notes, drafts, bills of exchange, or acceptances acquired under the provisions of section 13 of this Act, or bills of exchange indorsed by a member bank of any Federal Reserve district and purchased under the provisions of section 14 of this Act, or bankers' acceptances purchased under the provisions of said section 14, or gold certificates: Provided, however, That until [March 3, 1935, or until the expiration of such additional period not exceeding two years as the President may prescribe,] June 30, 1939, the Board of Governors of the Federal Reserve System may, should it deem it in the public interest, upon the affirmative vote of not less than a majority of its members, authorize the Federal Reserve banks to offer, and the Federal Reserve agents to accept, as such collateral security, direct obligations of the United States. [On such date or upon the expiration of such period so prescribed by the President,] At the close of business on such date, or sooner should the Board of Governors of the Federal Reserve System so decide, such authorization shall terminate and such obligations of the United States be retired as security for Federal Reserve notes. In no event shall such collateral security be less than the amount of Federal Reserve notes applied for. The Federal Reserve agent shall each day notify the Board of Governors of the Federal Reserve System of all issues and withdrawals of Federal Reserve notes to and by the Federal Reserve bank to which he is accredited. The said Board of Governors of the Federal Reserve System may at any time call upon a Federal Reserve bank for additional security to protect the Federal Reserve notes issued to it.

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Mr. [illegible]
[illegible]

75TH CONGRESS
1ST SESSION

H. R. 2302

IN THE HOUSE OF REPRESENTATIVES

JANUARY 8, 1937

Mr. STEAGALL introduced the following bill; which was referred to the Committee on Banking and Currency and ordered to be printed

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A BILL

To extend the period during which direct obligations of the United States may be used as collateral security for Federal Reserve notes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That the second paragraph of section 16 of the Federal
4 Reserve Act, as amended, is amended to read as follows:
5 "Any Federal Reserve bank may make application to
6 the local Federal Reserve agent for such amount of the
7 Federal Reserve notes hereinbefore provided for as it may
8 require. Such application shall be accompanied with a ten-
9 der to the local Federal Reserve agent of collateral in amount

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1 equal to the sum of the Federal Reserve notes thus applied
2 for and issued pursuant to such application. The collateral
3 security thus offered shall be notes, drafts, bills of exchange,
4 or acceptances acquired under the provisions of section 13
5 of this Act, or bills of exchange endorsed by a member bank
6 of any Federal Reserve district and purchased under the
7 provisions of section 14 of this Act, or bankers' acceptances
8 purchased under the provisions of said section 14, or gold
9 certificates: *Provided, however*, That until June 30, 1939,
10 the Board of Governors of the Federal Reserve System may,
11 should it deem it in the public interest, upon the affirmative
12 vote of not less than a majority of its members, authorize the
13 Federal Reserve banks to offer, and the Federal Reserve
14 agents to accept, as such collateral security, direct obligations of
15 the United States. At the close of business on such date,
16 or sooner should the Board of Governors of the Federal
17 Reserve System so decide, such authorization shall terminate
18 and such obligations of the United States be retired as secur-
19 ity for Federal Reserve notes. In no event shall such col-
20 lateral security be less than the amount of Federal Reserve
21 notes applied for. The Federal Reserve agent shall each
22 day notify the Board of Governors of the Federal Reserve
23 System of all issues and withdrawals of Federal Reserve notes
24 to and by the Federal Reserve bank to which he is accred-

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1 ited. The said Board of Governors of the Federal Reserve
2 System may at any time call upon a Federal Reserve bank
3 for additional security to protect the Federal Reserve notes
4 issued to it."

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75TH CONGRESS
1ST SESSION

H. R. 2302

A BILL

To extend the period during which direct obligations of the United States may be used as collateral security for Federal Reserve notes.

By Mr. STEAGALL

JANUARY 8, 1937
Referred to the Committee on Banking and Currency and ordered to be printed

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February 10, 1937

EXTENSION OF AUTHORITY FOR USE OF GOVERNMENT SECURITIES AS COLLATERAL FOR FEDERAL RESERVE NOTES

Reasons why the authority given to the Federal Reserve banks by the Glass-Steagall Act of 1932 to use United States Government obligations as collateral for Federal Reserve notes should be extended were presented in a statement sent by the Board to the Chairman of the Senate and House Banking and Currency Committees. Some further considerations in this matter are discussed in this memorandum.

Under the Federal Reserve Act Federal Reserve notes theoretically are issued not by the Federal Reserve banks, but by the Board of Governors through the Federal Reserve Agents. These agents must obtain from the Federal Reserve banks collateral consisting of eligible paper or gold certificates to cover the entire issue of Federal Reserve notes, 100 percent. Under the authority of the Glass-Steagall Act, as extended from time to time, United States Government obligations can also be used as collateral. These collateral requirements are entirely independent of the 40 percent gold certificate reserve requirements for Federal Reserve notes, which have always remained in effect.

In practical operation Federal Reserve notes are paid out by the Federal Reserve banks in response to the public demand for currency. They are not and cannot be forced out or kept out by the Reserve banks, since the public will not keep more currency than it requires for its needs, and all redundant currency comes back to the Reserve banks.

The requirement that collateral for Federal Reserve notes should consist only of eligible paper or gold certificates is based on a mis-

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conception of the way the Federal Reserve banks function. It is based on the idea that there is something inherently sound and safe in a currency that is covered by commercial paper and gold certificates, and that currency covered by Government obligations is somehow inherently inflationary. As a matter of fact, the Federal Reserve banks have two important liabilities to the public, Federal Reserve notes and deposits. All the assets of the Federal Reserve banks, including gold certificates, eligible paper, and United States Government obligations, are in effect security for both types of liability. There is no advantage in segregating one type of asset against one type of liability, and the other assets against the other type of liability. The soundness of each is equally important to the public. copy to end)

Since it was deemed necessary for the Federal Reserve banks to acquire a large portfolio of United States Government obligations for the purpose of carrying out a policy of monetary ease in the interests of economic recovery, it would not be good policy now to decree that the Reserve banks may no longer use these United States obligations as collateral for their notes.

To be sure, it happens that at the present time the twelve Federal Reserve banks combined hold enough gold certificates to cover their Federal Reserve notes, but this situation may not continue. If large exports of gold should occur and the Federal Reserve banks should lose a considerable part of their gold certificates, they might find themselves confronted with the same situation that existed in the autumn of 1931 and in the winter of 1932. At that time a terrible deflation was sweeping the country with devastating effects on our economic life. Banks were heavily in debt to the

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Reserve banks and were losing gold to foreign countries and currency to the American public which was withdrawing its deposits from the banks for safe keeping. In these circumstances the Federal Reserve banks were helpless to come to the assistance of the member banks, even though the Reserve banks had $1,400,000,000 of gold in excess of legal reserve requirements. They were helpless because nearly all this gold had to be held as collateral for Federal Reserve notes and could not be used as a basis of open-market purchases which would have helped to stop the deflation and might have prevented the worst phases of the depression.

It was to meet that situation that Congress passed the Glass-Steagall Act on February 27, 1932. After that the Reserve banks were enabled to engage in open-market operations - which greatly, though belatedly, relieved the situation, contributed to monetary ease, and were an important factor in assisting the recovery movement. It would not be wise now to deprive the Reserve banks of the authority to pledge United States Government obligations as collateral against Federal Reserve notes and run the risk of a repetition of the situation which existed in 1932.

While this country at present has a large and growing supply of gold, foreign countries have large claims against this gold, which may at any time result in a great outflow of gold from this country. At the end of September banks and brokers in the United States held about $1,500,000,000 of short-term balances due to foreigners, and foreigners held about $6,500,000,000 of stocks and bonds of American corporations. A substantial withdrawal of these funds could rapidly change the situation and make it imperative once more

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to permit the Reserve banks to pledge United States obligations against Federal Reserve notes. In these circumstances the only wise and safe course is to continue this authority, which is used but little now, but may become important in the future.

It is at a time when gold is leaving the country, and when a liquidation is under way that collateral requirements hamstring the Reserve banks and prevent them from following the course required by the public interest. At times when credit is expanding and restraint may be necessary, collateral requirements do not exercise any restraint, because at such times the banks borrow from the Reserve banks and their borrowings produce the eligible paper required as collateral for Federal Reserve notes. Collateral requirements, therefore, are a perverse instrument of control: they restrain when expansion is urgently needed to arrest deflation and they cease to function as a restraint when a restraining influence would be in the public interest.

It should be mentioned also that, while the twelve Federal Reserve banks combined have at present enough gold certificates without pledging any United States Government obligation, the gold certificates are not evenly distributed among the Federal Reserve banks, and there are two Federal Reserve banks, those of Atlanta and Minneapolis, that would have to liquidate a part of their portfolio, if they were not permitted to use Government securities as collateral. The total amount of such securities pledged as collateral at the present time is $87,000,000, of which $60,000,000 is at these two banks.

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A table showing the amount of Federal Reserve notes outstanding in each Federal Reserve district and the collateral against those notes as of February 3, 1937 is attached. (Here insert)

Another table showing the position in regard to collateral requirements and to reserves on February 24, 1932 is also attached. (Here insert)

Certain questions are sometimes asked about this proposal. ~~(1)~~ Is it inflationary? The answer is that it enables the Federal Reserve banks to counteract a dangerous deflation by making it possible to engage in open market operations at a time when gold is leaving the country and a liquidation is in process. At other times it may increase the limits to which open market operations of the Federal Reserve banks may be carried, but since these operations must be conducted in accordance with decisions of the Open Market Committee and on principles definitely laid down by Congress, it can become inflationary only if the Board and the Open Market Committee flagrantly disregard their duties and responsibilities.

~~(2)~~ Sometimes it is asserted that this proposal reintroduces bond secured currency, which was one of the great evils prior to the establishment of the Federal Reserve System, and does away with the elastic character of our currency.

The answer to that is that the elasticity of our currency at the present time does not depend upon the nature of the collateral back of the currency, but upon the mechanism by which currency not needed for circulation purposes finds its way back to the Federal Reserve banks, and a currency demand can always be met through these banks. The situation differs from the one that prevailed prior to the Federal Reserve System in that at that time there was no effective method of absorbing redundant

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currency nor of expanding currency when a demand arose. The fact is that the establishment of the Federal Reserve System has made our entire supply of currency responsive to changes in the public's needs, and consequently elastic. There is nothing in the proposal that would in any way interfere with this elasticity.

(9) Sometimes it is asserted that this proposal is a device by which the Federal Reserve banks can finance Treasury deficits. This assertion has nothing to sustain it. The Federal Reserve banks do not issue currency except in response to a demand, and if they did the currency would not remain in circulation but would come back. The power of the Federal Reserve banks to help the Government finance deficits rests not on the collateral requirements of Federal Reserve notes, but on the authority to buy Government securities, even though these purchases must be made in the open market. The power exists but is under control of the Open Market Committee, which has clearly defined duties and responsibilities and principles to guide it in its operations.

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