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HEARINGS BEFORE THE HOUSE COMMITTEE
ON S. 417, FEBRUARY 16, 18, 1937

Mr. Patman. If the Federal Reserve bank at Richmond wanted to increase its stock of Federal Reserve notes it would have a right to get these notes without paying any interest at all, would it not?

Mr. Eccles. That is correct.

Mr. Patman. Section 16 of the Federal Reserve Act says - that is, one part of it does, but I do not recall which paragraph it is - that when the Federal Reserve agent issues Federal Reserve notes the Federal Reserve bank shall pay such interest charge as may be agreed upon by the Federal Reserve Board, which I presume is the Board of Governors of the Federal Reserve Bank. What is the policy of the Board of Governors on carrying out that particular section of the law?

Mr. Eccles. I am not familiar with the section to which you refer. I do not know just what you are attempting to prove, but the Federal Reserve banks as such, of course, have never paid interest. There is no one to whom they could pay interest. There was a time when they paid a franchise.

Mr. Patman. I am not talking about the franchise, but about the part of this section.

Mr. Eccles. To whom would they pay interest?

Mr. Patman. It would go to the Treasury, I presume.

Mr. Eccles. That is what the franchise tax was, of course. It was a form of that.

Mr. Patman. And by the reason of the fact that there was a franchise tax and those excess earnings would go into the Treasury, the Board of Governors of the Federal Reserve Board fixed the zero rate of interest?

Mr. Eccles. I could not say as to that.

Mr. Patman. At any rate, they never charged any interest rate?

Mr. Eccles. That is right.

Mr. Patman. Since that time the law has been amended so that the excess earnings do not go to the Government, has it not?

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Mr. Eccles. Until such time as their surplus is built up to a certain amount.

Mr. Patman. Are you not mistaken about that, Governor?

Mr. Eccles. At the time the F. D. I. C. was organized there was $149,000,000, as I recall it, of the capital of the Federal Deposit Insurance Corporation.

Mr. Patman. That is not what I am asking about, if you will pardon my making the suggestion. And I think we can shorten this a great deal.

Mr. Eccles. Then, what is your question?

Mr. Patman. My question, Governor, is it not a fact now that excess earnings of the Federal Reserve banks go into the Treasury, as originally contemplated by the law?

Mr. Eccles. That is correct. Of course, the Federal Reserve banks have practically no earnings. They have had practically none the past several years. It has been a very small amount.

Mr. Patman. The excess earnings under the present law would go into the surplus fund of each bank?

Mr. Eccles. Yes, sir; that is correct.

Mr. Patman. And would not go into the Treasury?

Mr. Eccles. That is correct.

Mr. Patman. Was that the same reason that was given back in 1914 or 1915 as to why there should be no interest rate charged, because excess earnings go into the Treasury anyway? That reason is not logical now, is it, for the reason that the excess earnings do not go into the Treasury.

Mr. Eccles. Inasmuch as the member banks are limited to a fixed rate of return on the capital, any earnings in excess of that fixed rate of return would go to the surplus of the Reserve banks. And, of course, they could not be utilized except as Congress determined.

Mr. Patman. By special act of Congress?

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Mr. Eccles. Yes, sir; by special act of Congress. In other words, any excess, in case of liquidation after the stock of the Reserve banks was retired at its par value, which would include all earnings, would accrue to the Government.

Mr. Patman. That is only in the event of liquidation, is it?

Mr. Eccles. Yes sir; or at any time that Congress decided, they could do just as they saw fit.

Mr. Patman. There is no question about that.

Mr. Eccles. So that the franchise tax, of course, would just eliminate any current earnings and may create a deficit.

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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 fact 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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HEARINGS BEFORE THE HOUSE COMMITTEE ON H.J. RES. 377, JULY 14, 15 AND 23, 1937

Mr. Patman. Chapter 16 of the Federal Reserve Act says that when Federal Reserve notes are issued to a Federal Reserve Bank, the Federal Reserve Board, under the original law, should cause that Federal Reserve Bank to pay the interest rate that was fixed by the Federal Reserve Board, and I understand that at that time the Board met and said, "Well, all the excess earnings go into the Treasury, anyway, and we will just fix the zero rate of interest." Then in 1917 the law was amended, on June 21, 1917, so as to provide that the Federal Reserve Banks would only pay interest on the notes representing the difference between the gold certificates that were used as collateral security or gold and the amount of the notes issued, and I have checked that up since 1917, and my investigation discloses, from information that was obtained from your office that ever since that time some of these banks have obtained notes in violation of that law.

If that is true, I would like to know why the Board has not carried out that provision which requires an interest charge to be levied.

Governor Eccles. Well, as a matter of fact, it would seem that you are of the opinion, Mr. Patman, that private ownership of these reserve banks is a deterrent, that some one gets a particular advantage--

Mr. Patman. That is not the question at all. I am just asking about that specific point.

Governor Eccles. I could not answer that. The question has not come up since I have been connected with the Board. It is a question that has never been raised, and the Reserve System has been operating for the last three years with practically no profit whatever.

Mr. Patman. Well, of course, their income has been principally from Government bonds.

Governor Eccles. Entirely so, and it could not be from any other source.

Mr. Patman. Don't you believe that that law should have been complied with, Governor, and that those banks owe that money, that they still owe it, and should pay it now?

Governor Eccles. I do not know what rate you would fix upon the use of that currency, and if you fixed a rate on it, the Government would turn around and appropriate funds to the Reserve System to keep that going.

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CRITICISM IN CONGRESS OF BANK EARNINGS ON GOVERNMENT DEBT

There is reason to expect that Mr. Patman and his following in Congress may renew pressure to have the Reserve System finance, without interest, further increases in the public debt that would otherwise add to earnings of commercial banks.

Up until last Spring, Mr. Patman and his group had for some years repeatedly spoken in Congress and by radio in favor of having the Government finance all deficits by issuing non-interest-bearing bonds. He and his group charged that the Reserve System was dominated by the private bankers and emphasized the sovereign right of the Government to finance itself without interest if it decided to do so. All of this led me to address an open letter to Mr. Patman on March 21, 1941, to counter his argument and point out, among other things, the truism "that someone must pay for everything", that banks were not making inordinate profits out of Government financing, and that they could not be expected to operate on a sound basis with less income. I emphasized that in the 10-year period, 1930-1939, the average rate of net earnings on invested capital by member banks was 2 per cent, which was less than a reasonable rate of return. I mentioned also the depressed market for bank stocks as evidence that the banks were not unduly profiting from Government financing.

Time and again, in hearings before House committees, Mr. Patman had something of a field day catechizing me on this general theme. Subsequently he moderated his view, and at the hearing on April 5, 1943, before the House Banking and Currency Committee on the bill to exempt war loan accounts from FDIC assessments and from reserve requirements, Mr. Patman for the first time publicly, to my knowledge, accepted as justifiable a sufficient income for the banks from Government financing to sustain them, but served notice that when bank earnings from this source reached greater proportions both from new financing and refinancing than he would consider justified, he would advocate having the Reserve System absorb without interest issues that otherwise would yield returns to commercial banks.

It should be borne in mind that Mr. Patman is well-informed, persistent, and capable of leading a formidable group in Congress as well as of influencing public opinion on the outside. What seems to be his present attitude cannot be dismissed as belonging in the crank category. Despite my efforts to head him off, he persistently hammered away, at the April 5 hearing, on the point that the Reserve System could finance without interest the Government debt beyond what would net the banks a reasonable living. He asked whether I had "given consideration to any plan, or tried to devise or formulate any plan, that would enable the Government to do any part of its financing without the payment of interest".

He pointed out that if the Reserve Banks could buy up to $5 billions, as authorized, of interest-bearing debt directly from the Treasury, there was no reason why it could not buy that much and more of non-interest-bearing debt. When I sought to draw him off into the question of why,

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logically, he did not propose to finance all the debt without interest, he replied:

"There is a good reason for that. I am opposed to that. I am in favor of selling all the bonds you can sell to the people that have the money to buy them, or the corporations. I am in favor of considering just as high a tax as possible to pay off as much of this debt as we can, but after we have sold all the bonds we can to people who have the actual money to buy them, and we have raised all the money through taxes that it is possible to raise, a lot of bonds will have to be sold at about 45 to 50 percent of the amount of money we use, and that will be obtained by letting the commercial banks create that money just by a flick of the pen, and we will be in this position of having a perpetual debt on our hands. If this debt gets to be $200,000,000,000 or $300,000,000,000, as many people think it will, the debt for interest alone will be from $5,000,000,000 to $7,500,000,000 a year just for interest. It occurs to me that this Congress will be falling down in its duty if it sits idly by and permits this money to be created in that way and obligates the people and the taxpayers to forever pay the interest. It just does not make sense to me. ....."

I recurred to the point that bank earnings for the year 1942, despite the large increase in Government holdings, were less than in 1941, and that it did not make up for the shrink in bank loans. He apparently was satisfied for the time by this line of argument, but continued to press as to my attitude in case the picture changed. I stated that: "There may be a point where the earnings of the banking system are more than adequate to take care of their increasing expenses, together with a reasonable return on capital ....", but that the trend was the other way at the time and his argument, therefore, academic.

He insisted that at some point the bank earnings from Government debt would be excessive, and said he was "disappointed that Mr. Eccles refuses to give consideration to it; he insists on closing his eyes and not trying to solve the problem at all." He added that he could not understand why the Federal Reserve "officials" do not "give some consideration and try to save a large part of that interest."

I replied that, "When the problem of excess profits of the banks begins to appear, you will find me just as diligent about attempting to avoid profiteering on the part of the banks as we have been to prevent profiteering by anyone else."

He remarked that "you are not thinking about the taxpayers", and after referring to the fact that the capital stock of all banks amounted to $3-1/2 billions (this would not include surplus and undivided profits), he said:

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"Now, you already have the Government in this position, which I consider is a position that cannot be justified, of encouraging the sale of bonds to the banks to the extent that by the end of the next fiscal year these banks that have a capital stock investment of 3-1/2 billion dollars will be receiving from 1 to 2 billion dollars a year interest on the Government obligations they will then hold. Now that does not seem to make sense to me. ......

"So I am apprehensive that one of these days the banks will have so many Government bonds upon which they receive interest that there will be a clamor in this country, 'Why pay the banks 3-1/2 billion dollars a year interest when they only have 3-1/2 billion invested in capital stock; why not take all of the banks over and save that 3-1/2 billion a year interest?' I am in favor of the private banking system, of free enterprise, and I think the banks are doing something against themselves when they place themselves in that vulnerable position."

"What would you suggest," I asked, "to take the place of the interest that these banks now receive on Government securities?"

He replied, "I would permit them to receive a certain amount that is reasonable, but I would have the date fixed and, if that was not satisfactory, I would fix another date."

When I pointed out that the banks then held a large amount of short-term debt with low yield, Mr. Patman retorted, "You are talking about the short-term debt, but you know there will be a refinancing and these certificates will be refunded probably with long-term bonds drawing a much higher rate of interest."

The foregoing, from the printed hearings, reflects only highlights in an extensive catechism in which several committee members of both parties indicated a disposition to side with Mr. Patman. That the matter was prominently in his mind, was indicated again on February 9 of this year, when at a hearing on the Brown-Maybank Bill, he interjected the following (page 675):

"Well the banks are pretty well taken care of; they are pretty well provided for, and it won't be long before the banks will be in a very vulnerable position, when the point is reached, as it doubtless will be reached, that they will own so many Government securities that the interest on those Government securities will amount to as much as their entire capital stock is. And when they reach that point, they are in a very vulnerable position, and some fellow might get up over here on the floor of the House and say 'Why pay these fellows a billion and a half or two billion dollars of interest; why not buy them up and buy the stock, and save all this interest every year.' ......"

While Mr. Patman and his group probably could not get far at any time with their original program for financing all deficits without interest, their revised program, conceding the need to sustain the private credit system, but proposing to rely on the Reserve System to finance the debt without interest once that need has been met, presents issues which can hardly be ignored in the light of the current situation.

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