April 26, 1943.

Honorable Robert F. Wagner, Chairman,
Committee on Banking and Currency,
United States Senate,
Washington, D. C.

Dear Senator Wagner:

The Board of Governors of the Federal Reserve System respectfully recommends that the temporary authority contained in the second paragraph of section 16 of the Federal Reserve Act to use direct obligations of the United States as collateral security for Federal Reserve notes be extended for an additional period of two years expiring on June 30, 1945. For the consideration of your Committee there is enclosed a draft of a bill which would accomplish this purpose.

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 Board, if it deemed it in the public interest, should have authority, by the 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. This authority was extended for temporary periods by the Acts of February 3, 1933; March 6, 1934; March 1, 1937; June 30, 1939; and June 30, 1941. Unless renewed this authority will expire on June 30, 1943.

During the early years covered by these amendments direct obligations of the United States were pledged as collateral for Federal Reserve notes until the amount of gold certificates held by the Federal Reserve Banks and due from the United States Treasury increased to such an extent that it became unnecessary to continue the use of direct obligations of the United States as collateral. From May 28, 1938, until recently the amount of such gold certificates was so greatly in excess of the amount of Federal Reserve notes in circulation that the Federal Reserve Banks were able to pledge gold certificates with the Federal Reserve Agents as collateral security for all Federal Reserve notes issued to them, without in any way impairing their reserves against deposits. However, as the result of a steady increase of money in circulation during the past two years, it has become necessary for the Federal Reserve Banks to pledge government securities with the Federal Reserve Agents as collateral for Federal Reserve notes. Furthermore, the demand for currency has been increasing at the rate of $400,000,000 a month. As of April 14, 1943, six of the Federal Reserve Banks had pledged government securities as collateral for Federal Reserve notes in an amount totaling $505,000,000.

The Federal Reserve System has undertaken to see to it that member banks have reserves which will be adequate at all times to enable them to carry their share of private and governmental financing due to the war program. Purchases of United States government securities by the Federal Reserve Banks in the open market or otherwise in order to carry out this undertaking result in additions to member bank deposits, and to their reserve accounts at Federal Reserve Banks against which the Federal Reserve Banks are required to hold 35% reserves. For Federal Reserve notes issued, the Reserve Banks are required to provide collateral, dollar for dollar, in the form of eligible paper of which the Federal Reserve Banks hold very little, or of gold or of United States Government securities.

In these circumstances, if the authority to pledge government securities as collateral for Federal Reserve notes should be allowed to expire, the Federal Reserve Banks could not continue to meet the combined requirements of reserves against deposits and collateral for Federal Reserve notes due to the heavy credit requirements of war financing. Accordingly, it is urged that the authority to pledge government securities against Federal Reserve notes be extended.

Very truly yours,

(signed)

M. S. Eccles,
Chairman.

Enclosure

# 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 the 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 hereby amended by striking therefrom the words "until June 30, 1943" and by inserting in lieu thereof the words "until June 30, 1945".

April 28, 1943.

My dear Senator:

Chairman Eccles asked me to send up to you the enclosed statement on the importance of continuing the authority to use Government securities as collateral for the issuance of Federal Reserve notes -- a subject which you have already discussed with him.

Sincerely yours,

Elliott Thurston,
Special Assistant
to the Chairman.

Honorable Robert F. Wagner,
United States Senate,
Washington, D. C.

Enclosure: "Importance of Authority to Use Government Securities as Collateral for Federal Reserve Notes" - dated April 28, 1943.

ET:b

Goldenweiser
Lent to Wagner on Leg'n.

April 28, 1943

**IMPORTANCE OF AUTHORITY TO USE GOVERNMENT SECURITIES AS COLLATERAL FOR FEDERAL RESERVE NOTES**

The authority of the Board of Governors to permit the Federal Reserve Banks to pledge direct obligations of the United States as collateral for Federal Reserve notes is indispensable to the fulfillment of Federal Reserve responsibilities in connection with prosecution of the war. At no time since Congress granted this power on a temporary basis in February 1932 has it been more essential to the effective functioning of the banking system. Then it was a matter of making it possible for the Board to ease credit conditions so as to encourage business recovery from a severe depression; now it is a matter of enabling the Federal Reserve System to perform its functions in helping to finance the war.

Legal requirements concerning reserves and collateral

Under the terms of the Federal Reserve Act the Federal Reserve Banks are required to hold a 40 per cent reserve in gold certificates against Federal Reserve notes in actual circulation, that is, against Federal Reserve notes that the Reserve Banks have paid out to the public. They are also required to hold 100 per cent collateral against Federal Reserve notes, although gold certificates used for collateral may also count as reserves.

The provision of the Glass-Steagall Act which is at present under consideration for renewal does not change the 40 per cent reserve requirements in any way or reduce the amount of collateral required for Federal Reserve notes. It merely authorizes the inclusion of direct obligations of the Federal Government as a part of the collateral pledged.

against Federal Reserve notes. Previous to the enactment of this provision in 1932, only gold and eligible paper, which includes in addition to commercial and agricultural paper member bank notes secured by United States Government securities, were acceptable as collateral.

The Federal Reserve Banks must also hold a 35 per cent reserve in gold certificates or lawful money against their deposits and a 5 per cent redemption fund in gold certificates with the Treasurer of the United States for such Federal Reserve notes as are not covered by gold certificates.

The use of direct obligations as collateral

At the time the Glass-Steagall provision was enacted, a terrible deflation was sweeping the country with devastating effects on our economic life. Banks were heavily in debt to the Reserve Banks and were losing gold to foreign countries and currency to the American public, which was withdrawing its deposits from the banks. In these circumstances the Federal Reserve Banks, even though they had $1.4 billion of gold in excess of legal reserve requirements, were unable adequately to assist the member banks by open-market operations, because a large part of this gold had to be held as collateral for Federal Reserve notes.

After Congress passed the Glass-Steagall Act on February 27, 1932, the Reserve Banks were enabled to engage more freely in open-market operations. Their open-market purchases greatly relieved the situation, contributed to monetary ease, and were a factor in assisting the recovery movement.

From May 28, 1938, until recently, the amount of gold certificates held by the Reserve Banks and due from the Treasury was so much in excess of the amount of Federal Reserve notes outstanding that the Reserve Banks were able to pledge gold certificates in lieu of direct obligations as collateral security without impairing their reserves against deposits or restricting necessary open-market operations.

As the result of the steady increase of money in circulation and of Federal Reserve Bank deposits that has accompanied the rising volume of war activity, however, it has now become necessary for some of the Federal Reserve Banks in the discharge of their wartime obligations to pledge direct Government obligations as part of their collateral for outstanding Federal Reserve notes. As of April 21, 1943, six Reserve Banks had pledged a total of $525 million of such securities. So long as this situation remains true only of some of the Reserve Banks and not of the System as a whole, adjustments within the law will be possible, such as the sale of Government securities by one Federal Reserve Bank to another or inter-bank borrowing; they would be burdensome, however, and would not be conducive to efficiency of service. But the time is now approaching when, in the absence of authority to use United States Government securities as collateral, the twelve Federal Reserve Banks as a whole will be short of the collateral necessary to meet the growing demands of the war.

The position of the Reserve Banks as a group with respect to gold certificates available for use as reserves and collateral <u>in the absence of the authority to pledge Government obligations as collateral</u> may be judged from the following figures derived from the combined condition statement of the twelve Banks as of April 21, 1943:

| | (millions of dollars) |
|---|---|
| Gold certificates available as collateral 1/ ........................ | 15,713 |
| Federal Reserve notes outstanding (also the amount of collateral required) ............... 13,491 | |
| Eligible paper pledged as collateral ................ 7 | |
| Gold certificates required for collateral if Government securities were ineligible ........................ | 13,484 |
| Excess of available collateral over requirements ................ | 2,229 |

1/ The figure for gold certificates available as collateral was obtained by deducting from total cash reserves ($20,669,512,000) the 35 per cent reserves required for deposits ($4,956,699,300). Since practically all the Federal Reserve notes would be secured by gold certificates, requirements for the redemption fund would be negligible.

Were it not for the authority to pledge Government obligations as collateral for Federal Reserve notes, the Federal Reserve Banks would have a margin of only $2.2 billion with which to meet the expanding need for gold certificates that will arise both from the growth of deposits and from the expansion of note circulation. Currency in circulation has been expanding at a rate of $400 million a month and may be expected to continue to expand in response to increasing military and industrial activity. The amount of eligible paper available for collateral is so small that virtually all the 100 per cent of collateral would have to consist of gold certificates. If Government securities could not be used as collateral, the margin of $2.2 billion would soon be exhausted by additional currency requirements alone. Some of this margin will be needed also to meet expansion in the Reserve Banks' requirements for reserves against their deposits, which will increase as holdings of United States Government obligations increase.

The Federal Reserve authorities have undertaken to see that member banks have reserves which will be adequate for the necessary private and Governmental war financing that is required of them. Although they are vigorously cooperating with the Treasury's efforts to finance Government war borrowing with as little recourse as possible to the banking system, the Federal Reserve authorities have the responsibility to keep member banks in a position to furnish such credit as the Treasury may require of them. The Reserve Banks, therefore, must from time to time make substantial purchases of Government securities in the open market or otherwise. These purchases result in additions to member bank deposits, in their reserve requirements, and in their reserve balances with the Reserve Banks. Against these balances the Reserve Banks must hold 35 per cent reserves.

In view of the double demands on Reserve Banks for collateral against rapidly expanding Federal Reserve note circulation and for reserves against a growing volume of deposits, the margin of $2.2 billion of available gold certificates would be too narrow to permit these Banks to discharge their wartime obligations. It is for this reason that the Board of Governors urges the renewal of the power to use Government securities as collateral for Federal Reserve notes.