**FEDERAL RESERVE BANK
OF DALLAS**

Dallas, Texas, January 29, 1941

ADDRESSES MADE AT THE FEDERAL RESERVE DINNER
JANUARY 24, 1941

To the Bank Addressed:

We are enclosing for your perusal copies of two addresses that were delivered at a dinner given by this bank for the bankers of the Dallas district on January 24, 1941, in honor of members of the Board of Governors of the Federal Reserve System—one by Mr. M. S. Szymczak on the subject, "Certain Aspects of Reserves," and one by Mr. Walter P. Napier on the subject, "A Member Banker Looks at the Federal Reserve System."

So many requests for copies of these addresses have been received from bankers who attended the dinner that we believe they will be of interest to each member and nonmember bank in the district.

Yours very truly,

R. R. GILBERT
President

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A Member Banker Looks at the Federal Reserve System

AN ADDRESS

By

WALTER P. NAPIER

President of the Alamo National Bank, San Antonio, Texas

and

President of the Texas Bankers Association

at a

DINNER

Tendered by the

FEDERAL RESERVE BANK OF DALLAS

In Honor of

Board of Governors

of the

Federal Reserve System

Dallas, Texas, January 24, 1941

A Member Banker Looks at the Federal Reserve System

I AM NOT quite certain in my own mind of the reason why I find myself assigned a speaking part in tonight's program. It is a far cry from Washington to San Antonio. I am thinking of the electrician who was puzzled. "Hey," he called to his assistant, "Put your hand on one of these wires." The assistant did as he was told. "Feel anything?" "No." "Good," said the electrician, "I wasn't sure which was which. Don't touch the other one or you will drop dead." I beg for your prayers that in what I may say I will touch no wires that are hot.

To be numbered among those privileged to participate in this gathering and to lift my voice in recognition of one of the nation's monetary agencies which through effective administration has proved its worth, is for me a happy occasion. Good men have always gathered around its council tables, shaped its policies, and directed its activities. And when I speak of good men, I recall the kindness, the virtues, the energy and ability of that grand character recently departed, Buck McKinney. And I am equally conscious of an exemplification of the same exalted traits in the person of the Dallas bank's existing President, Randle Gilbert. Personalities such as John McKee and M. S. Szymczak command respect and merit esteem.

I believe in the necessity for the Federal Reserve System. I am conscious of the good that it has accomplished. I have faith in the effectiveness of its power to adjust our banking policies to changing economic conditions. I have never questioned its motives in attempting to correct defects in our banking practices, as they have developed from time to time.

Since 1929 capital and labor, rich and poor, in these United States, have witnessed and experienced the presentation, adoption and trial of one expedient after another, in an effort to restore social and economic normalcy. Some of these measures have proved to be of value and will, no doubt, remain a part of the law of the land. Others were so palpably vicious, inherently unsound and contrary to the fundamentals of our capitalistic system, as to justify suspicions concerning the motives of their sponsors.

To be "the master of his fate and the captain of his soul," has always been the goal of man. He has had his joys and he has had his sorrows. He listened to logic and reason when contentment and honest ambition were in his heart, and he prospered; he heeded the lure of sophistry when envy and greed beset him and he suffered. The pages of history are replete with evidence of this fact. But they have failed to serve as a lesson, and, therefore, we must understand that so long as human nature remains as it is, each generation will have to learn for itself "that water will wet and fire will burn."

In a society where the talents and abilities of men are arrayed against each other in an effort to attain social security, the disparity in the possession of these attributes are prone to be forgotten not only by those possessing the lesser talents but due to their numerical superiority, have influence on those who enact the laws of the land.

The existence of these inequalities and disparities in the mental and physical abilities of men have always been a self-evident fact. But, have you ever stopped to consider, strange as it may seem, that at no time do we hear of them being decried except in the field of business as evidenced by income and wealth? Many men and women have risen to the highest pinnacle of success in

the various arts and sciences. They have been acclaimed by the populace in their day. Their names and accomplishments have become legendary and used to inspire succeeding generations to strive for greater undertakings. But when a man achieves success in business, accumulates a fortune and earns a large income, he often becomes an object of scorn and is frequently publicized as being a bane to society. It appears that little serious thought is given to the fact that the successful business man, in achieving success, not only contributes to his own advancement, but to the advancement of his community as well.

The great actor, the famous painter and the literary genius are accepted and praised for their contribution to the cultural development of society. They contribute little, if anything, to its economic progress. We know that it is the successful business man who contributes most to the advancement of the material program of a people.

In our effort to understand this attitude we must, of course, keep in mind that the masses necessarily assume an active part in our economic life, while only a limited number ever wander in the fields of art. And then again, we must never forget that man's greatest weakness is a disposition to attribute his lack of success to causes other than his own inherent limitations. This invariably gives rise to the unjustifiable suggestion that the successful business man may not always have been careful in his methods and possibly has been ruthless in his efforts. Such expressions and opinions furnish material which is often used in constructing political platforms. They prompt the placing on the statute books of the nation law after law designed to lessen inequality, by a redistribution, in various ways, of the wealth of the people of the nation.

The scheme is as old as is civilization itself and has proved, time and again, to be as unproductive of stability as are the sands of the deserts. On the other side, however, we must never lose sight of the fact that the periods when the masses are disposed to clamor the loudest and most effectively for assistance from the Government in an attempt to adjust their economic and social affairs are during those years of extreme business recession; times when capital is nervous and idle, unemployment large, and the demands for relief heavy. These periods which we have come to call depressions, amount, in fact, to crises, and are always preceded by periods when everyone seems to be content and optimistic, periods which we refer to as boom years.

These business cycles, in their alternating periods of booms and depressions, have been characteristic of the economy of this country. They have been harmful, not only to our business economy but to our efforts to maintain a sound political economy. We must strive constantly to lessen their frequency and minimize their effect.

I am one of those who recognize that my right "to have and to hold," in a democracy such as ours, comes from the will of a majority of the people. And for me to remain secure in the enjoyment of this right, I know that the majority of the people must remain content in my being so.

In the last century we have experienced six of these business cycles, all of major proportions, in addition to a number of a lesser nature. Much has been said and volumes have been written as to the predominant cause of these cycles and the remedies needed to prevent, or at least minimize, their effect upon our social and economic life.

There has been no denial of the fact that a period of more than normal prosperity has always immediately preceded each major depression. It seems clear that the characteristics of these boom periods have uniformly been, not excessive over production but great activity of a speculative nature; speculation made easy and encouraged by the existence of easy money and easy credit involving an excessive increase in the amount of bank credit.

Speculation gives momentum to rising prices of almost everything.

As the speculation continues, interest rates finally begin to rise, suggesting a shortage of credit. Once this apprehension is felt, fear takes hold. Credits tighten, prices stop rising, selling sets in, prices decline, loans are called, failures occur, and business receives a set-back, resulting in a decline in values, production, consumption and employment, the collapse of the boom and the beginning of a period of liquidation and re-adjustments.

While, of course, there are many factors that contribute to boom years, over some of them business men have no control. There is always present, however, as I have just stated, one important contributing cause, and one over which we, as bankers, do have control, and that is an over expansion of bank credit in financing excessive speculation.

If these business cycles, alternating between boom and depression periods, are to be interrupted or their trends kept within a more adjustable relation to each other, then we must expect and cooperate in an intelligent control over the expansion of credit.

As has been said by many who have written and spoken on this subject, this thought is not new. It has

been advanced many times before. Our experience with the boom preceding the collapse of 1929 should leave us with no other opinion than that the over expansion of credit, used in speculation, and the subsequent contraction thereof were prominent among the direct contributing causes of the depression that followed.

I, of course, understand the economic law of supply and demand. I am conscious of the natural urge to constantly push upward the trend of values. I realize that ambition and management are not things that can be standardized. I insist, however, that sanity should be considered a proper governor in good times as well as in hard times.

We are emerging from one of the most serious depressions this nation has witnessed. Forced liquidation has now about stopped, bank deposits have risen to an all time high, interest rates are lower than we have ever known, and programs are in the making that promise a tremendous industrial activity and production that may be far reaching. We are moving rapidly into the economics of war.

We have reached a time in our democratic way of life when we must muster all of our resources and abilities and formulate a program, not alone for the purpose of protecting us in the fortunes of what may prove to be war, but against renewed attacks from within upon our capitalistic system. Such attacks will most certainly be made if we fail to adequately and soundly finance the defense program and, in doing so, take such measures as will lighten the effect upon the masses of the recession which we know will inevitably follow the close of the war, if we have one, and, if we are fortunate enough to escape war, then when we feel it safe to cease preparing therefor.

Business men must be made to understand this fact. As bankers, controlling credits, we must early recognize and support every intelligent proposal to properly finance the contemplated increase in production and consumption, but, in doing so, we must endeavor to prevent an over expansion of credit in the field of speculation.

As chartered bankers, we have no right to insist, in view of what is ahead of us, that entire control over the expansion of bank credit be left solely in our hands and to our judgments. As trustees of the people's money, it behooves us to welcome a reasonable method of control that will affect all alike and serve to insure the future of chartered banking. We know that during prosperous times every one is optimistic. We are prone to deal with values as they appear to be at the time.

The Federal Reserve System was established in 1913. Reforms in the banking laws had been discussed for more than twenty years prior thereto. Panics had occurred with comparative frequency and regularity. And whenever a panic occurred, the defects of the National Banking System became increasingly apparent. Students of finance, economists and many bankers were of the opinion that panics were avoidable, especially those arising from a scarcity of currency, as was the cause of the panic of 1907; that agriculture, commerce and industry were entitled to banking facilities of the highest efficiency.

It is not necessary for me to enumerate before this audience the many defects incident to the inadequacy of the National Banking System as it existed prior to the establishment of the Federal Reserve System. Neither do I think it necessary to refer to the many defects which the System has remedied.

The Federal Reserve Act as adopted was not considered revolutionary in its nature. No new and untried banking principles, of a radical nature, were incorporated in the Act.

Providing for an elastic currency was, at the time of its enactment, accepted as the outstanding feature of the Act.

The Act gave to the Federal Reserve Board, however:

1. Control over the funds of the System, including the legal reserves of the member banks, which may vary within certain limits.
2. The right to fix, from time to time, the rediscount rate.
3. The right to invest their assets in Government securities, and some others.

We have come to learn that with these powers the Federal Reserve Board is provided with the means for maintaining control over any attempt at an excessive expansion of bank credit. When these powers have been timely and properly exercised, the results have been effective and beneficial.

Following the first World War after a short interval a rapid rise in commodity prices began, at a faster rate than at any time during the war. The upward trend through 1920 was so violent that business men became apprehensive of its effect. Repressive measures were called for. Finally the Federal Reserve Board allowed the Federal Reserve Bank of New York to raise its disrount rate to 7 per cent. This was followed by an abrupt fall in the stock market and then in commodity prices, bringing on the depression of 1921. It was then that the Reserve banks began considerable purchases of Government securities. Within a few months the fall in

prices had stopped, business began to recover and confidence returned.

Through 1922 and into 1923, there was again a sharp rise in prices and an expansion of bank credit, with a renewed outbreak of speculation. Reserve banks again intervened by raising discount rates. Again there was a sharp check to the rise in prices and likewise to trade. In 1924 Reserve banks again lowered the discount rates and bought heavily of Government securities. The recession in business was soon over and normal conditions restored.

For international reasons this program was not pursued in 1927 when speculation and expanding bank credit were again apparent. Instead, in the summer of 1927 the Federal Reserve Board not only lowered its discount rate but renewed its purchases of Government securities. Speculation and expanding bank credit were thereby stimulated and permitted to continue and gather momentum. In the late summer of 1928 the New York rediscount rate was raised to 5 per cent, which was wholly inadequate and the boom continued. In August, 1929, the rate was raised to 6 per cent, and promptly brought to an end a period of one of the wildest speculations this country has ever experienced.

Had the program of raising the discount rate and the selling of securities, which worked so well in the early 20's, been applied in 1927, it is the opinion of many that the seriousness of the collapse of 1929 and many of the problems that followed might have been avoided.

Speculation, supported by an over expansion of bank credit, can be controlled by the proper exercise of the powers that are now and such as may be properly vested in the Federal Reserve Board. But such powers, to be effective, must be exercised courageously.

Today we are face to face with that for which we have

been waiting, a sharp up-turn in business. A movement that can lead us to optimistic heights and to speculation, in spite of the pronounced injunction against the realization of abnormal profits.

The Federal Reserve Board is alert to the situation, conscious of the potential dangers and eager to avoid them. In collaboration with the presidents of the several Reserve banks and members of the Advisory Council, it has proposed a program of precautionary measures. We are familiar with them. They should awaken our interest in the necessity for formulating a program that will discourage unbridled speculation.

Under our Constitution, Congress alone has the power to fix the value of money. We all agree, I am certain, that the value of money should be fixed and when so established, in order that it may be accepted with confidence as a definite measure of value, while serving as a medium of exchange, should not be frequently changed. In this economy of ours, however, bank money, that which is created by the extension of credits, is an important factor. It has a fluidity that carries a measure of instability, the power to expand and contract the volume thereof. The volume of this bank money has a definite relation to prices. Violent fluctuations in price levels, are disturbing elements in our economy. The turnover of this credit in normal times follows the trends in trade activity and the two are, therefore, neutralized. It is when there has been an excessive increase in the volume of credits, over and above that needed to finance normal production and trade, that prices rapidly rise. It is when this volume of credit is suddenly contracted, that prices sharply decline. It, therefore, follows that with the value of money once fixed, there should be such control over the volume of credits as not to affect too suddenly and too violently, at any one time, the purchasing power of money.

Bank money has become the very life blood of modern business. Chartered banking renders a greater service to industry, commerce and society, and with an ease and at less cost than can that offered through any other plan evolved up to this good hour.

Notwithstanding the attacks that have been made upon it, chartered banking can and must be preserved. The bankers of the country, however, are the ones who must save it. They can do it by an intelligent control of bank credit. While chartered banking is primarily a private undertaking, it is impressed with a public service, and this public service we must recognize and render. In doing so, we must not only submit to but encourage reasonable regulations legally prescribed in the interest of economic stability.

It is upon the Federal Reserve System that we have a right to rely for a coordination of the influences affecting chartered banking.

It is to the Federal Reserve System we should be able to look as being the proper agency with authority capable of compromising the various opinions affecting banking.

It is with the Federal Reserve System that we should be able to plan the part that banks are to play in this war economy.

It is from the Federal Reserve System that we should be able to secure support in our program of public relations.

So let us join hands in an effort to formulate a program that will convince the masses of the advantages to them of the services that can be rendered by chartered banking and when we have done so, hold tight against all attacks upon our economic front. If we protect that front we will surely win on all other fronts.

Brief Remarks on Certain Aspects of Reserves

By

M. S. SZYMCZAK

Member, Board of Governors

of the Federal Reserve System

at a

DINNER

Given by the

FEDERAL RESERVE BANK OF DALLAS

In Honor of

Board of Governors

of the

Federal Reserve System

Crystal Ballroom, Baker Hotel
Dallas, Texas

7:30 *o'clock, January* 24, 1941

Brief Remarks on Certain Aspects of Reserves

THERE has been a great deal of talk about excess reserves. Some of it has produced more heat than light. It seems important to me, therefore, to undertake to throw increased light on certain aspects of the subject which is so important to you, to the Federal Reserve System, and to the nation.

First: We have today the unprecedented amount of seven billion dollars in excess reserves. This excess can be used by the member banks of the System to extend credit by means of loans and investments.

Second: On the basis of this enormous volume of excess reserves the volume of deposits—now 60 billions—could be doubled. A volume of deposits twice as large could do twice as much work and if the amount of goods and services did not increase at the same rate, there would be the danger that prices would rise rapidly. This is not in the interest of a stable economy.

Third: It may also be pointed out that the same result could be achieved by doubling the *use* of *existing deposits,* namely, the sixty billions. In other words, at the present time the velocity of deposits—that is, the use or turnover of the present deposits—is about "thirteen." There have been times in the past when this velocity was "twenty-six." Therefore, if existing deposits should be used twice as actively as they are now used, that too would represent a dangerous situation. This is not in the interest of a stable economy.

Fourth: *After deposits have once been created,* there is little that the Federal Reserve System can do about them. That has to be dealt with by non-monetary means

such as restricting of price advances, rationing, etc. The Federal Reserve authorities, if given sufficient power, can *regulate* the *growth* of *deposits* but they can not control the *turnover of existing deposits.*

Fifth: To control the growth of deposits, however, the Federal Reserve System needs sufficient powers in sufficient time to deal with the existing excess reserves should occasion arise for the System to act in the interest of a stable economy.

These facts are plain and simple. Let's now try to clarify the meaning of reserves.

I have found in talking about reserves that one often encounters misconceptions with regard to reserves and their functions. This is due principally to the fact that often the individual thinks of Federal Reserve Bank operations in terms of commercial bank operations.

An understanding of reserves requires more than that. It requires that the point of view of the banking system as a whole be taken; that the close inter-relation of bank with bank in an organic system be recognized as a fundamental condition and that the essential problems of central banking action be understood.

For example, there are those who sincerely believe that financing of Government deficits by banks increases excess reserves. This is not so, as I have attempted to show on previous occasions. When a bank buys a Government obligation and pays for it, the *banker's reserves* at the Federal Reserve Bank are thereby *diminished* and the Government's deposits at the Federal Reserve Banks are increased. On the other hand, when the Government later spends this money, the money goes into the hands of private persons in various sections of the country who pay their bills and the

money finds its way into banks, or who themselves deposit the money in banks. The banks in turn re-deposit the money with the Federal Reserve Banks. The net result is that there has been *no change* in the total volume of *member banks' reserves* but there has actually been an increase in *deposits.* In other words purchasing Government securities by banks is lending to the Government by a bank and has the same effect on the volume of deposits as when a bank lends to anyone else. The extension of credit in either case *increases deposits.*

Incidentally, it may be mentioned again that Government deficit financing through the banks *diminishes* excess reserves. As deposits increase, *required* reserves, according to present percentages of reserve requirements, increase by roughly one-seventh of the amount of the increase in deposits so that if the Government borrows a billion dollars from the banks, it will increase deposits by about one billion dollars and thus convert about one hundred and fifty million dollars of excess reserves into *required* reserves.

For the reasons outlined it has been suggested that a large part of future Government financing (though of course not all and certainly not at once) be accomplished, by drawing upon the existing large volume of deposits rather than by creating additional deposits through bank purchases of Government securities. This can be done by offering a security that will be desirable to and sought by the depositors, individuals, business corporations such as insurance companies and others. It has likewise been suggested that a means be provided for absorbing a large part of the existing excess reserves so as not to make possible a further large increase in deposits. The deposits are already large.

There is still another misconception. This misconception is even more widespread and has certain insidious implications.

Some think and say that when the Federal Reserve Banks engage in open market operations and are making discounts or advances to member banks the funds they use are the reserves of the member banks. What is worse, some even go so far as to say that the *reason* that the Federal Reserve System has raised or may in the future wish to raise reserve requirements is that it would have more funds to invest in Government securities. Of course this is not true.

It is perfectly apparent that an increase in reserve requirements does not necessarily result in an *increase* of *reserve balances*. The result is a *change* in amount of reserves from one to the other of the two labels—a *larger amount* on the books of the Federal Reserve Banks is labelled "*required* reserves" and a *smaller amount* on the books of the Federal Reserve Banks is labelled "*excess* reserves." The *reserves, as such,* at the Federal Reserve Banks may remain the same. The Federal Reserve System does not *acquire any funds* whatever by the process of increasing reserve requirements.

Furthermore, the Federal Reserve Banks are not dependent on the member banks for their lending power. Let us look at our balance sheet. At the present time the Federal Reserve Banks have, on the resources side, twenty billion dollars of cash and two billion dollars of earning assets and on the liabilities side they have sixteen billion dollars of deposits and six billion dollars of Federal Reserve notes. If all the deposits of the Federal Reserve Banks were withdrawn by the member banks which, of course, could not happen, the result would be that the Federal Reserve Banks would have the same

assets as before but instead of having sixteen billion dollars of deposits and six billion dollars of notes on the liability side of the statement, they would have no deposit liabilities but would have twenty-two billion dollars of note liability. There would be no change in the *ratio* of the Federal Reserve Banks' reserves to their liabilities which is about ninety per cent and there would be no *substantial reduction* in the Federal Reserve Banks' lending powers. I say no *substantial reduction* —because as you know, the law requires the Federal Reserve Banks to hold a *forty per cent* reserve against *notes*—and only a *thirty-five* per cent reserve against *deposits.*

The lending power of the Federal Reserve Banks is based in the first instance on the power which Congress placed in the Federal Reserve Banks when it established them to issue Federal Reserve notes and to create deposits, holding forty per cent reserves against the notes and thirty-five per cent reserves against the deposits. Therefore, the lending power does not originate with the member banks; it originates from the Government granted power.

Since we have a practical situation in the Federal Reserve System and not a theoretical one, I shall not take your time now to discuss hypothetical and highly improbable situations, though I shall be pleased to have you send me questions or ask them tonight—after this dinner.* Our actual situation is this:

> The liabilities of the Federal Reserve Banks—notes and deposits—are used by the banks or the public continuously because they need them in their business operations.

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*For discussion of a hypothetical situation, see Supplement on page 11.

Everyone needs a certain amount of pocket cash to meet certain kinds of expenditures. Therefore, Federal Reserve notes are issued. These notes stay out because they meet a public need and they stay out so long as this public need exists. When the public no longer needs them, they are returned to the banks and from the banks to the Federal Reserve Banks. If the need increases, the amount of notes increases and if the need decreases, the amount of notes decreases. This mechanism works well and we have no trouble with it.

As regards deposits, the member banks want their deposits to be in the Federal Reserve Banks and they want them there, not only because they are required by law to hold reserves in that form, but also because it is the most convenient way to clear with other banks and, finally, because the banks want to feel that a certain amount of their funds is absolutely intact and held in a public institution not operated for profit but devoted to the purpose of regulating the volume of bank credit in the interest of economic stability.

This is the case even in foreign countries where there are no legal reserve requirements. In those foreign countries, commercial banks maintain reserves with their central bank even though they are not required to do so under law.

To point this up, let me state that the power of the Federal Reserve Banks to invest in Government securities or to discount for or make advances to the member banks is based on the fact that Congress has given the Federal Reserve System certain powers and back of these powers lies the fact that modern economies have found central banking mechanisms an essential part of

modern life. The Federal Reserve Banks' lending power, therefore, rests in the final analysis on the fact that they perform necessary central banking functions.

The Federal Reserve authority can therefore make additional reserves available when needed, quickly and in ample volume to meet all the credit demands that go with economic activity. This authority is in the discount powers, the powers of open market operations and the power to lower reserve requirements. They have ample power to *increase excess reserves* should conditions require an increase.

Finally, let me point out that not only do the Federal Reserve Banks not depend on member bank deposits for their lending power, but, quite the contrary, the Federal Reserve Banks under normal circumstances have the authority to *regulate the lending power of member banks.* When the Federal Reserve Banks lend to the member banks or buy securities in the open market, they *create member bank reserves* and, therefore, *increase* the *member banks' lending powers.* When Federal Reserve Banks are repaid or when the Federal Reserve Banks sell Government securities, they *diminish member banks' reserves* and *reduce the member banks' lending powers.* It is, in fact, in this power to influence member bank reserves and consequently to influence their lending power that lies the principal instrument of credit control possessed by the Federal Reserve System and, therefore, since a large part of member bank reserves is created through Federal Reserve purchases of Government securities, it is absurd (isn't it) to say that the Federal Reserve Banks use the member banks' reserves. How can the Federal Reserve Banks be *using* member banks' reserves when the operation itself *increases* member banks' reserves? It would be a case

where the creature is supposed to be the creator of its creator.

I hope I have been helpful in throwing some light on the subject of reserves.

We are all concerned with our national success. Our part—yours and mine—in national success is in the responsibility we have in connection with influencing credit to the end of economic stability. It is plain common sense that to meet this responsibility, which is only one factor in the broad field of economic influences, the time to get ready to solve a national credit problem that may arise, is not when the problem is right on the doorstep of an individual bank—your bank for example—for then it may be too late.

Certainly too, everyone wishes to do his part in the program for national defense. That program has its effect on our national economy, now and later. You and I are in duty bound to be concerned with a strong national credit defense in the interest of economic stability in the United States. Economic stability makes for national success.

SUPPLEMENTAL

Hypothetical Problems on Reserves

Let me go even beyond that and assume for the moment something that at the present time is not possible, namely, that the member banks withdraw all their deposits in gold. They cannot do that now, as you know, because of the law, but let's assume that they could.

There is sufficient gold at the present time to permit the member banks to withdraw their sixteen billion dollars of deposits in gold and still leave the Federal Reserve Banks with four billion dollars in gold, which is more than enough to provide the necessary legal reserve for the six billion dollars of currency outstanding in notes.

In other words, at the present time the Federal Reserve Banks could pay out all their deposit liabilities in gold and still have sufficient gold left to meet the legal gold requirement on their Federal Reserve notes.

But forget this situation for the moment, which is the result of very unusual conditions that brought to our shores and into the Federal Reserve System an unusual amount of gold which, in the Federal Reserve System, is represented by gold certificates, and let us go back to an ordinary situation. Ordinarily a withdrawal of all the deposits in gold would have reduced the Reserve Banks' reserve below the amount necessary to support their currency in circulation and would have made it necessary for the Federal Reserve Banks to liquidate some of their assets.

But, as you know, the Federal Reserve Banks have the power to create two kinds of liabilities: deposit and note. These are the two main channels between the outside world and the Federal Reserve System.

To keep these two channels open, the Federal Reserve Banks are required by law to have forty per cent gold reserves against their notes and thirty-five per cent reserves against their deposits and whether or not they would have enough gold to meet one liability in full and still have enough to meet the legal requirements against the other, would change from time to time. At the present time they could; at other times they could not. But I do want you to note that this does not mean that the Federal Reserve Banks are dependent on deposits. They can and always could meet the deposit withdrawals by paying out notes and it is only in a highly problematical situation where member banks were withdrawing all their deposits and furthermore were not willing to accept Federal Reserve notes that the lending power of the Federal Reserve System would be materially reduced.

But it may be said: "Did not the gold in the Federal Reserve Banks come from the member banks?" The answer is that in part it did, but in part it also came from the Treasury. Moreover the answer also is that had the member banks not deposited the gold there would have been nothing to prevent the Federal Reserve Banks from going into the market and buying the gold by issuing Federal Reserve notes. Whenever a Federal Reserve Bank bought one hundred dollars worth of gold and paid Federal Reserve notes for it, forty dollars of the gold would be required as reserve against the notes and there would be sixty dollars left on which another one hundred and seventy dollars worth of credit could be extended because of the thirty-five per cent reserve requirement against *deposit* liability in the Federal Reserve Banks. Therefore, so long as the Federal Reserve Banks have the power to create one of their two liabilities, deposits or notes, they are not dependent on either one of these two for their lending power.