February 17, 1945.

Dear Bob:

In accordance with our telephone conversation, I am enclosing a copy of the statement I will read to the Senate Banking and Currency Committee at the meeting on Tuesday morning on the reduction in the reserve ratio and renewal of authority to pledge U. S. Government securities as collateral for Federal Reserve notes. I am also putting in a copy of the bill.

With best regards,

Sincerely yours,

Honorable Robert A. Taft,
United States Senate,
Washington 25, D. C.

Enclosures 2

ET:b

(IDENTICAL NOTE TO SENATOR MURDOCK)
(AND SENATOR FULBRIGHT)

REDUCTION IN RESERVE RATIO AND RENEWAL OF AUTHORITY TO PLEDGE U. S. GOVERNMENT OBLIGATIONS AS COLLATERAL FOR FEDERAL RESERVE NOTES

The bill introduced herewith would accomplish the following purposes: (1) Extend indefinitely the authority of the Federal Reserve Banks to pledge U. S. Government securities against Federal Reserve notes issued by the Federal Reserve Agents. Existing authority expires June 30, 1945; and (2) Reduce the requirements of reserves to be held by Federal Reserve Banks from their present level of 40 per cent in gold certificates against Federal Reserve notes in circulation and 35 per cent in gold certificates or lawful money against deposits, to a uniform minimum of 25 per cent in gold certificates against combined note and deposit liabilities.

The need for reducing the high reserve requirements of the Federal Reserve Banks was mentioned by the President in his Budget Message transmitted to the Congress on January 3, 1945.

Pledging of U. S. Government securities against Federal Reserve Notes. This power was first granted to the Federal Reserve Board in February 1932 at a time when our gold stock was low and the supply of paper eligible as collateral small. The power was granted for the purpose of enabling the Federal Reserve Banks to engage in open market operations which were necessary at that time in order to help banks get out of debt and to establish conditions in the money market favorable to the recovery of business which was at the depth of depression. The power was renewed from time to time; unless action is taken it will expire on June 30, 1945.

In conditions prevailing today, with Federal Reserve notes outstanding in an amount of 21.7 billion dollars and deposit liabilities of the Federal Reserve Banks in an amount of 16.4 billion, the extension of the power to pledge U. S. Governments is imperative. Without it, the Federal Reserve Banks would be obliged to sell a large enough volume of Government securities to make it necessary for banks to borrow as much as 10 billion dollars from the Federal Reserve Banks at this time and possibly as much as 15 billions by the end of the year. The manner in which this would work is that the banks would sell the securities in the open market; payment for them would take out an equivalent amount of funds from the market, and member banks would have to borrow this amount from the Federal Reserve Banks in order to replenish their reserves. The promissory notes of member banks at the Reserve Banks would be eligible under the law as collateral for Federal Reserve notes. By this process member bank promissory notes secured by United States Government obligations would be substituted for such obligations themselves as collateral held by the Federal Reserve Agents against outstanding Federal Reserve notes. No public interest would be served, but in the process the market for U. S. Government war obligations would be disrupted at a time when the Treasury must still raise vast sums to finance the war. It is clear that this must not occur and that, therefore, the power to pledge Government securities against Federal Reserve notes must be continued.

There is nothing to be gained in placing a time limit on the extension of this authority -- since it is impossible to foresee at present when, if ever, conditions will be such as to make it consistent with the public interest to revert to the provision of law, enacted nearly 30 years ago, which limited collateral against Federal Reserve notes to gold certificates, commercial paper, and member bank collateral notes.

Reduction of Reserve Ratio. Conditions arising out of the war have caused the reserve ratio of Federal Reserve Banks to decline from 91 per cent at the end of 1941, soon after our entry into the war, to 49 per cent at the end of 1944. If developments continue at the rate of recent months the ratio will fall almost to the legal minimum by the end of the present calendar year. If gold export or currency withdrawals or both should be greater than in 1944, the legal minimum will be reached sooner. The following table shows the factors in the situation, together with hypothetical projections through 1945 based on probable trends of currency, deposit, and gold movements.

Federal Reserve Bank	Dec. 31, 1941	Dec. 31, 1944	Projections	
			June 30, 1945	Dec. 31, 1945
		(In billions of dollars)		
Reserves	20.8	18.7	18.2	17.7
Deposits	14.7	16.4	17.4	18.4
F.R. notes outstanding	8.2	21.7	23.7	26.7
Liabilities requiring reserves	22.9	38.1	41.1	45.1
		(Per cent)		
Reserve ratio	90.8	49.0	44.3	39.2

It will be seen that the decline in the reserve ratio has been due to a reduction in Federal Reserve Bank reserves and to increases in Federal Reserve note and deposit liabilities. Reduction of reserves has reflected the fact that most of this country's exports have been on lend-lease, while our imports have been on a cash basis. Countries that have sold commodities to the United States have not been able to buy goods here, on account of war restrictions, and have either withdrawn or earmarked gold against the time when goods will once more be available for sale.

Growth of Federal Reserve note circulation has been a part of the general expansion of currency which has accompanied war activity in every country in the world. Expansion of both notes and deposits has reflected growth of Government war expenditures, enlargement of national money income, and advancement of payrolls and trade at higher prices. So long as the Federal Reserve Banks continue to do their part, as they surely must, to assist the Treasury in Government financing and in maintaining stable conditions in the market for U. S. Government securities, these Banks must not be restricted by an arbitrary reserve ratio.

There are several ways to meet the situation, all of which have been carefully considered. One way would be to issue Federal Reserve Bank notes, which require no reserves, in place of Federal Reserve notes; another way would be suspension of reserve requirements by the Board of Governors of the Federal Reserve System, which is authorized by law, and a third way would be a reduction of reserve requirements by the Congress. Other devices, such as issuance of currency by the Treasury, or reduction of member bank reserve requirements, have been reviewed and found to be inadequate or inappropriate. Reduction of the ratio by law, which is proposed in the bill, is the most clear-cut method, as well as the most consistent with the responsibility of the Congress to regulate the country's monetary policy.

Issue of Federal Reserve Bank notes in their present form was authorized by the Emergency Banking Act of March 1933, and the authority will expire when the President declares that the emergency is over. The need for the lower ratio may continue beyond that date. Furthermore, the difference between Federal Reserve notes and Federal Reserve Bank notes gives rise to misunderstanding, and it would be simpler and less confusing to the public if Federal Reserve currency were all of one kind. It would be best at a time like this to have a Federal Reserve ratio that indicated to the Congress and to the people the amount of gold certificates held by the Reserve Banks against their total deposit and note liabilities of all kinds.

The authority in section 11(c) of the Federal Reserve Act to suspend reserve requirements does not appear to be the best method of meeting the situation, because the power was not designed for a situation like the present which is of indefinite duration. Suspension must be for a period not to exceed thirty days, renewable at intervals of fifteen days. It also requires a penalty in the form of a progressive interest rate, to be determined by the Board, and added to the discount rate of the Federal Reserve Banks. At a time like the present, when discount rate charges must fit into the general rate policy adopted for war financing, this would not be the best procedure.

Consequently the bill provides for a direct reduction of the minimum ratio. Such an action would be entirely consistent with the changes in conditions which have occurred since the ratio was first established by the Congress. The original purposes of the ratio were (1) to assure adequate resources for the Reserve Banks to meet demands for gold or lawful money by depositors and note holders, (2) to limit the expansion of Federal Reserve Bank credit, and (3) to assure the public that there was at least 40 per cent in gold back of the Federal Reserve notes which were then being introduced for the first time.

The first purpose is no longer compelling since gold redemption is now not permitted for domestic use, and gold can be exported only under license. While the country's aggregate gold reserves are ample to meet any conceivable foreign demand, a reserve ratio high enough to meet possible demands for both domestic and foreign use is no longer appropriate under

present conditions. The second purpose -- limitation of Federal Reserve Bank expansion -- is not relevant at a time when expansion by the Reserve Banks is essential to the needs of war finance. Thirdly, confidence in Federal Reserve notes is well established, and whether the amount of gold back of the notes is 40 per cent or 25 per cent makes no practical difference.

War conditions have caused all belligerents to reduce or abolish central bank reserve requirements.

A reduction to 25 per cent is proposed because it would be sufficient for all foreseeable contingencies. It would enable the Reserve Banks to meet such additional demands for currency by the public and for reserve balances by member banks as are likely to occur. The currency supply and the bank deposit structure could nearly double before the legal minimum would be reached.

The bill provides for elimination of the distinction made in the present law between reserves required against notes and against deposits both as to percentage and as to composition of the reserves. Since the two liabilities are interconvertible at the option of the owners, the same requirements should apply to both. The provision in the bill that legal reserves should consist only of gold certificates would also eliminate controversy as to what constitutes lawful money, and whether the Federal Reserve Banks could, if so minded, use their own notes (Federal Reserve notes or Federal Reserve Bank notes) as reserves against their own deposits.

A clean-cut uniform requirement of gold certificate reserves of 25 per cent against both notes and deposits appears to be the best solution of the problem.

In conformity with the proposed reduction of the ratio to 25 per cent the bill decreases proportionately the levels of the ratio at which the imposition of the different penalty rates provided in the law when reserves are suspended would be prescribed.