Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 30, 1938

To Board of Governors

Subject:

From Ronald Ransom

I am handing you mimeographed copy of a memorandum from Mr. Dreibelbis to me, under date of March 29th, on the purposes and meaning of provisions of section 16 of the Federal Reserve Act relating to payment of interest by Federal Reserve Banks on Federal Reserve notes issued to it, together with a copy of a letter from Mr. Hamlin to Mr. Gifford, under date of May 2, 1933. It will be recalled that this was the subject matter of discussion at a recent Board meeting in connection with the Patman Bill.

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Federal Reserve Bank of St. Louis

L-556

March 29, 1938

To Governor Ransom

From Mr. Dreibelbis, Assistant General Counsel

Subject: Purposes and meaning of provisions of section 16 of Federal Reserve Act relating to payment of interest by Federal Reserve Banks on Federal Reserve notes issued to it.

CONFIDENTIAL

From time to time during the course of the present hearings upon the Patman Bill, as well as during the course of hearings on other bills (notably S. 417 to extend the period during which direct obligations of the United States might be used as collateral security for Federal Reserve notes and H. J. Res. 377 authorizing the destruction of Federal Reserve notes of the series of 1928 and their replacement at the expense of the United States), the Board's failure to fix a rate of interest to be paid by the several Federal Reserve banks upon the amount of the notes issued to them has been questioned.

Apparently considerable confusion exists in the minds of some of the members of the Committee with respect to the meaning and purpose of this particular provision and it is to be anticipated that in the event of a further appearance by any member of the Board, the examination will again be addressed in part to this subject.

The language giving rise to the question appears in a sentence in paragraph 4 of section 16 reading as follows:

> "The Board shall have the right, acting through the Federal Reserve agent, to grant in whole or in part, or to reject entirely the application of any Federal Reserve bank for Federal Reserve notes; but to the extent that such application may be granted the Board of Governors of the Federal Reserve System shall, through its local Federal Reserve agent, supply Federal Reserve notes to the banks so applying, and such banks shall be charged with the amount of the notes issued to it and shall pay such rate of interest as may be established by the Board of Governors of the Federal Reserve System on only that amount of such notes which equals the total amount of its outstanding Federal Reserve notes less the amount of gold certificates held by the Federal Reserve agent as collateral security."

For convenience, the colloquies occurring between Congressman Patman and Chairman Eccles on the occasion of the latter's appearances before the Committee on February 16th and July 14th, 1937 have been copied from the reports and are attached to this memorandum.

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CONCLUSION

It is the opinion of the writer that the provision in question was enacted as an implement of control to be used primarily in influencing the contraction of outstanding Federal Reserve notes, if conditions call for such action, and in preventing them from becoming redundant, and that, as in the case in issuing the notes to the individual banks in the first instance, the authority of the Board is discretionary and not mandatory.

DISCUSSION

The original Bill, as reported to the House by the Committee, contained substantially the same provision as now appears in the Act, except that it provided that the rate of interest to be paid by the banks should "not be less than one-half of one per centum per annum", and provided for the payment of interest upon the portion of notes covered by gold as well as the uncovered portion.

The Committee report on page 55 contained the following:

> " * * * But there remains the general question whether the public requirement of elasticity has been met and provided for. Elasticity must be considered from two standpoints - that of expansion and that of contraction. As to expansion, the regulatory mechanism is the Federal reserve board, which is given the power to veto applications for notes. The board, however, can not issue notes unless they are applied for and accompanied by a tender of proper commercial paper. This at least seems to assure that they will not be hastily or rashly overissued. The contraction feature is more difficult. In attempting to guard against the danger that the notes might remain in circulation after the need for them had passed, the bill makes the following provisions: (1) The notes can not be used in bank reserves; (2) the notes are not to be legal tender; (3) the notes can not be paid out by any Federal reserve bank (when not at first issued by it) under penalty of a tax of 10 per cent on their face value; (4) every Federal reserve bank is directed, upon receiving the note of another reserve bank, to (a) either send it direct to the bank that issued it, (b) to send it to the Treasury, charging it off against deposits, or (c) to present it to the Treasury for redemption in lawful money. On the other hand the Treasury is directed when it gets such notes in ordinary receipts to have them redeemed out of a 5 per cent fund kept with the department for that

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purpose, and then to send them home for ultimate redemption. The belief is freely expressed that these provisions will maintain the notes at par everywhere and will also prevent them from expanding or remaining out after the need for them has gone by." * * *

While the provision relating to the payment of a rate of interest to be fixed by the Board was not specifically discussed, it is to be observed that the whole of section 16 was considered in the light of its effectiveness to insure proper expansion or contraction of the circulation as the occasion might require. The particular provision was one of the means made available to influence contraction of the circulation and to prevent the notes from remaining out after the need for them had gone by.

In the House Bill authority to issue notes to the Federal Reserve banks was made discretionary upon the part of the Board. When the Bill reached the Senate there was feeling upon the part of some of the members of the Committee that the Board should have no such discretionary power and in the report of the minority it was said:

"We think it would be undesirable to permit the Federal reserve board to have discretionary power in issuing currency to a Federal reserve bank which in all respects complies with the provisions of this act. We therefore recommend that the Federal reserve board shall issue reserve notes to any reserve bank which complies with the requirements as to gold reserve, as to the deposit of security, and conforms to the other provisions of this act. This is a necessary change because if we give the member banks the right to secure discounts of the Federal reserve bank it is necessary for the Federal reserve bank to count on getting currency to meet the needs of business, provided, of course, the reserve bank can comply with the requirements as to gold reserve and security. By placing a limit to the amount of discounts that can be made by a reserve bank to any member bank we have placed a limit on excess. It should be noted also that the Federal reserve board has the power to check excessive loans and discounts by requiring reserve banks to raise their discount rates at any time." (Senate Minority views, page 4)

The substitute proposed by the minority would have made it mandatory for the Board to grant the application of any Federal Reserve bank for Federal Reserve notes, provided the bank complied with the requirements of the act as to gold reserves and collateral security and otherwise conformed to its provisions.

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The majority of the Senate Committee, however, felt that there should be discretionary control upon the part of the Board. This is evidenced by the following passage taken from page 25 of the Senate majority report:

"The emission of these notes is controlled by the Federal reserve board, which is authorized to control the volume of these notes and the terms upon which they shall be advanced to the Federal reserve bank and the conditions of retirement.

"The Federal reserve board is authorized to tax the issue of the notes and also to fix the rate of interest on the discounts of the Federal reserve banks, and in this way keep a double check on the issuance of the Federal reserve notes."

Thus, again it appears to have been the intent further to insure an elastic currency through the exercise of discretionary authority by the Board and it is clear that the Senate Committee viewed the provision in question as being a means to the accomplishment of a desired end to be used by the Board when it deemed the circumstances to require.

It is also significant that the Senate struck out the proviso appearing in the House Bill requiring that the "rate shall not be less than one-half of one per centum per annum". Inclusion of this proviso would have limited exercise of the Board's discretion.

The Bill emerged from conference in substantially its present form with the power to issue notes to the banks being discretionary upon the part of the Board and with the provision with respect to payment of interest by the banks being substantially as it now is except that subsequently, by amendment, it was changed to apply only to the portion of notes uncovered by gold or gold certificates. Thus the underlying theory of section 16 is that expansion of the circulation is possible only when the Board in its discretion grants the application of a bank for notes and that thereby is established effective control against undue expansion of the circulation. On the other hand, Congress sought to prevent redundancy and to promote retirement in due course by a number of measures.

The instant provision is one of them and it is to be noted that it does not say that the Board shall establish a rate of interest; it says only that the Board may fix such a rate and that if it does fix such a rate the banks shall pay it.

Furthermore, it makes no provision for the disposition of

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the proceeds of such interest payments if established by the Board, which would seem to be in order if the measure was intended as a revenue one and finally, it has always been interpreted as being a discretionary power to be exercised when desirable to encourage the retirement of Federal Reserve notes.

On October 15, 1915, Mr. George L. Harrison, then Counsel for the Board, wrote an opinion which, while not on the precise point here involved, clearly indicates that he regarded the provision as involving discretion and as being a measure of control. A copy of the opinion is attached.

The Board expressed a similar view in a letter subsequently published in the 1916 Bulletin at page 273. A copy of the letter is attached.

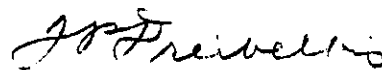
Furthermore, in 1920 the Board considered using the power for such purpose, as is indicated by its letter to the Governors of the banks under date of June 11, 1920, a copy of which is attached.

In conclusion, it is interesting to note the following quotation from Professor Kemmerer's book "The A B C of the Federal Reserve System", appearing at page 65 thereof:

> "Another device calculated to encourage the retirement from circulation of bank notes whenever they become redundant is the provision of the law authorizing the Board of Governors to charge such a rate of interest as it may deem desirable on federal reserve notes uncovered by gold certificates and issued to federal reserve banks. Up to the present time such an interest charge has never been imposed."

For the reasons above set out, the writer's conclusion is as stated on page 2 of this memorandum.

Respectfully submitted,



J. P. Dreibelbis,
Assistant General Counsel.

Attachments

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COPY

May 2, 1933.

Honorable Charles L. Gifford,
House of Representatives,
Washington, D. C.

My dear Mr. Gifford:

I regret that it has not been possible for me to make an earlier reply to your letter of March 14, 1933, in which you request comment on certain marked passages of a speech by Congressman Patman.

Mr. Patman criticizes the Federal Reserve Board for not having required the Federal reserve banks to pay an interest charge on Federal reserve notes issued to them and not covered by gold as collateral security. The following is the provision of Section 16 of the Federal Reserve Act on this subject:

> " * * * to the extent that such application may be granted the Federal Reserve Board shall, through its local Federal reserve agent, supply Federal reserve notes to the bank so applying, and such bank shall be charged with the amount of notes issued to it and <u>shall</u> pay such rate of interest as <u>may</u> be established by the Federal Reserve Board on only that amount of such notes which equals the total amount of its outstanding Federal reserve notes less the amount of gold or gold certificates held by the Federal reserve agent as collateral security."

Soon after the establishment of the Federal Reserve System, the Federal Reserve Board, upon consultation with its counsel, reached the conclusion that this language merely authorizes and does not require the Federal Reserve Board to fix a rate of interest to be paid by the Federal reserve banks; and the Board has followed that interpretation of the law since that time. In this connection it should be noted that, in the case of <u>Farmers & Merchants Bank of Monroe v. Federal Reserve Bank of Richmond</u>, 262 U. S., 649, 662, 663, the Supreme Court of the United States construed the word "may", as used in another section of the Federal Reserve Act, to be a word "of authorization merely", and said that, "This statute appears to have been drawn with great care. Throughout the Act the distinction is clearly made between what the Board and the reserve banks 'shall' do and what they 'may' do."

The question whether any interest charge should be made is one which has been the subject of careful consideration from time to time by the Federal Reserve Board and by the Federal Advisory Council; but it has not been deemed advisable, up to this time, to place any such charge upon Federal reserve notes pursuant to the authority of the above quoted provision.

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One of the primary purposes of the Federal Reserve Act was to furnish an elastic currency and accordingly the Board has felt that it is important that the volume of currency should fluctuate freely in response to the demands of the public and the requirements of commerce and business. The imposition of an interest charge of the kind in question would tend to restrain artificially the amount of Federal reserve notes in circulation and there has appeared to be no necessity to undertake to regulate the amount of currency outstanding in this manner. Of course, when member banks obtain Federal reserve notes from the Federal reserve banks, either by discounting eligible paper or by borrowing on their own notes, they pay interest on the amount of their indebtedness regardless of whether such notes are secured by gold or other eligible assets.

Furthermore, it is to be noted that all of the earnings of the Federal reserve banks in excess of necessary expenses, dividends of 6 per cent per annum on their stock and transfers to surplus as provided by the law, are paid to the United States as a franchise tax; and the payment of an interest charge to the United States upon their Federal reserve notes outstanding would, of course, have caused a reduction in the amount which they have paid to the United States as a franchise tax.

It may be also mentioned in this connection that the collatoral security for Federal reserve notes, which may consist of gold or of other eligible collateral, must at all times be not less than the amount of Federal reserve notes outstanding; and there must be maintained by the Federal reserve bank a reserve in gold of not less than 40 per cent against its Federal reserve notes in actual circulation. All of the expenses of printing, issue and retirement of Federal reserve notes are paid by the Federal reserve banks.

The other point in Mr. Patman's speech to which you refer has to do with the issuance of national bank notes. As you know, upon the deposit with the Treasurer of the United States of bonds of the United States having the circulation privilege a national bank may receive national bank notes, equal in amount to the par value of the bonds so deposited, subject to certain prescribed conditions and limitations. A tax of one-fourth of one per centum semiannually must be paid by the bank upon the average amount of its national bank notes in circulation. The circulation privilege, which during recent years had been confined to a limited number of 2 per cent bonds, was extended by Section 29 of the Federal Home Loan Bank Act of July 22, 1932, for a period of three years, to all outstanding bonds of the United States bearing interest at a rate not exceeding 3 3/8 per cent per annum. The Attorney General has ruled that national bank notes secured by bonds made eligible as a basis of circulation by the Act of July 22, 1932, must be retired at the end of the three year period. This matter

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was discussed in the Federal Reserve Bulletin for August, 1932, a copy of which is inclosed.

There is also inclosed for your information in connection with the matters above discussed a statement prepared by the Treasury Department entitled "The Monetary System of the United States."

Very truly yours,

C. S. Hamlin

Inclosure

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