

PROCEEDINGS OF A CONFERENCE WITH THE FEDERAL RESERVE BOARD OF
GOVERNORS AND CHAIRMEN AND FEDERAL RESERVE AGENTS
OF THE FEDERAL RESERVE BANKS.

ASSEMBLY ROOM
FEDERAL RESERVE BOARD
METROPOLITAN BANK BLDG.

WASHINGTON, D.C.

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SECOND DAY.

Washington, D. C.,

Friday, October 15, 1920.

11:30 o'clock A. M.

The Joint Conference of Federal Reserve Agents and Federal Reserve Bank Governors with the Federal Reserve Board resumed its session at 11:30 o'clock A. M., Governor W. P. G. Harding of the Federal Reserve Board presiding.

Appearances as heretofore noted.

Governor Harding. The next on the regular order of the topics is "Loans Secured by Liberty Bonds and Victory Notes." Under this topic there are Sections 1, 2, 3, 4 and 5, and the first is a paper by Governor Wellborn of Atlanta.

Governor Wellborn. Mr. Chairman and gentlemen, the first question for discussion - "Is there any moral obligation resting upon any of the Federal Reserve Banks to establish rates lower than commercial rates for paper

of this classification?"

I believe that there is a distinct moral obligation on the part of Federal Reserve Banks to carry for member banks Liberty and Victory Bonds that were subscribed for by such member banks during the campaign, as these bonds were taken by the member banks ~~under~~ high pressure from the Federal Reserve Bank of Atlanta and Government officials in order that their particular community might reach its quota.

These bonds that were actually subscribed for by member banks should be carried by the Federal Reserve Bank at as reasonable a discount rate as possible. The rate should be one quarter or one half above the rate of interest that the bonds bear in order to prevent speculation, but I believe the present rates on this class of paper to be a distinct burden on the member banks, inasmuch as the market values of the bonds are at present a great deal less than par, which represents to the member banks a potential loss, while not an actual loss. The subscribing banks are unable to sell the bonds without sustaining an actual loss, and being forced to hold them, are severely penalized by the present high rates of

interest.

The reasons given above apply only to member banks' direct notes secured by bonds actually owned by them. In the case of customers' notes secured by bonds, I do not think that the same moral obligations apply, as the purchasers of these bonds have had an opportunity during a very prosperous term of years to liquidate their indebtedness secured by Government bonds out of their profits and savings. The banks have not had this opportunity, as the bonds were not purchased by them as an investment in the first instance, but were purchased with the intention of passing them on to an ultimate investor, and on account of the shrinkage in the market, they have had no opportunity to pass them on to investors except at a loss. Moreover, the banks in our district have been called upon to extend unusual credits for commercial and producing purposes and therefore were unable to liquidate loans and absorb the bonds.

Demand deposits in banks, theoretically, should never be invested in long term Government securities or other securities, and the investments made by member banks in Government bonds were for purely patriotic motives,

with no intention or thought of retaining them as permanent investments.

The industrial purchaser of Government bonds, however, is an investor, and he should be required to pay for his investment out of his profits or savings and retire his obligations at the banks. Therefore, I believe that the rates of customers' notes secured by Liberty Bonds should remain at a high level, and such rate should be the same as the prevailing commercial paper rates.

Second question - "Would liquidation of loans of this class be retarded or promoted by the establishment of lower rates?"

In the case of member bank direct notes secured by bonds actually owned, I don't think that liquidation of such loan would be in any way affected by higher or lower rates, as member banks use their Liberty Bonds for borrowing purposes, principally because it is a simpler operation than rediscounting commercial paper.

In the case of customers' notes secured by Liberty Bonds, I am inclined to believe that a lower rate would retard liquidation of such loan and a higher rate would promote the liquidation.

Third question - "If lower rates are deemed desirable, would it be equitable and practicable to have such rates apply to original subscribers only?"

The lower rate should apply to member banks' direct notes only when bonds securing such notes were actually owned by the discounting bank prior to April 1, 1920.

I do not think it would be practicable to attempt to discriminate between bonds originally subscribed for and other bonds securing customers' notes. It would be a difficult problem to secure certificates as to ownership of these bonds, as it would cause a great deal of confusion and no particular aim would be attained, as the individual investor should be forced to pay for his bonds whether they represent original subscription or bonds later purchased on the open market.

Fourth question - "Should member banks' collateral notes be fully secured, taking market value instead of face value as a basis?"

The same moral obligation that applies in Question Number 1 applies to Question Number 4, in so far as Liberty and Victory Bonds actually owned by member banks, subscribed for by them during the Liberty Loan Cam-

paign, are concerned. I therefore believe that those banks which hold original bonds represented by original subscriptions should be permitted to borrow on these bonds from the Federal Reserve Banks at their par value.

However, customers' notes secured by Liberty Bonds should in all cases be margined on a basis of their market value.

Fifth question - "If so, how and when could the new policy be put into effect with a minimum of friction?"

If it is eventually decided that member banks' collateral notes shall be fully secured, taking market value as a basis, this new policy should not be put into effect until the present financial stringency has been relieved, which relief will not likely materialize until after January the first; and further, I believe that member banks should be given at least sixty days' notice within which to arrange their affairs.

Governor Harding. Before calling on Chairman Rich, I would like to state, in commenting on one particular phase of Governor Wellborn's paper, that Section 13 of the Federal Reserve Bank Act, in its original form, did not provide for any direct extension of credit to a

member bank, but merely permitted Federal Reserve Banks to rediscount eligible commercial and agricultural paper upon the indorsement of a member bank. In 1916, I believe it was, an amendment was made to Section 13, which provided for the discount by a Federal Reserve Bank of the direct obligations of a member bank, provided such notes running not longer than fifteen days were secured by notes, drafts and bills in themselves eligible, or by notes and bonds of the United States. Now, it seems to some of us here that it is inconsistent with the whole spirit of the Act that any credit should be extended by the Federal Reserve Bank directly to the member bank upon the member bank's own responsibility unsupported by collateral. I take it that there is no question but if a member bank should undertake to have a Federal Reserve Bank discount its note running not longer than fifteen days for \$100,000, and secured by, say, eighty five thousand dollars of Treasury Certificates, that the note would be turned down, for the reason that it is not sufficiently secured, that there would be an extension of fifteen thousand dollars to the bank upon its single name.

Mr. Williams. You mean bonds; you said certificates of indebtedness.

Governor Harding. Well, I mean what I said, Mr. Comptroller.

Mr. Williams. Would there be 15 per cent then there?

Governor Harding. All United States certificates of indebtedness are worth par. Suppose the bank offers its note for \$100,000 secured by only \$85,000.

Mr. Williams. Oh, I thought you said \$100,000.

Governor Harding. No, \$85,000 of Treasury Certificates of Indebtedness. If such an offer were made to a Federal Reserve Bank, the bank would say "You must put up additional security; we cannot take your straight note for \$15,000." What is the difference between taking an obligation of a member bank, a promissory note running not longer than fifteen days, for \$100,000 secured by \$100,000 of Liberty Bonds, if you know that the market value of those Liberty Bonds is only eighty-eight or eighty-nine thousand? There is clearly a difference of eleven or twelve thousand dollars there unsecured, which would be given to the bank upon its direct obligation. I think, though, this whole question

had better be discussed after we hear from Chairman Rich of Minneapolis, and then we can discuss the whole question altogether.

Governor Morris. How many banks are still accepting Liberty Bonds at par?

Governor Harding. I cannot answer that, if any. Suppose all that are hold up their hands.

(Four Governors held up their hands).

Governor Hamlin. I think it ought to be considered that the statute, Section 11-m, does recognize face value as against market value. I merely throw that out for the committee to consider.

Governor Harding. Chairman Rich of Minneapolis has the next paper on this subject.

Mr. Rich. I am suffering from a severe cold and with your permission I will ask Governor Young to read my paper.

Governor Harding. Governor Young?

(Governor Young thereupon read the paper referred to, which is as follows:)

TOPIC II--LOANS SECURED BY LIBERTY BONDS AND VICTORY NOTES.

The determination of the questions presented under

this heading must be controlled very largely by the decision of this body and the Federal Reserve Board upon the first point raised, namely, whether there is a moral obligation resting upon the Federal Reserve Banks to establish lower rates than commercial rates upon loans secured by paper of this classification. It may be argued with considerable force that owing to the method followed in placing the large volume of government securities, there is an obligation upon the Federal Reserve Banks, which were the distributing agencies, to recognize the fact that the sale of Liberty Bonds and Victory Notes was forced with considerably energy, and that they not only cultivated a disposition to buy, but used a certain amount of pressure in disposing of the allotments to the various districts during the five loans. If this creates a still existing moral obligation to recognize the low rate of return on government securities, it is pertinent to inquire why the discount rate on loans secured by paper of this classification should not be the rate borne by Liberty Bonds and Victory Notes rather than a comparatively small differential from the present high average level of discount rates.

It seems to me that we cannot recognize a moral obligation in part only. If the obligation exists, a small differential is not a satisfactory recognition of that fact. Purchasers who bought for patriotic reasons and from the reserve banks from which they are now borrowing, should not be penalized to the extent of the difference between Liberty Bond and Victory Note rates and the prevailing discount rates on this class of paper.

Before we accept this view it seems wise to recognize the fact that a period of time has elapsed since the Victory Loan which should be entirely sufficient to enable those who bought Liberty Bonds and notes of the last issue to save and pay up. A year and a half has now elapsed since the last loan, and this period will be lengthened out to nearly two years by the coming spring. The purposes for which banks used the proceeds of the rediscount of notes secured by paper of this classification should also be considered. Our experience is that banks do not treat this paper differently than other eligible paper, but the proceeds enter into agricultural, commercial and industrial operations the

same as the proceeds of the discount of other eligible notes.

After recognizing these facts, it seems fair to assume that there was a moral obligation resting upon the Federal Reserve Banks to treat loans secured by paper of this classification with consideration during the period when the public was saving and paying up its purchases of these government obligations, but that period of time has been sufficient to complete this process. It follows that Liberty Bonds and Victory Notes have from the standpoint of rediscount at the Federal Reserve Banks practically the same standing as any other collateral.

I am of the opinion that a differential is not justifiable, and that the time has come when the Reserve Bank should consider the establishment of discount rates on notes secured by paper of this classification at the same level as other discount rates.

In regard to the second point raised, I am of the opinion that liquidation of loans of this class would not be promoted by the establishment of lower rates. It seems obvious that concessions made on Liberty Bonds and Victory Notes would encourage bankers to increase

the volume of loans secured by paper of this classification rather than to reduce it.

Upon the third point, our officers are of the opinion that it is not practicable to establish a low rate for the benefit of original subscribers only, since our policy was to discourage investments by banks in Liberty Bonds and to urge them to pass the bonds on to their customers and avoid large holdings for their own account. In our district there is no method of separating purchases made for the bank and the bank's purchases for its customers. Our records show the aggregate subscriptions, which included those of the bank and its customers, and any effort to determine the amount actually taken by the bank itself would be impracticable because of the large amount of investigation and inquiry required.

The Federal Reserve Bank of Minneapolis has for many months past felt that member banks collateral notes should be fully secured and our practice has been to take the market rather than the face value in determining this point. In view of the present Liberty Bond market and the considerations to which I have referred, I do not

believe we would be justified in accepting the face value as a basis.

The above remarks are submitted with some additional considerations in mind. We anticipate in the course of the next six months some relief from the present strain on credit, at least so far as our district is concerned. It may be possible in the spring to reduce to some extent our present high discount rates. Paper secured by Liberty Bonds and Victory Notes now enjoys an advantage over other paper and takes a 6 per cent rate as compared with a 7 per cent rate for other paper. Should it be possible in the spring to reduce the present 7 per cent rate to 6 per cent, we feel that the present 6 per cent rate on paper secured by obligations of this classification should be allowed to stand. This would place member banks' collateral notes with this security on the same basis as other paper. When we arrive at this point, we have discussed a great many times the advisability of making some change in our discount rate policy. We are considering whether it would be practicable to have one rate with no differentials except those based on maturities. As an example, the discount rate for

90-day maturities on all classes of paper might be 6 per cent, with an advantage of one quarter of one per cent for 30-day maturities. This would make the 30-day rate 5-1/2 per cent, the 60-day rate 5-3/4 per cent, and the 90-day to six months rate 6 per cent.

Now that we are reaching a time when the operations of the Federal Reserve Banks are no longer affected by the moral obligation of granting low discount rates to assist in the absorption by the public of a large volume of government securities, it seems to us that there might be very practical advantages in establishing this simpler and more easily understood basis for our discount rates, and in recognizing the fact that to a very considerable extent the differential in favor of member banks' notes secured by government obligations simply represents an additional profit to the discounting bank and no advantage to the public, since the proceeds of the rediscount are used in our district for the same purposes as the proceeds of the rediscount of any other eligible paper which takes a high rate.

Governor Harding. Section 11-m reads as follows:

"Upon the affirmative vote of not less than five of

its members, the Federal Reserve Board shall have power to permit Federal Reserve Banks to discount for any member bank notes, drafts or bills of exchange bearing the signature or indorsement of any one borrower in excess of the amount permitted by Section 9 and Section 13 of this Act, but in no case to exceed twenty per centum of the member bank's capital and surplus: Provided, however, that all such notes, drafts, or bills of exchange discounted for any member bank in excess of the amount permitted under such sections shall be secured by not less than a like face amount of bonds or notes of the United States issued since April twenty-fourth, nineteen hundred and seventeen, or certificates of indebtedness of the United States: Provided further, That the provisions of this subsection (m) shall not be operative after December thirty-first, nineteen hundred and twenty."

Schedule A of the War Revenue Act, Stamp Taxes, goes on to say:

"This subdivision shall not apply to a promissory note secured by the pledge of bonds or obligations of the United States issued after April 24, 1917, or secured by the pledge of a promissory note which itself is se-

cured by the pledge of such bonds or obligations: Provided, That in either case the par value of such bonds or obligations shall be not less than the amount of such note."

You will observe that in each case the words "not less" are used, and in Section 5200, where the Comptroller is authorized, with the approval of the Secretary of the Treasury, to extend the loan, the words "not less" also occur--"not less than face value."

Those words "not less" would indicate that there is some discretion. Now, it is possible that some of these bonds may go to a premium. If our bonds were offered to you, issued since April 24, 1917, and were worth 105, you would still under this Act be obliged to have the face value in any event, no matter how high the premium, as you can take those bonds as security only at their face value, if the words "not less" are to control. Under the present circumstances, no matter how the question may be determined, I think everybody would be obliged to agree that it is a matter of discretion, that you are not compelled to take them at the face value, but that you must have not less than face

value.

Mr. Hardy. With the permission of the Federal Reserve Board.

Governor Harding. Yes. These topics are open for discussion.

Mr. Wills. I would like to ask a question about the moral obligations existing between the Federal Reserve Banks and the member banks, on account of the purchase by the member banks of these bonds for their own account. If you go one step down, corporations were purchasers of bonds instead of individuals, and were induced by the member banks to buy these bonds during the campaign. It is the same obligation existing between the member bank and the corporation that carries them at rates that are not losing them any money.

Governor Wellborn. I think there is a difference. I think the corporations and the individuals and the firms who have purchased these bonds, they have had opportunity to liquidate in the course of their business. They did not have obligations on them to extend the credit like banks have had.

Mr. Wills. They are not savers and investors in

bonds like individuals. They bought those bonds for patriotic reasons, and under pressure.

Governor Wellborn. But in the course of their business they have had opportunity, most of them, to liquidate, and banks have not. Banks have obligations, and they have had to extend the credit in a number of ways, where individuals and corporations should use their own discretion about their funds, whereas banks could not; they had to go ahead and extend these accommodations.

Governor Harding. If I understood you correctly, Governor Wellborn, you said in your opinion any bank should be extended a preferential rate on governmental obligations, Liberty Bonds or Victory Notes, acquired by it prior to April 1, 1920.

Governor Wellborn. Yes sir.

Governor Harding. Now, the last government flotation was in May, 1919. Why should a bank that bought bonds as an investment on the open market be given a special rate? There is no patriotic obligation there.

Governor Wellborn. We speak of April 1 because bonds did not begin to go down until that time, and they were not dealt in very much on the market, and people

did not buy them for speculation. We just fixed that date because after that time bonds went down and there was an incentive for banks to buy in the open market in order to speculate in the bonds.

Mr. Perrin. Mr. Chairman, the sense in which the term "patriotism" is used, I take it to mean the willingness to incur a sacrifice. I would like to raise the question of the extent of the sacrifice incurred where any bank buys bonds and passes that sacrifice on to the Federal Reserve Bank, and the bank, let us assume, by reason of the continuing consideration of the Federal Reserve Bank, carries the obligation to maturity and has it paid at par. Just what is the extent of the patriotic sacrifice?

Governor Harding. Governor Norris, what is your view as to the difference between subscribing member banks and subscribing individuals and corporations for these bonds?

Governor Norris. I was inclined to ask Governor Wellborn the same question that I asked Mr. Martin day before yesterday, on what ground you can base a discrimination in favor of a bank as against an individual. I

understand that the reason that is assigned is that the individual is supposed at least to have had an opportunity to liquidate, out of profits or otherwise, which a bank has not had. Now, a very large proportion of the bonds in our district are being carried by two large railroad corporations. They have had no possible opportunity to liquidate. As a matter of fact, I understand that one of them wanted to liquidate and take its loss before the termination of the period of government guarantee, and was refused permission.

The only reason that has been assigned up to date, certainly those railroad companies are even more entitled than any bank to have preference in their favor; I do not see where you can draw the line. There no doubt are individuals who have had the opportunity to liquidate or to pay up. There unquestionably are others who have had even less opportunity than a good many banks, who have been making large profits and declaring large dividends.

Governor Van Landt. It appears to me that the profits which banks almost without exception have been able to make by reason of war conditions have given them

just as much opportunity to charge those bonds down, and have had a very favorable opportunity to find a market and dispose of them, much more so than individuals or even corporations have had. Therefore, in my opinion, the bank is not any more entitled to preferential consideration on account of its ownership of bonds, even though patriotically subscribed for, than have individuals.

Mr. Williams. Mr. Chairman, with regard to Mr. Perrin's suggestion that we are passing on the sacrifice to the bank, I do not quite see it that way. The bank is not asking the Federal Reserve Bank to take the funds off of their hands at cost. They are simply asking, in view of the conditions connected with their original purchase and the fact that they are suffering very heavy depreciation, that they should allow them some consideration in the matter of interest, and the loss which they fear to face inevitably should not be increased by the carrying charges. They are not asking the bank to pay a part of their cost at all.

Mr. Perrin. May I make this suggestion in that connection? Would not the bank justify its claim of pa-

triotic action if it sacrifices the profit that it would make lending at 8 per cent, for instance, instead of accepting $4\frac{1}{4}$, if it buys one hundred thousand dollars of bonds and says "We are patriotic enough to buy these bonds and carry them, and we will content ourselves with $4\frac{1}{4}$ per cent interest upon that part of our investment; that if we had not bought these bonds we would have been able to lend that one hundred thousand dollars at eight per cent and thus would have secured $3\frac{3}{4}$ per cent additional to the $4\frac{1}{4}$ per cent which we are now getting" with what justice could it go to the Federal Reserve Bank and say "We therefore wish you to carry these bonds at $4\frac{1}{4}$ or $4\frac{3}{4}$, or some rate lower than the market price, in order that we might not suffer by reason of our patriotic impulse, but may make the same profit, the same as if we had not subscribed for the bonds."

I believe that while it is desirable for the Federal Reserve Banks to do everything possible to facilitate the financing of the war, everything within a reasonable limit, perhaps even beyond reasonable limits, that the Federal Reserve Bank may not justly be called upon to make good the mistakes of judgment ^{even} of those who

have bought bonds under patriotic impulse; that each individual corporation and bank must within reasonable limits face the consequences of its own acts. I believe that after eighteen months have elapsed, the time when special consideration should be extended to buyers of Liberty Bonds has gone by, and I believe that in a situation of this kind Federal Reserve Banks are called upon to see that they themselves keep their affairs in a sound condition, and it is not a sound condition, in my judgment, when they are lending one hundred dollars upon ninety dollars of collateral.

Governor Wellborn. Mr. Chairman, I intended to say that the views expressed by me were based on conditions in my own district. I do not care to go further into the matter.

Governor Harding. Governor Morss, will you favor us with your views?

Governor Morss. We had already experienced in our district the same thing which has been expressed by Mr. Rich. We made the effort in every loan to prevent our bank from subscribing directly for bonds, because we told them that those bonds must be subscribed for by

individuals or corporations. Of course, we did not succeed entirely in keeping our subscriptions from the banks themselves; in fact, a good many of them cropped up. We have felt, though, that the time had not gone sufficiently long to allow the banks, the corporations or the individuals either to have saved their income and paid for their bonds, or to have liquidated. A great many people sold their bonds out at a loss, and took their loss, saying that was the price of their subscription, and they were willing to give it. We now have a condition where we do give a lower rate on loans secured by Liberty Bonds. I think the time is fast passing away when that can be done, and that before a great while there will be no injustice done to raise our rates on loans secured by Liberty Bonds to the same rates as now prevail on notes or commercial paper.

Mr. Hardy. Mr. Chairman, speaking for the policy of the Richmond bank, our management studiously viewed and refrained from giving their pledge as to the extent, the time, or the rate at which they would carry government bonds, and while banks were urged to subscribe liberally, and some of those who had no authority to give

such assurances they have gone beyond a reasonable limit in soliciting subscriptions, the management has refrained especially from making itself responsible in any way for any such assurances, and we have felt long ago that our moral obligation as to carrying the bonds at a preferential rate or at any particular margin had expired, and that the conditions existing this year have brought us face to face with the necessity for handling the question purely on a business basis, and for that reason we abolished the preferential rate on securities, figured the volume of those loans as a part of the basic line, and applied the requirement for a satisfactory margin on the bonds. We never urged anybody to sell their bonds, and replied specifically to any communications to that effect that we did not urge them to sell their bonds. We never put any pressure on a bank or urged them in any way, or an individual, to sell their bonds, but it was a matter that they must decide for themselves. Unquestionably, the policy which we felt called upon to pursue, in order to limit our credit, so that we could meet the agricultural demands on us, probably led quite a number of holders of bonds to dispose of them. The

losses which they must have sustained, as Mr. Perrin expressed yesterday, was their contribution on the score of patriotism, but we have handled the matter strictly as we supposed on a business basis, and we felt in doing so we were not doing any one an injustice.

Mr. Williams. I feel a great deal of sympathy for the views expressed by Governor Wellborn. Say, for example, the First National Bank of Savannah subscribed to ten million dollars of Liberty Bonds at par, and has not sold them, and is still carrying them with the Federal Reserve Bank of Atlanta; that bank faces a loss of a million and a quarter, or a million dollars. It does not ask anybody in the government to share that loss. It is perfectly willing to make that sacrifice, to contribute that million dollars, but it does say that "We do not think that you should add to this loss by exacting an additional, say, 1-3/4 per cent per annum, or \$175,000 more a year, while we are carrying these bonds." That \$175,000 which the First National Bank of Savannah wishes to avoid incurring would simply be a reduction of the profits of the Federal

Reserve Bank of Atlanta. Nobody is called upon to make good that loss. This money which, if it is chargeable to the First National Bank of Savannah, goes against their profit and loss, \$175,000 a year, simply goes to swell the profits of the Federal Reserve Banks, and is turned into the government treasury.

Governor Harding. May I ask where the loss comes in if the Federal Reserve Bank of Atlanta should carry that loan until the bonds reached par, and carry that loan all the time at a low rate?

Mr. Williams. If it reaches par, as I believe it will, there will be no loss, but if the bank were required to sell the bonds, it would sustain a loss. I agree with Governor Harding, with what I understand to be his views, that the banks should not be expected to loan on these bonds more than their par value. I entirely agree with that point of view. I think that the First National Bank of Savannah should be required to margin its bonds down to their par value. I entirely agree with that point of view. I think it is entirely unjustifiable for it to be carrying 15 per cent without any security or collateral.

Mr. Hardy. We had a case where a bank got very patriotic and wanted to subscribe for ten million dollars' worth of certificates, and we declined to receive their subscription, and told them very frankly that we thought that they were making a mistake, that the time would come when they would need an unusual amount of collateral, and the subscription was finally cut down to two and one half millions, and it was not very long before we had to carry it, and the bank was very much relieved when these certificates matured, and if their subscription had been ten millions, I venture to say that I think we would have declined to allow it.

Mr. Seay. It is very well to say that at the time they were trying to make that subscription, they were excessive borrowers and we knew positively that they would have to rely upon us to carry them.

Mr. Jay. May I ask, for the information of those who have not a uniform rate on bonds and commercial paper, what the effect of making uniform those two rates in the Richmond bank was? Did it decrease the amount of government loans promptly or materially?

Mr. Seay. Quite promptly and also materially. There

was a time when 70 per cent--I mean to say there was a time when the aggregate of the loans of all the Federal Reserve Banks was about 50 per cent, and the loans of the Federal Reserve Bank of Richmond on such loans was 70 per cent, and they have now been reduced below 50 per cent, and they have been also reduced very materially in amount. They might, of course, be reduced to 50 per cent by the increase in commercial loans, but they have been decreased in amount, to a very material extent.

Mr. Jay. Was that by sale or by their merely substituting some other collateral?

Mr. Seay. We are unable to determine. We think in some cases it was by sale, but we are unable to determine. That means loans directed to the bank and loans upon paper of the bank's customers secured by government loans. We are satisfied that a great deal of the paper was taken up by the purchasers of the bonds in the ordinary course of the receipt of their income. That was intended. We believe that the bulk of the reduction in the loans against Government securities has been due to the absorption by the investor. We think that the majority of the loans we now have are loans made directly to the banks on

their own security.

Mr. Jay. Did the banks, upon you raising that rate to 6 per cent, raise their rate proportionately and make the public bear the additional expense.

Mr. Seay. Yes, they did. To the best of our knowledge, they raised their own rates under all circumstances.

Mr. Miller. I think we should get a principle out of the discussion of this topic. To my mind it presents this question at this time, whether a bank has bonds which it has bought originally on subscription and which it cannot liquidate without loss, shall be entitled to preferential treatment at a reserve bank. A question of principle ought never to be settled by reference to exceptional or isolated cases. If we are going to bank on the reserve system, on the basis of not injuring some one, we are going to bank on the basis of injuring the more in order to protect the few.

There is an aspect of this thing that has been overlooked that at this time is very important. We have been listening during the last few days to the lamentations of representatives of the great farming sections

of the country who come before the Board asking that they shall get such credit as they want in order to permit them to liquidate their commodities without loss, and in some cases they have gone so far as to ask a preferential rate in order that they may be able to liquidate their products without loss. Wherein do the two cases differ, except that the one is a banker and the other is a farmer? In my opinion it is preferential treatment that we are giving to bankers under the guise of patriotism, and let me say parenthetically, I think the time has long since passed when we ought to dispense with the subject of patriotism in reserve banking, but if you are going to talk in the terms of patriotism, where is there a ^{more} patriotic obligation resting upon us to buy a bond that there is upon a farmer who planted the crop, largely under the impulse and the doctrine that starvation would impend in the world unless he did? I am opposed to preferential treatment of anybody at a Reserve Bank, except that the preferential treatment is warranted from an economical point of view. If the charge of profiteering can rest against the Federal Reserve Bank System in any par-

ticular, it is right at this point where these people who nominate the directors of these banks and who do a great deal to create the atmosphere in which these banks are administered are the preferential customers of those Reserve Bank customers and facilities. In my judgment, the time has long since passed when any such concession to banking should be made by the authorities of the Federal Reserve System.

I want to say in behalf of Governor Wellborn's proposition, that it has the merit of consistency. They want low rates and easy money on both classes of paper, in order that cotton shall be carried to what they regard as par, as well as Liberty Bonds.

Governor Harding. Is there any further discussion? (after a pause). Then we will pass on to the next topic, Federal Reserve Note Issues. The first paper is by Mr. Jay of New York.

Mr. Jay. I regret to say that I have not been able to confine the study of the very comprehensive program on this subject which the Board proposed and which was assigned to Governor Morss and me to within the fifteen-minute period. I regret to suffer the

consequences of my sins, but I think I had better turn in my paper to be printed in the record.

Governor Harding. I think we might start your paper, and if there is a general sentiment that you should stop, I will not be mealy-mouthed about it, and will let you know.

Mr. Jay. It will take forty minutes, perhaps.

Governor Morris. Cannot you tell us what is in it and let us discuss it?

Mr. Jay. I cannot very well do that. I tried to see if I could not cut it down and I could not do so very satisfactorily.

Governor Harding. What is the pleasure of the Conference with regard to the matter?

Mr. Perrin. Just a word of explanation. Mr. Jay, I gathered from a conversation with him this morning, has made a very complete review of the European practices in the matter of note issues, in Great Britain particularly.

Governor Harding. Could not you state your conclusions, Mr. Jay?

Mr. Jay. Yes: Do not do anything about it.

Governor Harding. Then I presume I will have to

call on Governor Morss for his statement.

Governor Morss. I may say that I have not gone into it as extensively as Mr. Jay has done and I hope what I have to say will be gotten through in the time limit.

I find the subject of Federal Reserve note issues which has been assigned to me is a very interesting and difficult subject and one which would take a great deal of time to follow out in all its lines of thought. In this paper I can only touch on some of the points that seem to me to be the most important ones. I do not pretend that the paper which I now read is entirely the result of my own work; I have called for help on everybody whom I thought would be able to give me any information on the subject.

All of the principal banking systems of the world maintain a convertible paper currency and have attempted to limit the amount of credit which they extend, both by the discount rate which is placed in the control of a Board of Directors to be used at their discretion and by some sort of legal limit beyond which a bank can not extend credit. In some cases the main effort has

been placed on the control of the issue of currency, and in others it has been placed on the amount of credit which could be extended through bank loans.

The Bank of England is an example of the legal control of credit through a strict limit of the issue of currency. This worked well with a few exceptions for many years until the war came on, when the gold in circulation disappeared and there became an absolute need for more paper currency. Instead, however, of the Bank of England issuing more of its own notes, the English Government issued Treasury Notes practically without gold cover.

In the Bank of France there was a legal limit to the issue of notes which has always been kept with a very liberal margin for present necessities, and has been raised promptly whenever there was cause for more notes than the limit allowed. During the war there has been practically no limit, as I understand it.

The Reichsbank of Berlin had no legal limit to credit or notes but was obliged to pay a tax on notes issued beyond a given limit. When necessity arose for the issue of an amount of notes subject to the tax,

the Reichsbank absorbed the charge itself, and during the war I suppose there was practically no limit.

The Federal Reserve System controls its issue of credit and notes by a legal minimum of reserve for the member banks and also for the Federal Reserve Banks.

All of these systems, except the Federal Reserve System, while working well under normal conditions, have broken down under the strain of war conditions. The Federal Reserve Banks have been able to maintain a gold basis, but their reserve went from 84 per cent to about 50 per cent during the two years in which the five Liberty and Victory Loans were placed, and in all probability the Federal Reserve Board would have been obliged to waive the legal limit for reserve had the war continued long enough.

The Federal Reserve System was the last one established of the great systems referred to, and has had a most strenuous and interesting experience, and it is the one about which we are most concerned. It depends for its control of credit on the authority over discount rates and the making of loans vest in the Federal Reserve Board and the Directors of the Federal Reserve Banks, and also on the required legal reserves of the member banks and

the Federal Reserve Banks.

At the end of the war there was a general dread that when the soldiers and sailors were demobilized they would not find sufficient work to support them and that it would be necessary to encourage business in every way so that there might not be unemployment and distress. As a matter of fact, however, business began to boom in the spring of 1919 because there was at that time a shortage of goods and increase of prices that followed was made possible by the fact of the easy condition of the Federal Reserve Banks. This boom continued with increasing intensity and increasing prices and made heavy demands on the commercial banks of the country and on the Federal Reserve Banks. The result was a severe decline in the reserve position of the Federal Reserve Banks, and no serious effort was made to check this decline until discount rates were raised about January 1, 1920, when the reserve position of the Federal Reserve System had fallen to within a few points of the legal limit. In March, 1920, the average reserve had fallen to about 42-1/2 per cent within about five points of the required legal reserve.

One of the results of the increase in loans was a large increase in the amount of Federal Reserve notes outstanding, and this situation has raised the question whether the Federal Reserve Board should use the authority which it has under the law, to in some way limit the amount of notes which the Federal Reserve Banks may issue.

To my mind, the real question is whether a further limit should be placed on the total amount of credit which may be extended by the Federal Reserve Banks, and if it is desirable to limit that credit, whether the form it should take would be in the limit of deposits or the limit of the issue of Federal Reserve notes. In discussing this question, the first point is whether there is an ultimate limit of credit and notes that it is possible to issue, and the second point is whether there is any ratio between the amount of credit and notes that will be taken by the banks inside that limit.

As to the first point, there is a limit so long as no reduction is made of the reserves below the legal reserve. This limit would depend on the amount of gold held in the system and would vary only as that amount of gold was increased or decreased through transactions with foreign

countries.

On the second point I have supposed that it would be possible to go to the bank statements and from them establish a ratio between the amount of loans taken in notes and the amount taken in deposit credit. I have been unable to do this for the reasons that the making of loans and the issue of notes are not necessarily simultaneous operations and the demand for notes varies greatly under different circumstances and in different districts. Figures have been made which apparently show that approximately three fourths of the loans of the Federal Reserve Banks in normal times are taken in currency and that the other fourth is used as a reserve deposit on which the deposits of the member banks are multiplied between nine and ten times or to the limit that the reserve requirements allow. Whether or not there is any ratio that can be established it seems to me that the control of the total amount of the credit extended by the Federal Reserve Banks must control the amount of notes which can be issued within the limit that it is desirable to control them.

The question then arises, in what ways can the issue of credit be further restricted through the restriction

of loans? One way is to eliminate all preferential rates, whether on loans secured by government obligations or in the prices made for the purchase of acceptances in the open market, leaving the rates on acceptances to be controlled by the investment market rates rather than rates established by the Federal Reserve Banks and by raising the discount rates on loans secured by Government obligations at least as high as the rates on commercial paper, or perhaps higher.

Another way to control the amount of loans would be to raise the legal limit of the reserve ratios, and this may be a very necessary and desirable method to employ. I believe this would be effective, because the banks of the country are accustomed to a legal limit of reserve, are in the habit of making loans up to a legal limit, and when that limit is reached they accept that as a good and sufficient reason for limiting loans.

On the other hand, if the Federal Reserve Banks should attempt to keep a reserve position of say ten or twenty per cent above the legal limit, they might meet such opposition from public opinion that they would be unable to maintain such rates.

If the restriction on credit is to be obtained through

the issuing of Federal Reserve notes, the way to accomplish this is perfectly obvious--fix an arbitrary limit to the total amount of notes which may be issued and when Federal Reserve Banks are required to pay balances beyond this amount, pay them in gold or legal currency.

The suggestion has been made that if it were desirable to issue notes beyond such legal limit, gold should be put in reserve against these notes dollar for dollar. This would accomplish the same result as the former method and would keep the gold in possession of the Federal Reserve Banks. Both of these methods, when the demand for notes was large, would reduce the loaning power of the Federal Reserve Banks very rapidly.

I am myself inclined to the opinion that it would leave the Federal Reserve Banks in better position for possible necessary expansion or emergency to limit the amount of credit and notes through control of credit rather than through an arbitrary control of note issues. It may be that I arrive at this conclusion because I believe that about all of the gold that is available for bank reserves or for use as money has been gathered into the central banks of the world and that it seems to be absolutely necessary to furnish paper money because gold

money is no longer available.

I shall now take up the questions proposed by the Board and my answers to those questions will be based on the above statement.

1. Is the note-issue policy of the Federal Reserve System subject to legitimate criticism?

No. The criticism should be based on the total amount of credit that is issued, and not on the notes.

2. What connection is there between changes in the volume of credit and the volume of currency?

This is very hard to determine, but probably it will be found in normal times that about three fourths of the loans to member banks are taken in currency and one quarter in deposits.

3. Is there any difference in relation to effect upon price between the volume of credit and the volume of currency?

In my opinion no. Increasing loans will support increasing prices, and higher prices require more currency.

4. Can the note-issue policy of the Federal Reserve System be properly charged with any important responsibility for inflated prices? If so, what has been the responsi-

bility, and in what way does the issue of Federal Reserve notes promote or assist inflation?

I believe that the reserve position of the Federal Reserve Banks in the early spring of 1919 made large increases of prices possible, and I should put the emphasis on the amount of credit issued and not on the notes.

5. Can the accepted principles of bank-note currency regulation, applicable in normal circumstances when the commerce of the world is conducted on a gold standard, be safely taken as a guide in the abnormal circumstances now existing, when the gold standard is virtually suspended, except in the United States and Japan?

The accepted principles of bank note circulation certainly do not work today between nations when there is an embargo on the shipment of gold in most of the commercial nations of the world. It might work out between Federal Reserve Banks within the Federal Reserve System, but in order for it to do so I believe it would be necessary to abandon the policy of requiring Federal Reserve Banks to borrow of other Federal Reserve Banks in order to maintain a minimum of actual reserve. Also, I believe it would be necessary to impose a penalty on a Federal

Reserve Bank as soon as it was below its legal reserve and it would also be a necessity to devise a method by which this penalty should be immediately transmitted to the member banks and to the commercial community in the district where the reserve was deficient. I must confess, however, that I do not feel qualified to express a positive opinion on such an intricate subject.

6. In connection with the policy of credit control should the present note-issue policy of the Federal Reserve System be changed and restrictions be thrown around the issue of Federal Reserve notes?

It may be wise to put restrictions on total amount of credit, but not on the notes.

7. If the issue of Federal Reserve notes should be restricted, what form should the restriction take and what effect would different methods of restriction have?

(a). Imposition of charges against Federal Reserve notes upon the uncovered part of circulation issued to them at a given rate, for example, a fixed rate of 5 per cent or a rate varying with the commercial rate.

Imposition of charges against issues of Federal Reserve notes on the Federal Reserve Banks would be in-

effective unless this charge could be transmitted to the loan of the member banks, and I have been unable to think up any practical method by which this could be done.

(b). Would it be practicable to establish for each member bank a so-called normal currency list and to impose charges on member banks calling for notes in excess of their limit?

It would be utterly impractical to establish a normal amount of currency allotted to each member bank. Circumstances vary with each member bank, and it is impossible to establish a basis of how much each bank should have. Further, if some method was adopted, a bank that had not reached its limit and did not require it, might sell its surplus of currency to another bank and possibly at a premium.

(c). Would it be advisable while continuing to have the Federal Reserve Banks pay all transportation charges on incoming currency to have shipments of outgoing currency made at the expense of the consignees?

No. Because transfer charges are paid both ways, banks ship currency freely to the Federal Reserve Banks, and this keeps outstanding notes down to a minimum so far

as the banks are concerned. If transportation charges were made against shipments to them, they would not return currency as freely as they do now.

(d). Restriction by definition of the character of the paper acceptable as collateral by the Federal Reserve Agent against the issue of Federal Reserve notes. Should member banks' collateral notes or customers' notes secured by Government obligations be taken as collateral for Federal Reserve notes?

If the character of collateral against which Federal Reserve Agents could issue Federal Reserve notes were restricted, it would no doubt restrict the issue of notes unless there was a sufficient amount of acceptable collateral for all the notes that were needed. I should doubt the wisdom of refusing notes secured by Government obligations as collateral for Federal Reserve notes at the present time. Before that was done I should prefer to raise the discount rates on notes secured by Government obligations above the rate of discount of commercial paper.

(e). Limitation of the total volume of Federal Reserve notes by the Federal Reserve Board, the maximum

amount being fixed pro rata for each Federal Reserve Bank. (The Federal Reserve Board has statutory power to accept in part or to reject entirely all applications for Federal Reserve notes.)

Impractical to limit the amount of notes issued to each Federal Reserve Bank. The same objection could apply as restrictions on member banks.

3. Would restriction of note issues in any of the above mentioned ways operate to promote a better control of credit, and if so, what would be the effect upon the commerce and business of the country?

The answer to this question is included in the statement that I made in the beginning of the paper. It is a common and interesting study how far a basis of commodity prices can be maintained, fluctuating only between narrow limits, by regulating the supply of credit. This seems to have been fairly well accomplished by the use of the discount rates by the Bank of England and other Central Banks of the world for many years before the war. The discount rates ceased being effective during the war. Probably it can not be done again for many years and not until the finances of the nations of the world are again

placed on a stable basis.

Governor Harding. Mr. Jay, you will leave your paper to be incorporated into the record, please. Governor Morss's paper now is open for discussion.

Mr. Wills. Mr. Chairman, I would like to ask a question, whether the members of the Conference think the time has arrived for the Board to set a date, for instance, when government-secured paper would not be eligible as security for Federal Reserve notes.

Mr. Curtiss. I think that Governor Morss's suggestion was to raise the rates.

Mr. Jay. I hope the Board will never take such action as that. It seems to me to be a great slap at government security to say that they should never be used as collateral for Federal Reserve notes. The matter can be dealt with through the discount rate. If you were to raise the rate for government securities above the rate for commercial paper, they would all get out of the Federal Reserve system over night. It would not affect the banking system in the slightest. We would simply have a different set of collateral presented to the Federal Reserve Banks. It would be, it

seems to me, a tremendous discrimination and a most unfortunate discrimination against government bonds. We recognize that the Federal Reserve System was established to get away from a bond-secured currency, and under the Act we planned to gradually eliminate the National Bank bond-secured currency and substitute Federal reserve-secured currency for it, but one of the reasons we wanted to do that was because the National Bank currency was absolutely inelastic; there was no way of increasing it, and the legal restrictions tended to restrict its contraction, but with the Federal Reserve notes issued against government paper no such condition applies. The Federal Reserve Banks do not have to buy government bonds in order in order to these, as the National Banks have to do, and the bonds all come in bearing the indorsement in one form or another of a member bank. Most of them are very short loans, and there is just as complete flexibility of Federal Reserve notes with government security as collateral as is with commercial paper as collateral.

It seems to me that the way to deal with the government bond situation, when the proper time comes,---and I

certainly believe it is coming fairly soon--is to do away with the preferential rate on government bonds, then let the banks put in what they want for their discount, but not to establish, at the present time at least, either by a discriminatory rate against the government bonds or by a ruling of the Federal Reserve Board that they may not be used as collateral for government notes. A state of mind with regard to them, a complete turn-about with regard to them, which seems to me would be very unfortunate.

Mr. Austin. I want to concur in what Mr. Jay says. I believe the reason government bonds are now largely securing our notes was that for a year or two the government was the largest factor in this country. It was a great borrower. As time goes on, those bonds will be retired and other business will gradually take the place of the notes. It seems to me it would be a very great discrimination against obligations of the government to say that they shall not be security for the notes, and I think, in looking over the situation in foreign countries, it will be found that what is behind the Bank of England's notes is government bonds, and the

same is true of the Bank of France.

Governor Harding. How do you feel on the proposition at the proper time of advancing the rate on government bonds to make it uniform with the commercial paper rate?

Mr. Austin. I think most of us have already adopted a rate on government bonds almost the same as the commercial rate. I think the time may come when the investment demand will absorb the amount of government bonds being offered for sale, and if you want to raise those rates and force government bonds on the market, you will depreciate their price.

Governor Harding. Personally I think we ought to try the uniform rate first, before we attempt to make any rule that they shall not be accepted as security for notes.

Mr. Curtiss. I do not agree at all with what Mr. Jay says. I feel that while it is not the time now to do away with loans secured by government bonds, my idea of the entire Federal Reserve System has been that the Federal Reserve Banks should really have nothing but self-liquidating notes, and short time notes. Your

commercial paper should all be short time; you have limited it in the act to ninety days; you cannot say that a long-time government bond is a self-liquidating collateral.

Governor Harding. Yet Section 13 exempts notes, drafts or bills covering investment securities.

Mr. McGord. That clause was put in Section 13, to my mind, on account of the government lending its credit to the banks by issuing the notes. One principle involved was that in times of war the banks come to the rescue of the government. In times of peace the government would have to come to the rescue of the banks. To absolutely eliminate government securities from the Federal Reserve agents' hands for notes might be disastrous.

Mr. Ramsey. I think the views of Mr. Jay, as applied to present conditions at least, are thoroughly sound. I understand the desire of all of our officials to have self-liquidating paper. I think it is greatly to be desired, and in the course of time will come about, and I shall feel it exceedingly unfortunate for any action to be taken on that question now, and I think any large discussion of it perhaps might have a bad effect. In

this connection I desire to be recorded also as saying that my own judgment is that the matter of rates, which is new, might well be held in abeyance until there is a large liquidation and until we can say in the events as they occur what is the wisest thing to do. That is my own judgment. The matter has frequently come before our Board, and in a general way at least that is a very prominent view held by the Board. It is a matter which we should hasten slowly, and I believe it among the possibilities--on the question of Federal control--that there may be very little occasion for any large increase in rates, but probably we shall have an occasion to equalize the rates. I think it would be unfortunate to do anything, especially in some of the states at least, on the question of rates at all, and certainly it would be unfortunate and I fear disastrous to take any action immediately towards retiring government-secured paper as security for Federal Reserve notes.

Governor Harding. I understand that the Chairmen and Governors have not finished their own separate deliberations. Would it be practicable to resume this joint meeting say at 4:30 this afternoon?

Mr. Ferrin. I think I can speak for the Federal Reserve Agents.

Governor Harding. What about the Governors?

Governor McDougal. That will be entirely satisfactory. There were three or four specific questions which the general conference referred to the Governors for consideration, all of which have been acted upon, and the action taken can be stated in a very few words, if you care to have it at this time, but we have finished that part of the program, or we can delay that until this afternoon.

Governor Harding. We have fifteen minutes to spare before lunch time.

Governor McDougal. This will take only a few moments.

Mr. Jay. May I say in that connection that those were the questions which were given to us yesterday morning?

Governor McDougal. They were, yes.

Mr. Jay. The Conference thought that it might be wisest to postpone the reaching of conclusions on those questions until after the papers were presented this morning, as both of them related to the topics discussed

this morning.

Governor Harding. I think the only question was whether it would be advisable to put a tentative limit on member bank borrowings.

Governor McDougal. I might say, in response to Mr. Jay, that we recognized that some of these subjects were to be dealt with through the papers, and our answer has been deferred, but others of the questions, two or three of them, have been answered. We can bring that up at the conference this afternoon, and I understand, Mr. Jay, that you will have your answers ready then?

Mr. Jay. That is the only question the Board wants answered, and we took action on that.

Mr. Miller. With regard to the matters brought up a while ago, unless silence be construed as consent, as Governor Hamlin has suggested to me it might, I want to say that I am distinctly of the opinion that, with reference to normal conditions which will some time be restored, even if not present immediately or in the near future, that makes the discussion of this whole question to a certain extent academic. I believe that there will never be an effective system of restrictive control in this

country with reference to the issue of Federal Reserve notes. Like Mr. Jay, it would take me too long to develop my views on the subject and the reasons which have led me to that conclusion, but if you will permit me, Governor Harding, some time during the winter I will prepare a memorandum, if it seems timely, for presentation at the next Conference, on this question, and that can serve at any rate as an indication of my attitude and the reasons that have produced it.

Governor Harding. Would not the control of credit through the limiting of Reserve Bank discount control the matter?

Mr. Miller. Undoubtedly, but I think it is really a question, when you get right down to it, of what does the experience of the last hundred years, and particularly of the last fifty or sixty years, show? More particularly with reference to banking and credit conditions as they are in our country, which always, except in periods of industrial depression, is under the support of expansion as between the German and French principle and the English principle. That is pretty much what it comes down to, and if I understood Governor Morss's paper and posi-

tion, that was implied.

In the light of experience, which one of those is likely to produce the best results in this country? I want to say right there that such a restriction as the English Banking Act imposes upon the Bank of England, such as the recent British Committee, of which Lord Cunliffe, Governor of the Bank of England, was Chairman, said that they wished to have the law continued to impose a restriction, and that they did not want this power in the matter of note issue. My view is that a restriction of note issues would go a long way toward preventing unnecessary inflation.

Governor Morss. Dr. Miller, it seems to me that other banks, whenever they needed any more currency, they have always waived the laws and made them quite ineffective.

Mr. Miller. Just exactly as in the case of England.

Mr. Morss. I understand they have waived the law in the banks of England today.

Governor Miller. In these abnormal conditions, which they recognize as abnormal. I think the question with us

is not what we are going to do in abnormal times, but what is the policy in normal times which we expect to follow in this country. Are we going to continue a policy which has grown out of the abnormal days as normal days restore themselves?

Governor Morss. I think I was influenced in that opinion, as I said, by the feeling that the amount of gold that is today available for monetary purposes is hardly equal to the burden that it has got. It certainly is not equal to it on the inflated basis, and it is no more equal to it on a normal basis. The gold has been more seriously and more completely gathered into the central reserve banks of the world since the war than ever before, and it is even so in England; that England to my mind was always the one country where you have got gold in your pocket. If you went to a bank and drew \$100.00 they would give you gold by preference. It was so more or less in the European countries.

Mr. Miller. But, pardon me. They had nothing else to give.

Governor Morss. Exactly; and therefore, if they did not have currency or paper money to give out, they had to

give out gold, and that is what we can do. If we want to adopt a policy of paying our balances beyond the amount of notes that we want issued, if we want to pay them in gold, we can do so, and that will limit it, and that is the only thing that will limit it effectively, in my opinion.

There is a question of whether you shall adopt that method, which would be very severe, or modify that by holding \$100.00 in gold against \$100.00 in notes beyond the limit. If you want to do that, you will accomplish your object, no question about it. The question is whether you had better adopt a method as severe as that. If you are at any time at a point of expansion beyond your note issues and you do not raise the limit, the Federal Reserve banks would pay out their gold to everybody who came for it. How difficult it would be to get it back into the reserves of the Federal Reserve Bank as it was needed is another matter. It did come back during the war quite thoroughly, but you can accept that issue and take that if you wish it. That is a matter of judgment and opinion, but that is the only way to limit your notes, and it would limit your loaning power very

radically as soon as you get beyond that limit of notes.

Mr. Miller. Now, it is worth noting that the Federal Reserve System, at least as the Act was originally drawn, assumes that there is another method than the English method on the one hand which definitely restricts the issue of notes and the impounding of an equivalent amount of gold, and the French or German methods, one of which fixes a statutory limit upon the total volume of circulation that the Bank of France can issue, and the other imposes a severe tax where the note issues exhibit a certain proportion to the reserves. What is that limit that the reserve bank imposes? I think we have forgotten it, and we have forgotten a great deal that is very peculiar and very characteristic of the Federal Reserve System. The note-issuing provision of the Act says that the Reserve Bank may apply to the Federal Reserve Agent for notes. The Reserve Bank is not a note-issuing bank. It is merely, if you please, an agency for the distribution of circulation. The agent transmits that application to the Federal Reserve Board, which under the Act is given not only the power to grant in whole or in part, and to reject altogether the applica-

tion--there is no limit upon its powers; it is not restricted to doing this for particular reasons and occasions; the Act might just as well have said the matter should be determined by the discretion of the Federal Reserve Board. Its judgment as to whether or not the business in any particular district or in the country at large requires that there should be an addition to the circulation, shall be conclusive in the premises. In other words, instead of the rigid limit set down by the Bank of England Act and the somewhat limit of the French Act, and the rather elastic limit of the German Act, we have substituted the discretion of the Federal Reserve Board, and as I view the Federal Reserve System and the peculiar relation to it of the Federal Reserve Board, I cannot help but believe that consciously or unconsciously in the minds of the framers of the Federal Reserve Act was the theory and the belief that the primary function of the Federal Reserve Board was to sit in judgment on this question as to how much currency the country needed.

It is worth recalling, Mr. Morss, that not since the Civil War has there been in any effective sense a system of unlimited note issues in this country, until we come

to the Federal Reserve System. It is to my mind very notable as indicating the attitude of the men who shaped our policies of financial restoration after the Civil War that until the resumption of specie payments was effected, there was a definite limit by states and sections of the country upon National Bank note issues. We did not really come to a system of National Bank note issues until we were in sight of the resumption of specie payments. There was a definite restriction there.

Now, we talk about convertible currency. You talk about it as a matter of law, and as a matter of fact the Federal Reserve note is convertible. As a matter of fact, however, as a matter of practice, to what extent are those notes returned for redemption in gold except from one Federal Reserve Bank to another? And why not? Because the gold standard is practically suspended in all the important countries with which we have commercial relations, except one, and the theory of a convertible bank note currency is that gold will regulate the country, so that if the general level of prices in any one country gets out of scale with the general world, that will show its gold will be taken from the country, and the ordinary

method employed will be to return notes for credit to the bank. That will ordinarily decrease the gold reserves of the bank, and the bank, in self-protection, then has got to put in all of the instrumentalities of control.

Now, the difference between our system and the English in this important particular is that the English system under normal conditions very much more quickly recognizes the fact that the currency is getting redundant, because the Bank of England note is tantamount to gold, and when gold is taken from London, just as so many sovereigns are taken out of circulation or so many Bank of England notes, which are the precise equivalent of sovereigns.

Mr. Perrin, in his opening address at the Conference a few days ago, made a very pertinent and pregnant remark as regards banking under the Federal Reserve Bank System, to wit, the disappearance of the reserve requirement, as that has been commonly understood, and the substitution therefor of the mere requirement for national banks and member banks of a cash balance on the books of the Federal Reserve Bank. No bank need ever be without

adequate reserve, provided it wants to pay the going rate of discount on the collateral it offers. Under the old conditions, the banker was always confronted with the possibility that he might not be able to discount his paper and provide currency to his customers, or maintain his legal resources when he ran close. There was, therefore, a so-called danger line in this country which warns the banker that he was getting too much. No banker who is a member of the Federal Reserve System need ever dread the possibility of being unable to lend to his customers, because he has not got an adequate reserve, but he can always build up his reserve.

Now, what have we done in the matter of cash? When we come to analyze the thing, not as a proposition of law, but as a proposition of operation, I do not think it is an extreme statement, Governor Morss, to say that under the Federal Reserve System every member bank in the country is a bank of issue. I have yet to hear of a member bank that wanted currency for any purpose to put *its* customers over a situation that it could not get it. All that it needs to do is to establish the necessary credit at the Reserve Bank and to check out that credit in currency.

Instead, therefore, of the Federal Reserve Board exercising the function which I believe is its most important statutory function and its most important responsibility under the law of determining whether or not more currency should issue, who does it? That member bank and its customers, and you get this peculiar anomaly under our system. We have twelve banks and none of these banks are issuing alone the obligations of the United States government. They circulate, because of that, and it is well to bear that in mind at this time, when the discussions around this table are bringing out that there may be differences in the strength and the solidarity of the different Reserve Banks, which are also the different issuing banks. These notes, should that difference ever really develop to a serious point, will circulate at par, only because, in addition to being the obligation of the issuing bank, they are also the obligation of the United States Government.

Now, what does that mean? It means that any Reserve Bank that over-expands the currency, expands it or inflates it, not only for its district, but wherever

its notes go--Cleveland may pursue a very conservative policy with reference to discounts and issues; Philadelphia or Atlanta may pursue a very liberal and careless policy with reference to issues and re-discounts, but the man who lives in Cleveland, because of the fluidity of his currency, will suffer just as much from any harmful effect that always follow an excessive volume of currency in the country, whether Cleveland issues a note or Philadelphia or San Francisco issues a note.

In brief, you have got a condition under which the people in a section of the country who are perfectly conservative and cautious, on account of credit and currency practices, may be victimized, just exactly as if the Bank of France notes circulated in England, and vice versa, or notes of the Bank of Germany, the Reichs bank notes, circulated freely about Europe. Those are national frontiers, but while we are all within the boundaries of the same nation, there are a good many economic frontiers in this country, and there are a great many differences in the varieties of the soundness of the currency and banking and credit practices in the different communities that make up what we call the American nation.

I am definitely of the opinion, Governor--pardon me, and I will stop very shortly--that if we go on with our practice of allowing this thing to go on, there is only one conclusion at which we will eventually arrive, and that is that the original reserve system has got to be converted into a central bank.

Governor Morss. Mr. Chairman, may I say just a few words? There is no question of the authority of the Federal Reserve Board to limit the issue of notes if it sees fit to do so, but that the opinion and the judgment of the Federal Reserve Board would be seriously questioned in case they did that I thoroughly believe. So that the Board has got that to consider, whether their judgment would be accepted. The Federal Reserve System has one point which is not in other systems, and that is the legal reserve. The Act says that the Federal Reserve Bank shall not issue credits or notes combined below that legal reserve.

Dr. Miller. Yes, but when you say--

Governor Morss (interposing). They have got to replenish it.

Dr. Miller. But it immediately says that the Board

has power to suspend the requirements.

Governor Morss. It has, but there is the obligation of the Board and the banks to maintain that limit except under most extraordinary circumstances.

Dr. Miller. I ask you as a matter of fact to what extent is that obligation being respected today?

Governor Morss. My experience in commercial banks was that while they had a limit of legal reserve, they always kept their loans so that they were right close down to that limit. My idea is that it is very possible that that idea has become prevalent amongst the banks in this country that the Federal Reserve Board will not be able to force up the reserve of the Federal Reserve Banks far above that legal limit, except in times of great depression, when it would go up itself, and therefore I made the suggestion that it might be wise to raise that legal limit, if you thought there were credits being given out that ought ^{not} to be given out. The Board would still have the same authority to waive the limit in case of emergency, but there is a process and a method which appeals to all the banks of this country, to limit the legal reserve, and it is available, and some other method,

and especially the judgment of the Federal Reserve Bank, might not be acceptable.

Dr. Miller. Your position virtually comes to this, that the judgment of the Board will be received when it relaxes safeguards provided by the Act, but not otherwise. You may be right.

Governor McDougal moved that the meeting adjourn to meet again at 4:30 with the Federal Reserve Board, which motion was put and carried.

Whereupon, at 1:10 o'clock P M., an adjournment was taken until 4:30 o'clock P M of the same day.

JOINT CONFERENCE OF
GOVERNORS OF FEDERAL RESERVE BANKS AND
CHAIRMEN OF FEDERAL
RESERVE BANKS WITH THE FEDERAL RESERVE BOARD.

Washington, D. C.,

Friday, October 15th, 1920.

The meeting was called to order by Governor Harding, of the Federal Reserve Board, in the Board Room of the Federal Reserve Board, Metropolitan Bank Building, at 4.30 o'clock p.m.

Governor Harding. Gentlemen, here is a telegram which sounds as though it might be from the Anti Saloon League.

"At meeting tomorrow suggest Federal Reserve Board consider proposition that Federal Reserve System shall not engage in propaganda or news dissemination of any sort, except it might be the driest of dry statistics, and also that credit be determined exclusively by supply, also that system operate at reasonable profit."

That is signed H. H. Franklin, Syracuse, New York.

I wish to make a report to the Conference about a hearing in the offices of the Reserve Board, which may have some influence upon your statements. Senator Randsell, of Louisiana, Senator Smith of Georgia, Senator Swanson of Virginia, Senator Dial of South Carolina, Senator Harrison of Mississippi and several cotton factors of New Orleans and Oklahoma and Savannah appeared before the Board and wanted us to revoke or suspend our ruling on the cotton factors' paper. The ruling is that under Section 13 paper to be eligible must be paper the proceeds of which have been used or are to be used for industrial, commercial or agricultural purposes. In our regulations, of which the codification is out this afternoon, this ruling was made on advice of Judge Elliot about a year ago, in November, 1919, that these proceeds must have been used in the first instance. Now, Senator Hoke Smith says he is very clear that he thought about this when it came up, and that the words "mere investments" has something to do with it, and that our ruling is wrong,

and I think probably two or three members of the Board were inclined to agree with him. At any rate counsel is over there with him now, with a committee of seven or eight of them, and I presume the next question we shall have to decide is whether we are going to back water on this cotton factor ruling.

This cotton factor ruling is pretty closely linked up with the automobile finance companies. A number of the automobile manufacturing companies did not care about incurring large obligations themselves and organized subsidiaries and wanted their paper declared eligible on the ground they were being used for industrial purposes.

The contention of the cotton factors is they claim they are not private bankers; that they are not doing a general financial business, that these notes of theirs are not in any sense finance bills; that the cotton factor is a specialist; most of them are located in Memphis and New Orleans and Savannah and Augusta, Georgia and Charleston and Wilmington and Houston, Texas. They make arrangements with farmers in the spring of the year, usually taking a mortgage on the land

a chattel mortgage, or anything they can get, and the essence of the proposition is that it is not a gainful proposition from the standpoint of interest, they claim, and I guess in most cases that is true. What they want is to get the cotton. These factors usually have their warehouses and compresses and they charge a commission, and it is quite a profitable business and the advances that the factors make all during the year go to the making of the crop, and the advances they make now are made pending the sale of the crop. They say the whole proposition is intimately tied up with the production of the cotton crop, and that as they specialize in that and do not go into any other proposition it is purely an agricultural proposition, and that any loans they make are for purely agricultural purposes. I was rather adverse to agreeing with this ruling last year, because I knew the importance of the factors' business to the cotton growing industry in a good many sections, but counsel linked it up so with all these other financial corporations that are financing all sorts of things that just from the legal standpoint I overcame my reluctance and was among the number that voted to adopt this

ruling.

Governor Seay. It seems to me that, with some slight changes in the practices of the cotton factors, that they can accomplish what they desire under the ruling of the Board.

Governor Harding. The way they work it now, they keep a book account; they make an advance to their client, instead of taking his note they charge him up on the ledger; in the fall of the year he sends the cotton; they charge all freight and everything like that, then when the cotton is sold they do not remit him for the cotton unless he specifically requests it; they give him credit on open account; there is a credit shown there for any amount he has there; subject to draft and, as a rule, the farmer does not draw all this in one draft, he uses this a good deal as a bank, they let the money stay and draw on the balance as needed. I asked the question why they could not say to the farmer "You owe us \$2,000 or \$3,000 and your cotton is not ready for sale; we are needing some money and would like to close up your book account; send us your ninety day note," then there would not

be any question, here is the farmer discounting the note with an endorsement that would be eligible. They say, "No, here is a business that has been going on for a hundred years and we do not want to change our way of doing business," although the same people on yesterday said that the farmer was so very bad off for money he would not hesitate to sign a note, and now, these factors come here this afternoon and say it would insult the farmer to ask him to sign a note; that he would not do it.

Mr. Martin. When they change from the cotton factors' secured note to take the note of the planter of the cotton, that note of the cotton planter comes up say to the Federal Reserve Bank indorsed by the cotton factor and also by the offering bank, with no cotton behind it. We are presented a statement of the cotton planter, which is more or less questionable as a rule, or to the statement of a cotton factor, which never shows a good ratio, and you have got the indorsement of the bank. That is all you have got. I am speaking now about the security of the paper. But when the cotton factors'

paper comes in secured by the actual cotton, so far as security is concerned you are a great deal better off. It is true that you can make the demand that the note of the planter, indorsed by the factor, be also secured by the cotton, but they will immediately come at you and say that you are asking from them something entirely different from another class of borrowers; as security goes what they are shifting to Mr. Seay, in our experience, is not as good a piece of collateral from a banking standpoint as what they gave originally. I just suggest that.

Governor Harding. Another feature that might affect this statement,---I want to advise you that at this meeting this afternoon, while some of the old, familiar faces were there, there were a good many distinguished men, a much higher class gathering than any we have had heretofore this week, and it was open to the press, we had all The Associated Press people, and private correspondents of different papers here, and yet Senator Ransdell and two or three others made the statement, Senator Ransdell particularly, about the desperate condition of the South,

that it needed this help otherwise they were broke, and all that sort of thing. If this spreads all over the country that is going to start some trouble, they will say, "Here was a representative meeting." I cautioned Senator Ransdell about it, but could not get at him in time.

Governor Seay. Our counsel has examined into the warehouse acts of several States in our district and he has reached the opinion that the cotton factor has no title to the cotton; he has an equitable interest in it, but no title to the cotton.

The Chairman. They claim, under the laws of Georgia and Tennessee, that the cotton factor has title to the cotton equal to the amount he advanced against it. He has the right to pledge. The cotton is not a fundable commodity; they keep a separate record of each bale, and if there were one hundred bales of cotton as collateral they are careful not to pay on each bale any more than their amount of equity.

Governor Seay. That is so in the State of Georgia,

but is not so in the States of the Fifth District.

Mr. Wills. May I ask a question of the men in the banks? Is the cotton factor a financial corporation, primarily, or selling and marketing?

Mr. McCord. Selling and marketing.

Mr. Wills. Selling and marketing principally, is that correct?

Mr. McCord. Yes.

Governor Wellborn. Answering Mr. Wills, cotton factors have considerable capital themselves.

Mr. Wills. What do they do principally, are they a selling and marketing corporation, advancing funds to the farmers, either before or after, or are they a lending corporation primarily? That is the point.

Governor Wellborn. Their main business is marketing and selling.

Mr. Hardy. Making advances to the merchant and through him to the farmers for the purpose of planting and raising and harvesting of the crop. I was in that line of business myself.

Mr. Wills. The company itself is a marketing and distributing company primarily, and the advancing

of money to the farmers is incidental to that business, is that correct?

Governor Seay. He is borrowing money for the purpose of advancing to the farmers. There is no eradicating that from the conditions.

Mr. Wills. It is important there be some statement on that.

Mr. Hardy. Even if there is some question about the warehouse laws of any of the states, I have never known in an observation of forty years of but one case in which title to the cotton was questioned, and that was questioned when it was stored in a private warehouse and not in a regular storage warehouse, and I am very frank to say that I considered the ruling of the Board a great blow to the cotton factor business of the South.

Mr. Williams. The rule has not been enforced and it certainly creates a very keen situation, and I have felt that from the beginning. The business is a safe business; we have never discounted in the Richmond Bank any paper of cotton factors that did not make a good, substantial statement, and where the paper showed

clearly that it was eligible we have considered the credit a perfectly fair risk, and when it comes to be secured by the cotton itself I do not think, as a rule, there is any danger of the cotton being pledged beyond the equity which the factor has in the paper, and there is no better commodity stored than cotton; it does not deteriorate in quality; it is not easily damaged, and it is usually a commodity that is readily and promptly marketed.

Mr. McCord. I want to ask Mr. Hardy a question. Is it not true, Mr. Hardy, that a large bulk of the cotton is handled just for a few short days; that there is very little of that old advancing going on; that the merchants in the interior ship to the factor for sale and get advances in order to have it sold and immediately handled?

Mr. Hardy. I do not know as I catch the exact drift of your question.

Mr. McCord. I mean this, instead of advancing a lot of money in the Spring of the year to the planter, that that is largely a thing of the past; that the great volume now comes from the country merchants to be

sold on credit?

Mr. Hardy. At the time cotton is shipped that is true. There have been advances made in the early spring.

Mr. Williams. I should like to ask the Chairman of the New York Bank if he can discern any wide difference in principle between the business of the commission merchant, who is a factor in New York, Bliss-Fabyan Company, to whom are sent the products of the mills in Boston, Fall River, and Providence, and who are accustomed to advancing to those mills the money for this operation to produce their goods, and who in turn can assign their goods to these distributing agents who sell them over the country, between their paper on the one side and the cotton factors on the other. Is that not very much the same in principle?

Mr. Jay. There are two kinds of those commission merchants, Mr. Comptroller. One is the commission merchant who actually owns the goods.

Mr. Williams. I was speaking not so much of the---

Mr. Jay. Excuse me, and I will speak of the two

kinds if I may. One actually owns the goods, you find, when he makes his final statement, he shows he has the goods there. There are others who do part of their business that way and part of it by advances, but many of those commission merchants who borrow, who advance to their mills take a note of the mill and indorse that, and that is the way they get the credit.

Mr. Williams. Do you not sometimes simply advance them on open account, advance them on drafts?

Mr. Jay. To some extent.

Mr. Williams. And do they not then as an offset to the advances they make issue their commercial paper and dispose of it to their banks, which then reaches the reserve banks?

Mr. Jay. The main part of that business is done the other way, and the ones who do not take merchandise, who merely make advances, are those who take notes from the mills and indorse those and put those in the banks, just what it seems to me these farmers should do with the cotton factors. I understand they say it has not been the custom down there, but under press of great

emergency many customs change. There was the custom, for example, not to circulate paper on the Pacific Coast; always to circulate gold, but during the war they got rid of gold and circulated paper.

Mr. Hamlin. Is it not a kind of ownership of goods.

Mr. Jay. I would not say so. He does not show it on his statement, does he?

Mr. Hamlin. I should think the question was, can he give a note and secure it in that way by pledging that particular warehouse receipt?

Governor Seay. He can pledge his equitable interest, not the commodity itself.

Mr. Hamlin. He pledges his interest, it is a kind of title, it is treated in equity as a title, as a legal title for the purpose of pledge.

Governor Seay. That much he can pledge.

Mr. Hamlin. In other words, is he not exactly like the commission merchant who has the title, if he can do that. It is not the title up to the full value, but it is title to a certain proportion of the value on which he loaned. I do not see the

distinction if the man has the right to pledge whether he could pledge twenty-five per cent, or, if he owns the whole of the goods, he can pledge one hundred per cent.

Governor Seay. The owner can take the cotton.

Mr. Hamlin. He has got to pay all the broker got.

Governor Seay. Yes, the man that makes the advance on the cotton has not got it, and the broker has the funds repaid to him by the farmer to whom he advances it, and they do what they please with it; the Federal Reserve Bank, or the bank that advances has not the cotton.

Mr. Wills. I asked the question for a no or yes reply, whether the cotton factors can pledge it is up to the bank, if he has not got it he does not have it, but the point is, are these cotton factors primarily selling and distributing organizations, or just pledged to turn back to the farmers under a loan, or are they lenders of money primarily?

Governor Wellborn. I can explain that to you in two minutes. The essential part of the factor

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business is selling, because they classify the farmer's cotton, they grade it, you know. That is the most essential feature in the cotton factor's business, that the farmer's cotton is actually graded and sold on its merits; that is a great advantage to the farmer; it is the only way in the world he can get his cotton properly classified.

Governor Seay. I think I can answer both your questions in one. They lend the money to get the cotton to sell.

Mr. Williams. Are they or not in the business mainly for the purpose of making the difference between what they pay and what they charge the farmer, or for the purpose of getting control of his cotton.

Governor Seay. Getting control and handling the cotton.

Mr. Ramsey. I think I can partly answer Mr. Wills' question. The only purpose for which a factor borrows money is to enable him to have funds to advance to these farmers. The Governor and myself discussed it together and I was quite well satisfied. I may say in this connection it is not a large inter-

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est in our District and some of Houston's bankers, on the promulgation of counsel's opinion, had been inclined--the rule is pretty well settled in our State, and I think that the general rule, so far as the factor is concerned, is that he has a lien; his title is an equitable, possessory/^{title} in a way that extends over and beyond the claims of reimbursement for his advancement. Now how far he could transfer his lien by the hypothecation of the real ownership in some one else might be a very serious question.

Mr. Wills. May I ask Mr. Seay a question? You say, "lend to the farmer." That could not be construed that that was an advance on the purchase price of the cotton; it is a straight loan; if the cotton passed out of the hands of the cotton factor and was sold under any circumstances could this be construed as an advance payment ^{of} account of the sale price of the cotton?

Governor Seay. Partially I think it could.

Governor Harding. I stated to that meeting that even if counsel should advise the Board that it concurred in a previous ruling, and the cotton fact-

or's paper was taken to be eligible, there is no obligation on the part of the Federal Reserve Bank to discount if it considered it undesirable to do so. Two of the Senators said "We will relieve the situation at this end, we will put it ^{through} / our local banks."

Mr. Curtiss. I want to answer the Comptroller's statement with reference to the commission houses. We have just been in touch with every commission house in the New York district, particularly the names referred to; the factor does not borrow, the mill borrows, and it is a question of the eligibility of the mill note that we test when it comes to us. We have had several cases in our district where commission houses were doing nothing but advancing; that note was not eligible with us. We have a warehouse company that is advancing. They have control of the goods in their warehouse. We have refused to take that note, believing it was nothing but a finance bill, but in the case of commission houses the commission houses invariably indorse, but the mills themselves borrow, and the same question of eligibility comes up as it does in every mill case.

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Governor Harding. Another statement made by Senator Hoke Smith was that although we put ^{out} this ruling a year ago, that the bank--I do not know which bank he referred to,--the banks down there, he said, disregarded it entirely until about two months ago, and that brought about a very bad situation of affairs, and that they urged on us now, no matter what we might ultimately do with it, to suspend that operation so they could go ahead and load up pending our final decision. Does he refer to you, Mr. Wellborn, as disregarding the rulings of the Board?

Governor Wellborn. Well, the ruling came out, I think in February, the latter part of the season, I think the bankers' acceptance ruling came out in February, is my recollection. That was the only paper we had, and we did not disregard it, we simply did not put ^{it} into effect because it was the tail-end of the season, but this summer, in June, I sent out a formal notice to all of them, and printed the ruling of the Board and told them that would be our policy this fall.

Mr. Williams. He said it was a mighty good thing you did not put it into effect, that it would

have caused a more acute condition of things down there than there is now.

Governor Seay. You may recall the cotton factors in the State of Georgia negotiate bankers' acceptances in our district, based upon those conditions. I think the court held, and very properly under the circumstances, that it was not a proper subject for a banker's acceptance. I should like to say that, in my judgment, and in the judgment of our bank, that it is an exceedingly safe business, based upon the commodity of cotton; the only danger that I can conceive in classifying it as an eligible transaction is in opening the question with regard to other financial corporations which make advances on commodities.

Governor Harding. The counsel is over there with four Senators of the United States, all of whom are telling him that the ruling is altogether wrong; that they were in the Senate and helped pass the bill, and each one, I guess, has had something to do with this particular Section 13. My guess is that counsel is going to back-track on the proposition,

and it will come right straight up to the Board whether we are going to back-track. I do not mind back-tracking if I am wrong, but if I feel I am right I am going to stand to my guns if I am the only one that does it. But I want to know, in order to be perfectly conscientious about it. It is a close point from my limited knowledge of law, one of these things, I imagine, that might be decided either one way or the other. Looking at the thing from the standpoint of the system and the whole thing, I do not believe a change in this ruling is going to aid very much the lending power of the banks, because those banks in the particular districts where they expect to crowd this paper in have gone so far I do not see how they are going further, no matter what is eligible. I should just like to pass the word around the table, for my own information, as to whether or not, with the lights before you, you think you would, as a member of the Board, vote to rescind this opinion as to the eligibility of cotton factors' paper. What is your opinion, Mr. Martin?

Mr. Martin. May I make one statement?

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Governor Harding. Just let it go on record.

Mr. Martin. The cotton factors' paper first came for consideration before us, and it was in two characters, unsecured and secured. I have to go through this in order to give you the full detail. It was decided that an unsecured cotton factor's note was not eligible. There is a ruling of the Board in the last pamphlet in regard to commodity as to whether marketable staples, properly stored, whether such paper was collateral or notes. There was never any question raised about a secured cotton factor's note, but the unsecured cotton factor's note we ruled was ineligible. That was objected to seriously, and the matter was taken up with the Board; the Board suggested that in order to get a ruling that the Memphis banks offered a note to the St. Louis banks unsecured. Barton & Co's note of Memphis was offered to the St. Louis Bank, and, acting in the usual way, we said it was ineligible, but accepted from the Memphis banks a brief on cotton paper looking towards the establishment of an unsecured cotton factor's note as being

eligible. That brief, which is in the files of the Board, answers the questions that Mr. Wills has asked, and if it were referred to you would see that so far as the Tennessee factors are concerned it traces the transaction from the beginning to the end. The ruling of the Board was made by Mr. Harrison, if I remember; it was not in Judge Elliott's time.

Mr. Jay. What was the date, please?

Mr. Martin. In February, 1919. When that ruling came out, so far as our Board was concerned, we considered that it finally settled the case as to an unsecured cotton factor note. It did not enter our heads at all, as the case had come up on an unsecured note, that it referred to a secured cotton factor's note, since the commodity regulation was still among the regulations. Consequently we may have been in error, but under our understanding of that regulation, without question, until some little time ago, we did take the secured cotton factor's note, thinking that we were acting strictly in accord with the regulations of the Board. Since we have been

advised that that ruling of February, 1919, which on careful reading recently I find does not speak of unsecured or secured notes, but since we have been advised that that ruling may have covered secured paper too, of course, as we always do, we have tried our best to carry out not only the letter but the spirit of the rulings of the Board.

Mr. Miller. What is your answer, yes or no, to Governor Harding's question?

Governor Harding. I asked you, were you in my place to vote, if you would vote to reverse that previous ruling?

Mr. Martin. I should like to vote this way, that it be postponed until this crop movement is over, and that then the regulations be strictly enforced.

Mr. Miller. The vote is, no.

Governor Harding. You will remember the regulations in which we laid down the primary test of eligibility. That covers a broad mass of opinions. We back-tracked on all of that, let in all these things that have been raised here the last three, four or

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five years, if we say the paper is eligible where the proceeds are to be used, or have been used for industry or agriculture; we put that in the regulations there in the first instance; the Senatorial gentlemen questioned our right to do that, and you open up all of this question about mill commission men and automobile manufacturing, and everything--

Mr. Ramsay. And the wheat, too?

Governor Harding. And the wheat too.

Mr. Jay. I would not back-track on the general principles, but as to security that indicates fairly clearly that he has got title to it--he cannot give title if he has not that title.

Governor Harding. Do you think it would be possible to differentiate in favor of cotton factors, to save our faces without disturbing all other rulings we have made?

Mr. Jay. Where they give security.

Governor Harding. They claim in Georgia and Tennessee they have the right to give security up to the amount of their equity; that beyond that, I believe, they commit a penal offense.

Mr. Jay. I do not know anything about those details.

Mr. Ramsay. The Judge used the Board's ruling correctly, and we should not make advancement on--

Governor Harding. Mr. Van Zandt, do you agree to that?

Governor Van Zandt. Yes.

Governor Harding. Mr. McDougal?

Governor McDougal. I have not heard all this discussion, but my understanding of the situation would lead me to believe that cotton factors' paper, as it was described a few minutes ago, would be eligible either if the factor could show a satisfactory financial statement, or if the paper in question was secured, otherwise it was not.

Governor Harding. Mr. Wellborn?

Governor Wellborn. Our bank has ruled that we will not accept any cotton paper unless it is secured. We put in effect last fall, therefore I think you gentlemen ought to stand on the cotton factor's paper, because it is not a financial corporation or a financial business. That is only a small part of it.

Governor Harding. Governor Norris, what is your view?

Governor Norris. I am not at all sure that I understand the question sufficiently to express an opinion. My general impression is that I would not rescind the ruling.

Governor Harding. Mr. Ramsay?

Mr. Ramsay. I would not.

Governor Harding. Mr. Fancher?

Governor Fancher. I would not.

Governor Harding. Governor Calkins?

Governor Calkins. No.

Governor Harding. Mr. Rich?

Mr. Rich. No.

Governor Harding. Mr. Austin?

Mr. Austin. I would.

Governor Harding. Governor Morss?

Governor Morss. No.

Governor Harding. Mr. Curtiss?

Mr. Curtiss. No.

Governor Harding. Governor Seay?

Governor Seay. I think the Board's ruling that it must be used for commercial purposes in the first instance is too important to reverse.

Governor Harding. Any way of modifying without reversing?

Governor Seay. Yes.

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Governor Harding. Open up an avalanche and the work has to be done all over.

Mr. Heath?

Mr. Heath. I would say, no, on your proposition.

Governor Harding. Mr. McCord?

Mr. McCord. Only on secured paper.

Governor Harding. Mr. Hardy?

Mr. Hardy. I concur in Mr. Seay's answer.

Governor Harding. I am sorry that these matters have to come up and be reinforced by Senators and Congressmen. I think we are capable of discussing these things in an impassionate way without their help. At the same time the fact that they do come in on this thing is not going to influence me one way or the other as to the merits of the proposition. I do not want to be so straight as to lean backwards.

Governor Seay. May I say we had an interview with a cotton manufacturer and merchant about the ruling of the Board, and the explanation is satisfactory to them; he said he could do business in State of Virginia on that ruling.

Mr. Williams. Mr. Chairman, I was at that discussion.

today and I should like to say a few words. As far as I can see it would be hard to find, in my judgment, paper that is more eligible, within the meaning of the act, than the paper we have been discussing. The language of the act is, paper, notes, bills of exchange or drafts which have been or may be used for agricultural, commercial or industrial purposes. Have been or are to be used. Now, as I said before, it seems to me that this cotton factors' paper, which we are discussing, is eligible both as commercial paper and as farmers' paper. It has been made clear that the factors only borrow this money for the purpose of making advances to farmers and to enable them to grow their crops. They use it for no other purpose. They have no dealings with anybody else.

Governor Seay. And the merchants.

Mr. Williams. The factors who are there today told us, Mr. Barret, for example is one of the largest factors in the South, said his dealings are entirely with farmers. I think that that was the statement, was it not, Governor? Therefore his whole business is for the purpose of producing agricultural products.

When he has enabled the farmer to raise his crops and continues his loans the advances are then made for commercial purposes, for one step or another in carrying the product from the producer to the consumer, for the purpose of carrying the product to the mill man. So it seems to me that however we look at the business of the factor it comes either under the head of agricultural purposes or commercial purposes, or both.

Governor Harding. Mr. Comptroller, sometimes these factors are very heavy speculators. I know, of my own certain knowledge, that one of the gentlemen who talked to us today, made and lost in two seasons \$750,000; made it one season and lost it the next inspeculation. What would happen, supposing he had been advancing to farmers and we took his notes as commercial paper? That was one of these men who talked to us so very nicely this afternoon.

Mr. Williams. Governor Harding, is that not true as to every class of men who do business with the member banks? There are among them all tremendous speculators, and others who confine themselves

to the legitimate business of manufacturing or merchandising or commercial pursuit. I do not think because some cotton factors are great speculators at times that we should shut out at once from the benefits and advantages of the Federal Reserve System the whole class of cotton factors, through whom at least one half of the cotton crop of the country is financed. I think Mr. Barret, who was one of the leading speakers there today, stated that in his part of the country probably three-fourths of the cotton was financed through factors, did he not? Is that your recollection?

Governor Harding. I think he stated that, yes.

Governor Norris. I should like to ask the Comptroller a question for my own information. It would have some bearing on my judgment in this thing. Are these advances that the factors make exclusively for the making of the cotton crop, for the seeding, for the planting, for the cultivating, or are they general advances that are made to a

cotton planter out of which he buys his food and his clothes and whatever else he may want to buy?

Mr. Williams. ~~Is not~~ Is not the first part of your question part of the last? In order to make his cotton he has got to live while he is making it. I suppose that covers his living expenses while he is seeding, planting and cultivating his cotton. As I understand it they simply advance to the farmers to enable them to produce the crop and for no other purpose.

Governor Morris. When a man owes me for my whole year's living it does not seem to me he is advancing money for the benefit of the Federal Reserve System.

Dr. Miller. I think we have canvassed the opinion of all the Chairmen and Governors.

Mr. Williams. I just want to add one other thing, that is that these gentlemen present at the Conference this evening made it very clear that their business was not the business of making a profit by borrowing and lending money; that, as a matter of fact, the leading man there

explained to us there that they frequently are paid more for their money than they receive from the farmers; two conspicuous cases of that sort were mentioned in conference this afternoon, and that the money that they were borrowing was for the purpose of enabling them to make the advances to the farmer only for the handling of the cotton, where their profits came in, and they also made that differentiation between the commercial discount companies, whose profit is solely made in interest, and their profit, which is made by the handling of the commodity.

Mr. Hamlin. I should like to say that I listened with a great deal of interest to that debate this afternoon. Speaking from the general impression made on my mind, it was that the factors' note, unsecured, we could not consider as eligible. In other words, as the Governor has pointed out, it must be the use to the maker of the note which governs, but Senator Smith brought out the fact that the very next section provided that, "Nothing herein shall prevent such bills or notes being

discounted or secured by staple agricultural products, or by other goods, wares, or merchandise." I think under that you could put in a cotton factors' secured paper. You could bring him within the range of eligible paper, because it says if such paper is secured by Government bonds you can gamble or do anything you want, but it must not be as to other paper merely for investment. Now, the question is, can you say that advance of the cotton broker is merely for investment when those men testified, and I have no doubt they spoke the truth, that that is really the main business, to sell that crop, from the day of the planting of the seed to the final sale, that they make some advances and very often do not get back the interest, but the main product ^{is} the sale, and my mind hinges on that proviso which Senator Smith says was drawn for this express purpose, and I think it well for counsel to carefully study that and look up the debates and look up the amendments and see if that does add what I believe is not entirely a question of an unsecured note.

Governor Van Zandt. Mr. Chairman, it is

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certainly understood that occasionally the proceeds of an advance made by a cotton factor to a farmer is used by him to buy an automobile.

Governor Seay. Suppose, Governor Hamlin, he cannot give an absolute title to the commodity, but only an equitable interest. I do not want to argue against this thing, I only want to build up the fact.

Mr. Hamlin. If the factor has any interest that enables him to make a legal pledge of the certificate I should say that would come within the definition of an eligible paper, I should say that is the question.

Governor Van Zandt. But in the event that he cannot pledge the actual commodity, is there a difference in that case between the unsecured and the secured paper?

Mr. Hamlin. I should say no. The case they put to us, the certificate is in the name of the factor, he pledges that certificate to his bank, I understood that certificate goes to the Federal Reserve Bank, so that the farmer could never get back his profit unless the Federal Reserve Bank is paid the advance

and they also said, in Georgia, I think it was, any factor that borrowed more than his equitable title it was a State's prison offense. The question in my mind is as to whether such secured paper could be called eligible paper. I have no doubt whatsoever as to the first part, it must be the use of the proceeds of the original paper or note.

Mr. McCord. That is why we required a secured paper. We do not take an open cotton paper, it has got to be a secured paper.

Governor Calkins. It appears to me there have been two suggestions which might enable the Board to meet the situation so far as it should be met without reversing its rulings, the first is that these cotton factors should adapt themselves to the law to the extent of taking farmers' notes, which would be unquestionably eligible; the second is that the ruling might not be held to apply to secured cotton factors' paper. It seems to me that if that solution is offered it should be entirely sufficient, and that it can be offered without a reversal of the Board's ruling.

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Governor Wellborn. There is no question about that.

Mr. Hamlin. Or could we say that, pending our further investigation into the question, we made that preliminary ruling, pending a complete investigation, on a rehearing of the matter, we make that ruling?

Governor Harding. Secured paper means secured paper. If the factor has not title to it it is not secured.

Governor Seay. My recollection is the ruling of the Board covers two cases, one where the cotton factor absolutely owns the commodity, then it is eligible, and the other is when he takes the farmers' note. I think that is in the ruling of the Board at present.

Mr. Hamlin. Where he actually owns the cotton or has a right under the law of his state to get a valid title.

Governor Harding. These new regulations were intended to rescind all previous rulings and regulations except in so far as they were completed and codified.

Mr. Hamlin. We could say that in a rehearing---

Mr. Jay. It seems to me you would not have to make this in the form of taking any back track; merely an interpretation.

Governor Harding. I would not want to leave anything open on this thing. We should make it final. If not they will come again on something else.

Unless there is something else to come up I suggest that we consider this formal statement to be given to the press. I told them I did not think there would be anything ready for them tonight, that it would go over until tomorrow, but there is no question we have got to issue some sort of a statement.

Dr. Miller. At your request I sat in with the committee at luncheon hour today; I think two members of the committee were absent. Following my suggested form of statement last evening at the dinner I dictated something this morning, which I read to the committee at noon. It is clear to me, to use Judge Ramsey's general term, that the committee felt there was altogether too much sunshine in the statement. That led to a pretty thorough going discussion of the whole situation that lies back of the statement,

or the need for a statement, and I soon found myself in a minority of one as regards views of the conditions of business, economic, financial, credit, which are the reasons for making the statement, if that statement is to be made by the Federal Reserve Board. I therefore suggested that the matter should be referred back informally to the Reserve Agents' Conference that was in session this afternoon. That was done. A canvass of opinion was invited and it developed that of the Eleven Districts represented here eight felt that conditions in their districts were such as to make a statement at this time highly inadvisable, as locally to give rise to an unsettlement of mind where, on the whole, the existing state of sentiment seems pretty good. There were three districts, Dallas, Atlanta, and Minneapolis, where it was stated that a statement of the right kind might ^{be} expected to have a distinctly reassuring effect.

Mr. Williams. How about the Twelfth District?

Dr. Miller. One District was not represented.

The other districts, the agricultural districts, Kansas

City, Chicago, and San Francisco all felt there is nothing in those districts that would require anything in the nature of a statement by the Federal Reserve Board addressed to general conditions. That led me to take a distinctly different view of the situation, and for myself I felt more thoroughly informed after this canvass than before. I certainly was under the impression that the members of this conference, by reason of their silence when this subject was first raised day before yesterday, were in substantial agreement with the suggestion that a statement should be made. I now am very definitely of the opinion that these gentlemen are well informed as to their views of their own conditions, ^{and} that a statement would be inadvisable except in so far as that statement is addressed to the conditions in certain of the agricultural sections and as affecting certain of the important staples, not that the staples should be mentioned, but that in the statement nothing should be said that would tend to disturb a state of mind that is pretty good throughout the country as a whole.

Governor Harding. Here is an important conference a joint conference of the Governors and Federal Reserve Agents. Notice was sent out about it nearly two months ago; it has been talked about in the press off and on for the last six weeks. Now, it seems to me it is imperative for this conference to give the press some sort of a statement. It ought to be matter of fact, relating to this conference, then you can sandwich in any little other thing you want. That does not mean a labored statement about reaffirming the Declaration of Independence, and all that sort of thing, but simply a statement as to proceedings of this conference, going as little into details as you want to, with such incidental reference to other matters as you may want to put in.

Mr. Miller. That is very simple, that is an easy way out of it.

Mr. Williams. Have you prepared something, Doctor?

Dr. Miller. I prepared a brief reference on which the conference is asked to express its views.

Mr. Williams. I mean to say, did you prepare a statement for the press?

Dr. Miller. No sir, this is that the Board might transmit a letter to the Conference reading somewhat as follows:

"Representations having recently been made by delegates from the agricultural sections, which have been awarded hearings, before the Federal Reserve Board to the effect that conditions affecting the markets for their staples were so unsatisfactory as to merit the attention of the Federal Reserve Board and Banks with a view to modifying its practices and methods, the Board desires that the Chairman and Governors of the Federal Reserve Banks now assembled in conference in Washington at the call of the Board, should carefully canvass business, industrial, financial and economic conditions and sentiment in each of the Federal Reserve Districts with a view of informing the Board whether conditions in the districts are such as to call for any change in the existing policies and practices of the Federal Reserve System."

I thought the report might be made by this committee to the Board in such form as the Board saw fit to publish it, if not, to file it.

Mr. Williams. You rather agree with Governor Harding that the Joint Conference, through the Board, should give some flat footed statement?

Dr. Miller. Could we poll the Governors?

Governor Harding. What is the question?

Dr. Miller, The question is whether you feel the conditions in your district are so unsettled, the sentiment such that a comprehensive statement by the Board, addressed to the Banks or to the country as a whole, with a view of reassuring it, is needed.

Governor Harding. I will call the role.

District No. 1.

Governor Morss. I do not know that I heard the whole of that, but as I understand it, as near as I could get it, it was whether in our district it was advisable at this time for the Board to make a reassuring statement?

Governor Harding. Yes.

Governor Morss. Yes, if a reassuring statement

can be made. But if it is going to be a doubtful statement it should not be made. If the time has come when you can say with conviction that you believe the tide is turned and that we are going to have better things, say so, but if you cannot say that, I think you had better not say anything.

Governor Harding. Number two, Mr. Case is not present. Number three, Governor Norris.

Governor Norris. I do not think I am quite satisfied that there is no statement required for us in the third district. I think that weight, however, must be given to the consideration that an expectation has grown up, a general public expectation, that there is going to be a statement from this conference, and that therefore the failure to make any statement might be misconstrued as an inability on our part to make any statement that would be otherwise than disquieting. I think, therefore, that while as I say so far as the needs of the third district are concerned there is no necessity for a statement, I think that some statement has got to be made.

Governor Harding. Number four?

Governor Fancher. Governor Harding, I do not think that conditions in the fourth district are such that we need at this time any reassuring statement so far as our particular locality is concerned. I quite agree with Governor Norris, I think that this meeting has been given some publicity and it has been known for two or three weeks that this meeting was going to be held, and I think a statement is expected; I think some statement has got to be put out, but so far as some reassuring statement for the fourth district, I do not think it is required.

Governor Harding. District number five?

Governor Seay. When I left the bank I am sure there was no expectation on the part of the officers that there was any necessity that this board should make a statement as to conditions in the country, or in the fifth district. It is undoubted that in the strictly agricultural sections of our district there is a feeling of very severe disappointment at the very heavy fall in agricultural commodities, in the price, and some feeling of resentment. Since being here, however, and finding sentiment from different parts

of the country and from other agricultural districts, and in view of the attitude which the papers have taken, I do believe that it is desirable and has even become necessary for the Board to make some kind of statement, however general it may make it, but with particular reference to the fifth reserve district, we did not anticipate any such statement, nor do we believe, in the language of the query of Dr. Miller, that conditions in our district call for any change in policy or change in the practice of the Federal Reserve Banks.

Mr. Ramsey. That is not contemplated in any statement.

Governor Seay. That is contemplated in the statement addressed to us by Dr. Miller.

Governor Harding. The Sixth district?

Governor Wellborn. In view of the published statement of the Secretary of the Treasury, and the misunderstandings about those statements, and speaking in connection with what he said last night I think it is absolutely necessary for this Board to make a full statement and a reassuring one too, that they will stand back of the business interests of this

country. There is a fear all over this country that the Federal Reserve will not stand by it, I mean the business and agricultural interests of the country.

Governor Harding. District number seven?

Governor McDougal. When this subject was first introduced, Governor Harding, it was my understanding that the necessity arose from the fact that a good deal of publicity had been given to the calling of the conference and that the press was clamoring for a statement, and I think, wisely, the members of the conference were warned not to discuss the matter with the press or outside of these meetings. I did not understand, however, that occasion for this statement arose because of the general conditions which existed throughout the country. In our district we feel, while we are overloaned at the present time, we understand the reasons for it; we feel that we are blessed in having wonderful crops, gathered and in prospect, and we look forward with confidence to our ability to take care of the situation and are

expecting very material improvements, and I believe so far as our district is concerned no statement is necessary, although I can easily understand it is going to be an obligation of this conference to give something to the press, the nature of which I am perfectly willing to leave to this committee that has been appointed on the Board.

Governor Harding. District number eight?

Mr. Martin. Governor Biggs is not here.

Governor Harding. District number nine?

Governor Young. Mr. Chairman, I think a statement should be made, not because conditions are unsound in our district, but because the minds of our agricultural producers have been distorted through men that have spoken through that district in public meetings. I think that statement should correct some erroneous impressions that are in the minds of a good number of people out there, that is that the Federal Reserve Board and the Federal Reserve Banks have unlimited funds to loan. I think that it should show enough statistics to counteract any erroneous impressions that may be in the minds of the agricultural borrowers

that they have not been used fairly, and with the conclusion, possibly, that the Federal Reserve System has functioned for the benefit of business, finance and industry, is functioning in that capacity at the moment, and there is no reason why it cannot continue in that capacity.

Governor Harding. District number 10, Governor Moore not here.

District number eleven?

Governor Van Zandt. Governor Harding, I believe a statement of some kind should be given out. If not a reassuring one, as has been mentioned, such a statement as will cover the facts that this conference has been held, some of the principle topics discussed at this conference, and a survey, a resume as to the resources of the Federal Reserve System, and to the effect that nothing has occurred herein to change the views of the Board with respect to the statements that it has given out heretofore, but I think that some statement of some kind should be given out.

Governor Harding. District number twelve?

Governor Calkins. Mr. Governor, in order to be brief I shall endeavor to be direct. I believe no conditions in the twelfth district should call for a statement on the part of the Board or anybody else. However, it appears to me that it is expedient for the Board to make a perfectly usual, casual statement of its conclusions, based upon the conference here held.

Mr. Hardy. I want to make a motion to bring the matter to a vote.

Governor Harding. I think it is unthinkable that a statement should not be made here. We are obliged to make a statement no matter if everything is as rosy as you please, you could not let a conference of this sort assemble in Washington, with the publicity it has had without saying something about it. It is sometimes a very good rule when in doubt to pass the buck; instead of talking too much about our reserve and financial condition and the country and so forth, let us say something about the car movement, and let us say in what district it is bad, then bring out, incidentally, that owing to decline in prices of some of the staple agricultural products the crops

movement has not been accelerated to the extent that was anticipated a few months ago, and that therefore the whole process has been somewhat delayed, and that it is only fair to assume the peak of the movement will be extended over a longer time than anticipated, and not say very much else. Bring in something about the car service, because that would be entirely consistent with our answer to the resolution the Senate very kindly sent down to us wanting to know what we were going to do, and we replied that the proposition was one of transportation rather than finance. Now, let us carry that idea out.

Governor McDougal. In regard to the transportation situation, I can state that one of the principle factors in our over-loaned condition is due to the fact that the transportation facilities during the summer and recent months, and until quite lately, have been entirely inadequate.

Governor Harding. No doubt thousands of dollars are tied up in Alexandria for lack of transportation facilities.

Governor McDougal. I have stated further, and am

very glad to state it again, that I do not believe that it can now be claimed there are not cars available to move grain in our district. The transportation situation has improved very materially. I am told by the officers of the railroads that in many ways, largely because of the improved temper of mind, perhaps, of the employees, the railroads are moving their freight now satisfactorily, and I believe cars can be secured to move what grain they are ready to move in our district.

Governor Harding. You gentlemen will appoint from your number your own committee, or a sub-committee of two to cooperate with a small committee of the Board to get out a statement that will be satisfactory, I think.

Let us just go around the table very briefly. What is the condition of the car service in District number one?

Mr. Curtiss. Very much improved.

Governor Harding. Number two?

Mr. Jay. Highly improved.

Governor Harding. District number three?

Mr. Austin. Improved.

Governor Harding. District number four?

Governor Fancher. Improving.

Governor Harding. District number five?

Mr. Hardy. Improved.

Governor Harding. District number six?

Governor Wellborn. Very poor.

Mr. McCord. An embargo at New Orleans on grain.

Governor Harding. District number seven?

Mr. Heath. Improved.

Governor Harding. District number eight?

Mr. Martin. Improved.

Governor Harding. District number nine?

Mr. Rich. Improved.

Governor Harding. The tenth district?

Mr. Ramsay. Improved, but still unsatisfactory.

Governor Harding. District number eleven?

Governor Van Zandt. Very greatly improved.

Mr. Ramsey. Improved, but not adequate.

Governor Harding. District number twelve?

Mr. Perrin. Satisfactory.

Governor Harding. So we have got one cotton district where the railroad service is still poor.

Governor Norris. A small group of us at the other end of the room have a suggestion to offer as to the first two paragraphs of any statement that may be put out, the remainder of the statement to consist of such figures or statements as it may be deemed advisable to add to it. The first two paragraphs, which would be the substance of the statement, would be:

"At the April conference of the Governors of Federal Reserve Banks there was a quite general anxiety as to the ability of the banking resources of the country to meet the demands incident to the autumn crop moving period. At the joint conference of the Chairmen and Governors just concluded it was the general sentiment that these demands had been met up to date and that there was no longer any reason to fear that any future demands could not be met."

Mr. Hardy. I move, in order to get the sense of the conference, and see if agreeable, and only for that purpose, that the question be referred to the two chairmen, the Governors' Chairman and the Chairmen's

Chairman, to confer with the Board for the purpose of preparing a statement to be issued by the Board.

(The motion was seconded by Governor Wellborn and carried unanimously.)

(Whereupon, at 6.00 o'clock p.m., the Joint Conference was adjourned until 10.30 o'clock a.m., ~~Monday~~ day, October 16th, 1920.

JOINT CONFERENCE OF
GOVERNORS OF FEDERAL RESERVE BANKS AND CHAIRMEN OF FEDERAL
RESERVE BANKS WITH THE FEDERAL RESERVE BOARD.

Washington, D. C.,

Saturday, October 16, 1920.

The meeting was called to order by Governor Harding, of the Federal Reserve Board, in the Board Room of the Federal Reserve Board, Metropolitan Bank Building, at 10:50 o'clock A. M.

Governor Harding. I have before me a supplemental list of topics that were suggested for the Joint Conference. Some of them have already been discussed. Here is a letter from the Federal Reserve Bank of Minneapolis on the circuitous routing of checks by Federal Reserve Banks. Has that been discussed?

Governor Young. We discussed that at the Governors' Conference.

Governor Harding. The next topic is Boards' Inter-

District Time Schedule. Advisability of its incorporation into all inter-district schedules. Has that been discussed?

Governor McDougal. That has not been discussed.

Governor Harding. If there is no objection, I would like to ask Mr. Hoxton, Secretary of the Board, who prepared these schedules, to make a statement regarding them.

Mr. Hoxton. I think that all of the banks have adopted intra-district schedules, with the exception of Boston, New York, Philadelphia and Chicago. Now, the inter-district schedule was gotten up and compiled by the Board on actual transit time, taking into consideration the clearing houses at the different points, after the transit managers, at a meeting in Cleveland last year, had said that they were unable to agree on it and had thrown it back to the Board. The time schedules were all set down upon the agreement of both banks concerned, except in two or three cases where the banks could not agree and we had to arbitrarily fix the time, and in fixing the time we were supposed to adopt a longer time in order to save float in the system.

We feel, however, if that schedule is not right, so

far as actual transit time taken in connection with clearing time is concerned, that it should be made right, and that after it is made right it is really of very little practical use unless it is incorporated by the several banks into intra-district schedules. A bank in Memphis, for instance, does not want to be deferred on its Boston items three days if Boston banks are only deferred two days on their Memphis items. It is my feeling that the inter-district schedule is of very little advantage to the system as a whole unless it is incorporated by the several Federal Reserve Banks into intra-district schedules.

Governor Harding. Is there any discussion on the proposition? Just what is the objection on the part of any bank which has not established the Board's intra-district schedule?

Governor McDougal. Our bank is not using that schedule and I am not prepared to answer as to why we are not doing it. I would be glad to look into it and if it is your wish will advise with you.

Governor Harding. I wish you would, because this is unfinished business on our records and we want to

dispose of it one way or the other.

The Federal Reserve Bank of Kansas City has made a suggestion that there ought to be Federal legislation making robbery or attempted robbery of National Banks a crime under the Federal statute.

I agree with him in the position that there is, generally speaking, a more wholesome fear of United States courts and United States penitentiaries than there is of State courts and jails and penitentiaries. The question of legislation, however, depends entirely on Congress. The only practical question in connection with this that we have before us this morning is as to whether it would be advisable to have a bill prepared and request Congress to enact such a law.

Governor Wellborn. I think there is a bill already before Congress, which was introduced by Senator Gore, although I think the bill has been held up. I have read the bill and I think we ought to go on record, gentlemen, as favoring that bill, or favoring action in the matter; it may not be proper to adopt that specific bill.

Governor Harding. What is the pleasure of the Conference on that subject? Are you willing to go on record

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as favoring legislation of that kind?

Governor Fancher. I move that it is the sense of the meeting that we favor such legislation.

(The motion was duly seconded and unanimously carried.)

Governor Harding. The next topic deals with the guarantee of indorsements by member banks in one district on items sent direct to Federal Reserve Banks in another district.

Governor McDougal. That topic was considered at our Conference and will be considered in our regular report.

Governor Harding. Here is a matter we want to discuss here: Policy to be pursued by Federal Reserve Banks in furnishing their own Federal Reserve notes to the Treasury Department for use in making current disbursements in exchange for gold to be deposited by the Treasurer with the Federal Reserve Board for the credit of the Federal Reserve Banks in their gold settlement fund account.

Here is a memorandum from Mr. Emerson, the Board's Assistant Secretary, who has supervision of the gold

settlement fund. He goes on to say:

"The Treasury Department and the Federal Reserve System have been cooperating since 1917 to secure the gold reserves of the country and to centralize the same in the Federal Reserve Banks.

"In order to carry out this policy the Treasury offices have been instructed by the Secretary of the Treasury not to pay out gold coin or gold certificates, and in order to carry out this policy they have secured Federal Reserve notes from Federal Reserve Banks in exchange for gold. Since November, 1917, to date the Federal Reserve Banks have supplied new Federal Reserve notes to the Cashier of the Treasury at Washington, in the amount of \$573,040,000. In return the Treasury Department has deposited \$1,169,500,000 with the Federal Reserve Board to the credit of the Federal Reserve Banks in their Gold Settlement Fund accounts. The Board has no figured available as to the amount of Federal Reserve notes and other kinds of currency furnished various sub-treasuries by the Federal Reserve Banks.

"Recently, one Federal Reserve Bank (Minneapolis) advised the Board that it objected to furnishing the

Cashier of the Treasury Department with its own Federal Reserve notes because it wished to maintain its Federal Reserve note circulation at the lowest possible figure, and further desired its circulation figures to reflect only the issue of notes in its own Federal Reserve District.

"I am advised by Treasury Department officials that the Department is willing to continue cooperating with the Federal Reserve System in maintaining the above policy, and it is suggested that this matter be submitted to the Governors' Conference to determine if the Federal Reserve Banks desire to continue the policy of conservation of gold and centralization of gold reserves in Federal Reserve Banks, and if so whether or not the policy is to be adhered to by all the Federal Reserve Banks. In this connection, it might also be pointed out that as long as the Treasury has deposit balances with the Federal Reserve Banks such balances are payable in gold or currency.

"The above policy was adopted because the circulation of gold coin and gold certificates tends to dissipate the reserves, and the circulation of gold coin in-

volves a considerable loss due to abrasion, which is avoided by having the gold carried in the vaults of the Federal Reserve Banks and the Treasury.

"Attached hereto is a memorandum which has been prepared giving the establishment and history of the policy, and a statement as to the manner of its operation."

Governor Harding (continuing). Our policy here has been that if the Treasury announces that it is ready to exchange ten million dollars of gold for notes, it was prorated among all the Federal Reserve Banks. A month or so ago, when they offered one bank its part, we got a telegram saying they did not want it, and we had to allot that to some other bank. Of course, the question comes up now as to the availability of Federal Reserve notes, the supply is running short; the Bureau of Engraving and Printing promises they will do better, but they are not meeting all the requirements.

Governor Van Landt. I move that it is the sense of this Conference that the practice of conserving gold in the manner described be continued, and that at every possible opportunity we exchange Federal Reserve notes

for gold.

Governor Young. I think Mr. Rich handled the transaction referred to. I know I came in a day or so later.

Governor Harding. Does your institution wish to be eliminated from any future distribution of gold received from the Treasury?

Governor Young. I would not say that, I do not know enough about it at the moment to make a statement about it. As I understand the transaction, the Treasury Department has the option of paying gold out or paying Federal Reserve notes, and that is, as it has been explained here, and rather than pay gold out they request a Federal Reserve Bank to furnish its Federal Reserve notes, and while you might not get the gold at the moment, the System gets the gold. Is that correct?

Governor Harding. Yes.

Mr. Perrin. We also feel very strongly that the practice of exchanging gold for Federal Reserve notes, thereby conserving the gold, should be continued. We also believe that the Board should suggest to the Secretary of the Treasury that gold coinage of a denomination below twenty dollars be discontinued entirely, so as

to force the use of currency for all cash payments except where gold is absolutely necessary, in which case twenty dollar coins will serve every purpose.

Governor Harding. The motion has been made that it is the sense of the Conference that the policy of exchanging Federal Reserve notes with the Treasury for gold be continued.

(The question was put and the motion passed.)

Governor Harding. Now it might be in order to discuss the question, in case any Federal Reserve Bank at any time should prefer not to take its pro-rata part of the allotment, how many volunteers are there to take that bank's part?

(The hands of eight gentlemen present were raised.)

Governor Young. I would not want to be understood that we would not share in this.

Governor Harding. Under this resolution, then, when any offer was made, you would be given an opportunity to come in, and if you did not want to come in you could say so.

Governor McDougal. I think there is one point involved concerning which Governor Young is perhaps not

fully informed. He says he understands that the change would result ultimately in their securing gold. As a matter of fact, they get their gold at once.

Governor Harding. Immediately. Of course there might be times when certain banks might need notes of certain denominations and the banks might not have them. There was some correspondence--

Governor Young. I do not remember that correspondence.

Governor Harding. It was with Mr. Rich. He wrote and said that they had taken a pride in holding their note issues and they would prefer to limit their note issues to their own district requirements.

Governor Young. As I remember the telegram, the request made was that we would put these notes out for some other bank, and of course we do not understand this transaction. Some other bank may have been short of a smaller denomination.

Governor Harding. There must have been some misunderstanding, because I was surprised to know that they were so well off in their reserves. But the transaction as put to you would have resulted in an immediate accession

to your reserve of a million dollars in gold.

here is the next topic:

Uniform report to the Federal Reserve Board of current expenses of the branches of the Federal Reserve Banks.

Governor Harding (reading): "The reports of current expenses of the Branches of Federal Reserve Banks received by the Federal Reserve Board indicate that there is little uniformity among Federal Reserve Banks in the preparation and rendition of these reports to the Federal Reserve Board. This is due to the fact that certain Branches include in their expense reports items which are not directly incurred by the Branch, such as

Assessments a/c expenses F. R. Board,
Federal Advisory Council,
Governors' conferences,
Federal Reserve Agents' conferences,
Cost of Federal Reserve currency,
Miscellaneous charges a/c note issues,
Taxes F. R. Bank note circulation.

"In addition, the Federal Reserve Bank of Atlanta charges its Branches with a part of the overhead expen-

of the Head Office on account of the salaries of the Governor, Federal Reserve Agent, auditor, etc., under authority of the Board granted in 1917. So far as I can learn no other Federal Reserve Bank has adopted a similar policy.

"Inasmuch as Branches of Federal Reserve Banks are now established for the purpose of rendering more prompt and efficient service to member banks located in sections remote from the parent Federal Reserve Bank, it is thought that the accounting records of such Branches should be kept in such manner to show so far as practicable whether or not the improved service given to member banks in the Branch territory is of sufficient value to warrant the added expense of maintaining such Branches, rather than to what extent, if any, the Branches contribute to the net profit of the parent Federal Reserve Bank.

"With this in view, and in order that the Board may have expense figures of all Branches on a comparable basis, I would recommend that the attached draft of letter be sent to the Chairman of all Federal Reserve Banks in this connection."

There is a recommendation made to the Board. Before

sending out this letter, I agreed to discuss the matter with the Governors and Federal Reserve Agents of the Conference.

Now, the apportionment of administrative and overhead expenses between Federal Reserve Banks and their branches. That is the subject of the letter. This letter reads:

"It is the present practice of some of the Federal Reserve Banks to charge their branches with a portion of the overhead expense of the Head Office on account of salaries of the Governor, the Federal Reserve Agent, and the Auditor, also with certain expenses not actually incurred by the Branch, such as the cost of Federal Reserve currency, including taxes on Federal Reserve Bank note circulation, issued to banks in branch territory, etc.

"In order that the Federal Reserve Board may have figures of the expenses of all Federal Reserve Branch Banks on a comparable basis, it is requested that beginning with the month of October the current expense reports, Form 96, of each Federal Reserve Branch Bank be made out so as to show both for the current month and

for the period since July 1, 1920, only such expenses as were actually incurred by the Branch, i. e., they should not include any charges connected with the issuance of Federal Reserve currency, for overhead expenses at the Head Office, for the expenses of Federal Advisory Council, Governors' and Federal Reserve Agents' Conferences, or for the maintenance of the Federal Reserve Board."

Now, the law in the case is governed by Section 3 of the Federal Reserve Act, which is the second section in the entire Act. The Board's construction of that section is that a ^{branch} / is an essential part of the Federal Reserve Bank itself, that it exercises no independent function, it is merely an office of the Federal Reserve Bank and a part of it just as much as the transit department in the home office is a part of the bank or just as much as your currency department is a part of the bank. The Board regards it as very important, in order to make a uniform report to Congress, which we are required to do in respect to all these matters, that there be some uniformity in the methods of accounting of these banks' expenses. Now, after all,

just what reason is there why all this bookkeeping should be determined, why you should go to the trouble of figuring your proportion of overhead and all that against your branch bank any more than you figure that against any one of your own divisions and your own home office, I do not see.

Governor Galkins. It seems to be obvious we should not try to do it, because it cannot possibly be done.

Mr. McCord. It was established for this reason. Branches would vie with each other and with the parent bank when it came to the matter of showing profit, and our Board of Directors deemed it advisable to allocate the overhead expense in each separate branch in order that it might be determined as to whether that branch was a profitable branch or not, and keep down any competition or controversy as to whether this branch or that branch or the other branch was making more money, and so forth. That was one of the prime reasons for allocating that.

Governor Harding. In view of the acknowledged supremacy of the Bank over its branches, which supremacy has been acknowledged by the Board, in view of the

fact that you have three other branches besides New Orleans, and in view of the policy adopted by all the other Federal Reserve Banks, and in the interest of sound accounting, what is the objection to your pursuing that policy and complying with the Board's request if this letter is sent out?

Mr. McCord. None whatever.

Governor Harding. Does any other member see any objection to this letter?

Mr. Hardy. I think that there is a feeling of jealousy aroused and competition among the points that have branches, and I do not think it is a logical proposition.

Governor Harding. The officers of the Atlanta banks will bear me out when I say that the Board has always sustained them and taken the position that the branch was actually under the control of the parent bank, but that the Board did not regard themselves responsible directly for the conduct of the branches, but would hold the parent bank responsible for the conduct of the branches.

Mr. McCord. We asked for authority at the time, and we were proceeding on that course, and we had no objection to it whatever.

Mr. Hardy. I am satisfied we have no such practice, and I am inclined to agree with Mr. Galkins that if we start to do it we will find that we cannot do it, except to guess at it.

Mr. McGord. You could do it on a basis of reserve and capital.

Governor Harding. There were some questions propounded here at the first meeting of this Conference. I understand that Governor McDougal is ready to reply to them.

Governor McDougal. Governor Harding, the five questions submitted by the Conference on the opening day to the Governors' Conference were considered, action was taken, and the replies are brief, and I will read from this memorandum. The first question was:

Will it be advisable or practical next year, or in the near future, to establish in each district a uniform rate on all classes of paper except bankers' acceptances, doing away with any differential on government-secured paper?

It was the vote of the Conference that it will be advisable and practical in the near future to establish in each district a uniform rate on all classes of paper

except bankers' acceptances, doing away with any differential on government-secured paper except possibly Treasury certificates.

The second question was:

Should there be a limit fixed in advance on inter-bank borrowings?

The Conference answers this question in the negative.

The third question was:

Should there be a uniform inter-district discount rate?

The Conference answers this question in the affirmative

The fourth question was:

Shall the borrowing Federal Reserve Banks be required to fix a rate to its customers to meet the rate of the Federal Reserve Bank from which it borrows?

It is the sense of the Conference that to take such action would introduce a new factor into the fixing of a discount rate and might involve, under certain circumstances a change of rate on the part of the rediscounting bank which would not be justified by fundamental conditions in the district, and that therefore such action would be injudicious.

The fifth question was:

Should there be a theoretical limit on issue of Federal Reserve notes to member banks?

The Conference answers this question in the negative.

With respect to the regular program considered by the Governors' Conference, Governor Harding, we shall report in a very short time to the Board with respect to all action taken, recommendations made, and we hope that the Board will be considerate enough to give attention to these matters at the earliest possible time.

If that report is satisfactory, that will constitute our report. If there is any topic concerning which you wish a discussion, we will be glad to have it presented.

Governor Harding. I see Mr. Harrison of the Federal Reserve Bank of New York here. He is Deputy Governor of that bank and until recently has been General Counsel of the Board. Unless objection is raised, I will ask Mr. Harrison to discuss briefly the theory of the Board's ruling that a cotton factor's paper is not eligible for discount at Federal Reserve Banks. You are probably aware that a strong committee appeared before the Board

and insisted that that ruling be abrogated or dispensed with and that cotton factors' paper be allowed to be discounted. Before you start, Mr. Harrison, I will say for your information that two or three of the Senators said that they were co-authors of the bill or had something to do with that particular paragraph, and they claim that cotton factors' secured paper is eligible, under the wording found in Section 13.

Mr. Harrison. The history of the matter in reference to the cotton factors is so long and interesting that I am sorry I did not have a little more opportunity to prepare myself in speaking on this subject. To start, it would be interesting to go back of the specific question to some extent. In the early days of the System a question was presented to the Board which involved at the outset the question of what was the commercial purpose to which the proceeds of a particular note might be put. In other words, should the Board declare to be eligible a piece of paper the proceeds of which, by affidavit or otherwise, might be determined to have been put ultimately to a commercial purpose, or should the Board arbitrarily define a limit which would

ascertain the purpose at the outset. There was a bank in Georgia, as I remember, that raised the question in the first instance.

Governor Harding. Texas, I think it was; there may have been a Georgia case too, but I remember the Texas case.

Mr. Harrison. Well, a bank in the South, I will say. This was long before, I may mention, the Federal Reserve Banks were authorized to make discount upon member banks' notes. This bank borrowed some money from another bank upon its own note. That note was presented to a Federal Reserve Bank for discount. That raised at the outset the fundamental principle upon which the Board has acted ever since; could paper the proceeds of which were used by a bank or banker or financial institution of any kind for the purpose of lending to some other person be considered eligible? The Board ruled that this particular note was financial paper and it was ineligible, The bank came back and said that all its customers were farmers, that they made no loans to any one but farmers, and that they could prove that the proceeds of this note were lent to farmers. But the Board said no, that

in this particular case the proceeds were used to lend to some other person.

That ruling, which was not objected to at the time and was regarded as fundamental, was the basis of the subsequent amendment to the Act which permitted the Federal Reserve Banks to make advances upon the notes of member banks provided they were secured by eligible commercial paper.

The purpose of that amendment was two-fold: First, I think partly to avoid--well, the real purpose was to avoid the difficulties incident to handling notes of varying maturities, on a short transaction of perhaps five or ten days. The fact, however, that that amendment was necessary in the case of member banks' paper showed that the Congress itself felt clearly that no note the proceeds of which were used by some third party could be considered eligible, no matter how secured. When, therefore, the cotton factors' paper was presented to the Board for consideration, it was made to appear that the cotton factor is in no way ^{different} from the banker who was borrowing money to send to a farmer upon the security of cotton shipped to the factor for sale. It is argued that that

is incident to the necessary functions of making the cotton. That is true, but that is the very function of every bank in the country, its business is incident to the production of goods. The mere fact that a bank is lending money for that purpose is not making its paper per se eligible.

For the same reason the paper of the cotton factor who borrows money to loan to a farmer is a bait, if you will, to get business, and his business is the selling of cotton.

Immediately this brings into consideration one section of the law, which says, quoting from memory, that nothing in this Act shall be construed to prohibit such notes, drafts and bills of exchange, secured by staple agricultural products, or other goods, from being eligible for such discount. The Conference I think will be interested in a history of that particular phrase.

At the time the Act was under consideration there is no doubt that a large element of Congress tried to make eligible at all events paper which was secured by agricultural products, regardless of the purpose for which the loan was made, and that particular section was

put in the law with the avowed purpose of making eligible at all events paper which was secured by agricultural products, and a Congressman with whom I conferred in regard to the matter told me that he inserted the word "such" before "paper". This Congressman to whom I refer was on the Banking and Currency Committee at the time. He said he was interested to know whether the Board ever made a ruling involving the construction of this particular section of the law. I told him yes, that we had ruled that no paper was eligible even if secured by farm products, unless it conformed with the prior provisions of the Act, which provided that its proceeds must be used for an agricultural or commercial purpose. He said "Bully for the Board," that was the necessary ruling and the one demanded by all the fundamental principles of the Act."

He said "I will tell you the history of that. When that section was put into law the agricultural interests wanted to make eligible at all events paper which was secured by agricultural products", and, he said, "I inserted the word 'such' before 'paper.'" He said "I confess a great many people did not know what it meant,

the purpose of it, but," he said, "the purpose of it, and the one which you have followed since then, was to take that particular section in connection with the prior section, which says "commercial paper is that paper the proceeds of which have been used for a commercial or agricultural purpose."

So this is the situation: You have the first part of Section 15 defining what is commercial or agricultural paper and you have another provision which says "such paper shall not be ineligible when secured merely by farm products."

Governor Harding. May I interrupt you a moment?

Mr. Harrison. Certainly.

Governor Harding. The point was raised by the Senators yesterday afternoon, also, that we had no right in our new regulations to use the words "in the first instance."

Mr. Harrison. That is only putting into the regulations a principle adopted by the Federal Reserve Board and every one of the banks since their inauguration, and it was merely to make evident that very principle that that amendment was placed in the regulations. If we do

not do that, you make eligible every bit of bank paper issued by all sorts of companies, guaranty companies and all these institutions which in the past few years have been trying to finance automobiles.

Mr. Williams. You say that the word "such" was perhaps inserted unobserved. Now if Congress thought that it was giving effect to that statute, giving it the effect which it had before the word "such" was inserted, and passed the bill in good faith, with that expectation, do you think that the word "such" was inserted--while the debates in Congress may have shown that they did not intend to give it the meaning which it would carry with the insertion of the word "such," that that would have any bearing, and, if so, what bearing upon the construction we should give to that act?

Mr. Harrison. Mr. Comptroller, I feel, though the history of the manner in which that word was inserted is a matter of interest to us at this particular time, it is not a matter that is pertinent in determining the ultimate construction of the law. After all, you may prove very conclusively that nine tenths of members of Congress in many instances do not know what they are enacting in a

particular paragraph, and that fact, whether established by oath or not, is not determinative of the construction of the law, because if it were you would never have any stable legislation. I should perhaps make some reservations in making that statement. I am simply speaking from my recollection of past conversations with a member of Congress, and I will not give his name for the record, although I have no objection to mentioning it to any of the members here, because I am sure that he is proud of the fact this word was inserted, if only because of his realization of its necessity in maintaining the very deep principles for which the Act stands, that is, that money shall be loaned only for a commercial or agricultural purpose in helping production, the carrying on or marketing of goods, and not for the purpose of covering goods in storage or otherwise or for purely speculative purposes, and if we do not give the Act the particular construction I have referred to, it would make possible the carrying of goods and farm products for an indefinite purpose.

Mr. Hamlin. I understand that provision merely to say that agricultural paper is still agricultural paper

although it may be secured by agricultural products.

Mr. Harrison. If the proceeds of the paper in the first instance were used--

Mr. Hamlin. What necessity would there be for saying that that agricultural paper still remains agricultural paper if secured by agricultural products? Congress must have had something else in mind than that trite statement, I should think.

Mr. Harrison. No, not necessarily so, Mr. Hamlin, for this reason that you know, as well as all the members of the Board, that many people have been told for a long time that a piece of paper secured by bonds of the Pennsylvania Railroad Company, for instance, was ineligible, on the theory that it is a loan to carry on finance the holding of Pennsylvania Railroad bonds. As a matter of fact, the Board has ruled very decidedly that that paper is eligible if used for a proper purpose regardless of the security. That is, used for one of the purposes specified by the law.

In the case of National Banks, the question of the eligibility of a loan depends always upon the collateral. Congress has known that, and it is the backbone of the

National Banking System. Personal security is all right, real security is not.

Now, it seems that an attempt is being made to change the whole fundamental nature of the eligibility of paper. When it comes to the Federal Reserve System, the collateral makes no difference, they say, the purpose of the proceeds of the loan is no criterion, except government bonds.

Mr. Hamlin. What does "merely investment" mean? That is, agricultural paper secured by agricultural products is all right if not merely for investment.

Mr. Harrison. I confess I am a little bit at a loss, because I have not a copy of the Act here, and I have not reviewed it for some time. As I remember, however, that particular feature of the law was inserted for the purpose of precluding the eligibility of any paper created for the purpose of carrying investment security.

Mr. Hamlin. "But "Merely for investment" seems to qualify it.

Mr. Harrison. Well, as I say, I have not looked that up.

Mr. Williams. Do you not think it was the purpose of Congress, in introducing that clause relative to agricultural products, to liberalize, not to limit?

Mr. Harrison. I think so originally, Mr. Comptroller, I agree that that was the original purpose, but I feel also equally certain that the subsequent amendment to that particular section on the floor of the house was in itself sufficient to neutralize the main purpose.

Governor Harding. Let the record show that the House Bill in conference essentially prevailed, that in all disputed points the House got the better of the Senate.

Mr. Harrison. This is, on the floor of the House even before going to conference, I think.

Dr. Miller. Yes, but the House wording in that section went to the conference--

Mr. Harrison. I believe it did.

Dr. Miller. And the Senators were more liberal in these particulars.

Mr. Harrison. It is very obvious, from reading the particular paragraph, that it is not only not very clear in its intent anyway, but is really ungrammatical and so involved as that it is pretty hard to tell what

was really intended in the first instance. So when it comes to a question of constitutionality we have to do the best we can with the law before us. The word "such" clearly refers back to eligible agricultural paper. I will read the sentence:

"Nothing in this Act contained shall be construed to prohibit such notes, drafts and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount."

Governor Harding. It does not say any note, but says "such notes."

Mr. Harrison. Yes, and the construction of the sentence, too, rather makes it more consistent with the insertion of the word "such" than I had supposed, because it says "such notes, drafts and bills," etc., secured by staple agricultural products. In other words, it just says--it is in the negative--that nothing in this Act shall make ineligible eligible paper when secured by agricultural products.

Dr. Miller. Agricultural paper might be eligible, if secured by agricultural products, just as a commer-

cial note might have a chattel mortgage or a land mortgage to secure it, that would not destroy eligibility as commercial paper.

Mr. Harrison. And that we have accomplished by regulation of the Board, whereas this other thing is accomplished by a provision of the law.

Dr. Miller. Yes.

Mr. Harrison. In other words, you might properly argue that this has provided in advance for a contingency that subsequently did arise.

Dr. Miller. I have always considered that in the case referred to it was not a speculative note any more than if a Pennsylvania Railroad bond is attached to a commercial note, a merchandise note, that that does not make it a speculative proposition, it does not lose its eligibility by reason of the security attached to it.

Mr. Harrison. I think that is a necessary construction, for the reason that if you do not place that construction upon it you have the effect of making eligible any paper regardless by whom made and regardless of the purpose for which it is made, so long as it is

secured by an agricultural product--

Mr. Williams. Unless held by investment.

Mr. Harrison. Even assuming that his construction of that part of it, unless held for investment, would be unnecessary, because no products^{that}/are being held for any other purpose would properly come within the distinction of the eligible part of the law.

Mr. Hamlin. Could you just read that, merely for investment, that clause.

Mr. Harrison. The particular sentence in which that occurs begins with the part I have just read, nothing in this act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares or merchandise, from being eligible for such discount.

Mr. Hamlin. Suppose you read the sentence before that.

Mr. Harrison. That is, the discount of eligible agricultural paper. The word "such" occurs twice. Then there is a semi-colon, and then the words "But such definition shall not include notes, drafts, or bills covering merely investments." It is not a definition,

because it is purely in the negative. And then it reads: "or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States."

One man's guess is perhaps as good as another one's on that.

I think that provision of the law relates to the subject which is covered by the Board in its specific paragraph of regulations, which says "No note the proceeds of which are used for permanent or fixed investments, such as land, machinery," and what not, "shall be considered eligible for discount," including the bonds and notes of commercial corporations or any institution other than the Government of the United States, and that gives it a logical conclusion.

Mr. Hamlin. May I ask another question?

Mr. Harrison. Certainly.

Mr. Hamlin. Do you consider a cotton factor a banker?

Mr. Harrison. Not in the ordinary sense.

Mr. Hamlin. A money lender?

Mr. Harrison. I think he is, yes, just as Wanamaker might be considered to be a money lender, because part

of his business is running a little bank in connection with his big business. So far as he is borrowing for commercial purposes, his paper is eligible, but so far as the cotton factor was borrowing to conduct the incidental part of his business, lending money, it would be ineligible.

Governor Harding. An argument was made yesterday that the whole essence of the cotton factor's business was to get control of the sale of the cotton, that the advances he makes in the spring of the year are not made for the sake of the interest received on the money advanced, that that was not the underlying basis of the proposition at all, but the cotton factor wanted to get control of the sale of the cotton when it was ready, and a good many cotton factors claim that their interest accounts show a balance on the wrong side of the ledger, some of them do, and that they claim that they are entitled to consideration in this matter for the reason that their business is very clearly and essentially part of the production and making of an agricultural staple. They claim that they are not money lenders, that they confine their business entirely to making advances to producers of a certain commodity and to the sale of that commodity, and that the

Board could therefore distinguish in their favor as against anybody else who might be in the general money lending business.

Mr. Williams. They lend the money to produce the cotton, to enable the farmer to produce the cotton.

Mr. Harrison. There is really not much difference in that. Well, to take a specific case, the Continental Guaranty Corporation organized originally to finance the automobile business. Their original proposition was this, that the manufacturer of automobiles did not know his customers or had no way of knowing the various dealers, and the Continental Guaranty Company, through its various correspondents, was able to say who the dealers were and knew them, and was in a position to sell to the dealer on cash, and they said they would lend the dealers the money required, and they tried to make eligible their notes the proceeds of which were used to lend solely to dealers who were buying automobiles.

Mr. Williams. That is not an agricultural commodity?

Mr. Harrison. No, but it is a commercial commodity.

Mr. McCord. May I ask a question?

Mr. Harrison. Certainly.

Mr. McGord. The Continental Guaranty Company is in the business of lending money and they are not in the business of carrying on the operation of a warehousing proposition and they do not depend upon a warehousing proposition for the main part of their profit.

Mr. Harrison. I think in this connection it may be interesting for me to review for a minute the situation that we have been confronted with in New York. Some of the Federal Reserve Banks, I think it was Kansas City, in the first place, refused to discount the paper of one of the packer commission merchant houses, as they are called, on the ground that the paper was ineligible under the terms of the cotton factor ruling. That made us take notice for the first time, made us go into the fundamental character of that particular class of paper. We have been investigating that for nearly three months, interviewing all the various commission houses, interviewing the attorneys and interviewing the members of one admittedly banking house that is doing the same character of business. I hesitate to give any conclusions yet, because I have not finished our investigations.

Mr. Hamlin. And that paper is being taken by other banks?

Mr. Harrison. Yes, and we are taking it ourselves. Those people do business in a very different way from the cotton factor.

In the case of the commission merchant, the mills ship goods direct to the commission merchant and the commission merchant agrees to sell those goods to anybody he cares to sell them to. At the outset that looks very much like the cotton factor, particularly as the commission merchant advances funds pending ultimate sale by the commission house to the buyer. If, however, you look into the decisions of the courts interpreting those transactions, in most of the states of the South and the State of New York, you will find that the New York courts have held that the Massachusetts mill shipping to the commission merchant in New York is not doing business in New York at all, that this is the commission merchant that is making the sale of the goods, that the creditor will cannot attach the goods in the hands of the commission merchant in the sense that the attachment would usually be made, subject to the lien of the commission merchant or subject to moneys advanced.

In other words, the courts have said that the mill no longer has any interest in rem, to use a legal term.

That means an interest in the goods themselves, against the commission house, under the contract to sell.

You take a case in the South, however, and not only has the farmer still an interest in the cotton, but under the laws of those various states he can trace the cotton to the ends of the world in the hands of bona-fide purchaser to make good the amount of money received by the factor but not paid over by the factor to the farmer. In other words, if the factor fails, the farmer can trace his goods anywhere.

Mr. Hamlin. Do you mean to say he could take them from a Federal Reserve Bank?

Mr. Harrison. Yes. The Federal Reserve Bank would hold the cotton.

Mr. Hamlin. Hold the certificates.

Mr. Harrison. Hold the certificates or have an interest in the cotton only for the amount that the cotton factor may have advanced to the farmer. But if a cotton factor makes a loan of 10 per cent of the value of the cotton to the planter, if that cotton goes into the hands of a Federal Reserve Bank, it may have an advance of 50 per cent of the value of the cotton.

Mr. Williams. No, they say that is not done; these

large factors appearing before the Board yesterday stated specifically that they never pledged the cotton for more than the amount they were loaning on the individual bale.

Mr. Harrison. I asked the cotton people about that last spring and they said all they could guarantee was that the aggregate of their loans did not exceed the aggregate of their interest in the cotton, but they did not know, or did not attempt to undertake to prove, how much was advanced against any one particular bale.

Governor Harding. I asked questions about that yesterday and they said if they borrowed \$5,000.00 on cotton they were very careful to figure out how much had been advanced on each particular bale. They said that they kept a record of it.

Mr. Harrison. In order to clinch the record, may I^{say} something in that connection, regardless of whether or not the cotton factor borrows only to the extent of his interest in the cotton. I am citing that not to show that the Federal Reserve Bank has not got a good line on the cotton, but rather to show only that the cotton factor is borrowing from a bank to lend money to somebody

else on the security of cotton, and that is what I say the commission merchant in New York will not do.

Mr. Hamlin. I would like to ask about the notes of this commission firm you spoke of, in New York, or that type of note. Does the Federal Reserve Bank take them when they are not secured?

Mr. Harrison. Oh, yes.

Mr. Hamlin. In other words, you recognize that that type of note is commercial paper?

Mr. Harrison. Yes.

Mr. Hamlin. What is the difference between that and the cotton factor, that is what I cannot see?

Mr. Harrison. There is the same difference between them as there is between Woodward & Lothrop and the Commercial National Bank. One is financing, if you will, the marketing of goods he has acquired from a producer. The other is helping the producer finance his own goods by lending him money just like a bank would.

Mr. Hamlin. I do not see that.

Governor Wellborn. Does the commission merchant advance money to the mill?

Mr. Harrison. Yes.

Governor Wellborn. If he advances it to the mill, why

not to the farmer.

Mr. Harrison. But my point is that under the decisions of the courts the mill no longer has an interest in the goods, so it is equivalent to a part payment on goods purchased. I am trying to describe as to what is the fundamental nature of the paper of each of these concerns, and I am at a little disadvantage because we have not quite finished our investigation in regard to the commission merchants in New York. That investigation is still going on. But so far as our investigation has gone, we feel that there is a real difference as the business is conducted.

Mr. Hamlin. Suppose he had complete title, as the commission merchant has, would not that put the two cases absolutely on a parity?

Mr. Harrison. No sir, for the reason that in the one case legal title goes to the factor and in the other case the legal title never touches the factor.

Mr. Hamlin. Wouldn't the commission merchant have a legal title?

Mr. Harrison. Yes, he has a right in the goods themselves.

Mr. Hamlin. I am assuming that the factor gets the cotton itself and has the legal title to that cotton.

Governor Harding. But he has not. Tell me how the commission merchant gets a legal title, that is what I want to know.

Mr. Harrison. In the old days the commission merchant in New York did only one thing, he bought imported goods to resell in this country, and he borrowed money to pay for goods that he bought abroad. There was never any question that the foreign seller was borrowing money from the commission merchant, he was merely taking money as part payment for goods sold, under a contract which provided that he should get the balance as soon as the commission merchant had effected the disposition of the goods. This business has developed steadily for years along those same lines, so as to extend to commercial business, so as to provide an effective means of marketing the wares of practically all the mills in New England. The greater part of it is done through these commission merchant houses; they know the buyers; they take all the credit risks; if the buyer fails, they lose entirely.

Mr. Williams. Suppose the cotton factor sells cotton to a man that fails. He is responsible to the farmer?

Mr. Harrison. But if the cotton factor fails and neglects to make good his obligation to the farmer, the farmer can get his money back.

Mr. Williams. Not against the Federal Reserve Bank.

Mr. Harrison. Against any one.

Mr. Hamlin. Do you mean to say that the Federal Reserve Bank does not get any title whatever?

Mr. Harrison. They do subject to the amount--

Mr. Hamlin (interposing). That the factor has advanced?

Mr. Harrison. Yes.

Mr. Hamlin. Well, that is all that they advance.

Mr. Harrison. I know, but I am afraid, again, we are confusing the affected security of the Federal Reserve Bank upon the determination of whether or not the paper is eligible, and the Board has never considered the question of security, except in the case of Government bonds, in determining the question of eligibility. I am going into security only to show that as a matter of fact, cotton factors do not buy and sell cotton, but merely act as agents for the farmers, and that a cotton factor does a little banking business on the side, lending to the farmer pending sale.

Governor Harding. Let me put this case. Some times when the pig iron market is dull and the furnaces do not want to shut down, they will ship No. 2 foundry or gray forge , for instance, to a certain concern and that concern, pending sale of that pig iron, will make advances to those furnace companies of, say, 75 per cent of the value of the pig iron. Now suppose a firm whose entire business was receiving consignments of pig iron and advancing to the furnace company against that pig iron to them, would that firm's note given for the purpose of getting funds to conduct their business be eligible or not under your rule?

Mr. Harrison. As I understand it, as you state the facts in that case, probably it would be ineligible. There are lots of cases like that. There is the case, for instance, of the Lumber Sales Corporation, who are a lot of lumberdealers combined for the purpose of effecting sales organization, and they ship goods to the sales organization for sale at prices that they fix themselves. The sales organization finance themselves by borrowing from their banks on their notes. The Board has ruled time and time again that the notes of the Lumber Sales organization are not eligible unless it is an independ-

ent corporation which buys and resells.

There has never been any doubt that if the farmer will draw on the factor and use the proceeds of the draft for the purpose of producing his farm products, the paper is ineligible.

Mr. Hamlin. Suppose a customs broker on an import transaction covered by an import acceptance advances the money temporarily to pay the duties and then accounts to his client; supposing he wanted to borrow money to furnish himself with capital for making those advances, would not that be considered eligible commercial paper?

Mr. Harrison. What is the nature of the man's business?

Mr. Hamlin. He is a customs broker, he takes goods from the custom house, advances the money to pay the duty, and he wants to raise some money for that, and he issues his notes, and that note goes to the Federal Reserve Bank, would that be eligible according to your definition of eligible paper?

Mr. Harrison. As I understand it, it probably would not be eligible, but I would like to look into the facts more closely before I answered that. It is not at all

different from any other corporation; whether you call it a bank or banker or credit company or guaranty company or what not, they are all a part of the machinery of marketing goods, that is what they are for, but the mere fact that they are a part of that machinery does not make their paper eligible.

Mr. Hamlin. The point I wanted to make was that they might be considered a part of an agent, so to speak, not the general banking agent, but an agent of the factor, and that his advances might possibly be considered commercial paper.

I would like to ask this question of Mr. Curtiss. Is it not a fact that in Boston your construction of the law differs from what Mr. Harrison has stated?

Mr. Curtiss. He does, as he explains with reference to the commission house he mentioned several times. We have similar cases and we are investigating one particular case now to see whether it comes up to this classification that you refer to.

Mr. McCord. You say the paper of these commission houses is taken. Now, that statement shows possibly advances to mills, so much, which is an account.

Mr. Harrison. It shows also bills receivable.

Mr. McCord. But hold on--

?? Mr. Harrison. Well, all of them word their statement in a different way--

Mr. McGord. It all means the same thing. They charge up as accounts, or as bills receivable, advances to mills, and it is all an account and regarded as a quick asset. Now those commission houses you speak of charge the mill a commission for the sale of their goods, and those goods are consigned to them and advances made against them. I can see no difference between that and a cotton factor.

Mr. Hamlin. Of course, in all those cases a mill could give a note and a commission merchant endorse it.

Mr. Harrison. As a matter of fact, in a conference I had day before yesterday with the Textile Banking Corporation, admittedly a bank, and trying to do business the same way as these other people do, they wanted to know what I would suggest that they should do. The Board has ruled that their paper is ineligible for the reason that it is impossible for them, under their charter, to do business in a way to make it eligible. They asked what I would suggest, and I said "You can continue to do your business that way, but your paper will be ineligible, or you can do the thing that will make it eligible,

and "acceptance drafts drawn against you as a banker."

The gentleman with whom I was talking asked "Can we do that?" I said "Yes, because the goods are shipped to them by the mill on a bill of lading, they are prospective buyers."

Mr. Hamlin. They could give a banker's acceptance.

Mr. Harrison. Yes, they could give a banker's acceptance. As a matter of fact, they are giving bankers' acceptances.

Mr. Hamlin. Well, could a factor give a banker's acceptance?

Mr. Harrison. It is rather ^{im-}material whether you call a draft given by him, an acceptance on him, a banker's acceptance or not; his paper would ^{be} eligible because the proceeds would be used by the farmer for an agricultural purpose. You have the case of the Cotton Sales Corporation or the Cotton Cooperative Association, or whatever it is, where I understand the Board has already ruled that the paper drawn by a farmer on that association is eligible.

Governor Harding. They say they have done business in one way for a hundred years and we have to let them alone.

Dr. Miller. It strikes me that we are giving altogether a disproportionate time to the discussion of a technical detail, and it strikes me that this is a settled question in the minds of most of us. As a question of interesting argument, we might go on indefinitely, but I should think that those who wish to discuss it further might discuss it with Mr. Harrison personally, and I would suggest that the Conference might well proceed to the discussion of other questions that it may have to consider.

Mr. Harrison. I apologize for taking so much time.

Mr. Williams. I wish to dissent very strongly from Dr. Miller's position that this is a mere technical question. I happened to be present at the hearing yesterday. There were six United States Senators present and representatives in behalf of the cotton industry of the Southern states, who apprized us that their interests and the prosperity, the prosperity of the whole section, was jeopardized and endangered and will be further endangered if the ruling recently made goes into effect. So I do not know anything we can discuss with more profit at this time than this particular question. It is not a

sectional matter, either, for the principle involved affects all agricultural districts.

Dr. Miller. I do not mean to imply, when I say it is technical, that it is not an important thing, but I do not think it is important to go on discussing this question any further at this Conference, at this session, in view of the time we have given to it and in view of the fact that the discussion for the last fifteen minutes has apparently not advanced very much. Not that it is not important in its effects, but I do not think a further discussion of it at this time is very important.

Governor Harding. Do you raise the point of order that these proceedings are out of order?

Dr. Miller. Nothing so rigid as that.

Governor Harding. I am sure none of us wishes to protract the discussion unnecessarily.

Governor Wellborn. This discussion has brought out some facts that Mr. Harrison did not seem to be acquainted with, one of them being that they give these notes and also these acceptances.

Governor Harding. The strong point that they made yesterday was that the cotton factors "could be distinguished from any other business, inasmuch as their busi-

ness was connected from start to finish with the production of a staple crop, and that they did not lend money. That impressed me.

Mr. Williams. It seems to me the solution of this problem would be for the factors to be given notice that they must call upon their farmers to give notes early in the season, in February, March and April, when they make those advances, and those notes will be eligible unquestionably when those factors want to use them in the banks.

Governor Harding. They were so advised last spring.

Mr. Williams. But later on, when the time comes for the marketing of the cotton, they need more money than they have in hand or than they have available, and they want to be able to have farmers ship the cotton and get further advances from them, and they want to be able to use the cotton which is shipped to them on warehouse receipts and on bills of lading. The bills of lading and the warehouse receipts come in at this season of the year and the farmers' notes earlier in the season.

Mr. Harrison. I am sorry I took so much time, but I would be glad at any time to discuss this question further

with anybody, either with the Board or anybody that is particularly interested in it.

Governor Harding. Mr. Jay has a paper which he did not read yesterday on account of the lack of sufficient time, and we will be very glad to hear from him now.

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Mr. Jay. The third topic of the programme for the conference prepared by the Federal Reserve Board is:

III. FEDERAL RESERVE NOTE ISSUES.

1. Is the note-issue policy of the Federal Reserve System subject to legitimate criticism:
2. What connection is there between changes in the volume of credit and the volume of currency?
3. Is there any difference in relation to effect upon prices between the volume of credit and the volume of currency?
4. Can the note-issue policy of the Federal Reserve System be properly charged with any important responsibility for inflated prices, if so, what has been the responsibility and in what way does the issue of Federal Reserve notes promote or assist inflation?
5. Can the accepted principles of bank-note currency regulation, applicable in normal circumstances when the commerce of the world is conducted on a gold standard, be safely taken as a guide in the abnormal circumstances now existing, when the gold standard is virtually suspended, except in the United States and Japan?
6. In connection with the policy of credit control should the present note-issue policy of the Federal Re-

serve System be changed and restrictions be thrown around the issue of Federal Reserve notes?

7. If the issue of Federal Reserve notes should be restricted, what form should the restriction take and what effect would different methods of restriction have?

(a) Imposition of charges against Federal Reserve notes upon the uncovered part of circulation issued to them at a given rate, for example, a fixed rate of 5% or a rate varying with the commercial rate.

(b) Would it be practicable to establish for each member bank a so-called normal currency limit and to impose charges upon member banks calling for notes in excess of their limit?

(c) Would it be advisable while continuing to have the Federal Reserve Banks pay all transportation charges on incoming currency, to have shipments of outgoing currency made at the expense of the consignees?

(d) Restriction by definition of the character of the paper acceptable as collateral by the Federal Reserve Agent against the issue of Federal Reserve notes.

Should member banks' collateral notes or customers' notes secured by Government obligations be taken as

collateral for Federal Reserve notes?

(e) Limitation of the total volume of Federal reserve notes by the Federal Reserve Board, the maximum amount being fixed pro rata for each Federal reserve bank.

(The Federal Reserve Board has statutory power to accept in part or to reject entirely all applications for Federal reserve notes.)

(f) Restricting issues of Federal reserve notes to Federal reserve banks as a potential means of enforcing credit control; canvass of English experience and views.

Would restriction of note issues in any of the above-mentioned ways operate to promote a better control of credit, and if so, what would be the effect upon the commerce and business of the country?

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I. INTRODUCTION

(a) The questions proposed by Federal Reserve Board.

The third subject which the Federal Reserve Board has proposed for consideration at this conference is, properly speaking, the relation of Federal reserve notes to inflation. The questions proposed by the Board seem to indicate the desirability of considering whether Federal reserve notes are sound in both theory and practice and to what extent note expansion has contributed to the existing price inflation. The inference is that if the theory or practice under which they have been issued has proved unsound, or if their influence on price inflation has been baleful the Board should now exercise some of its discretionary powers to restrict their volume.

These remarks will be directed chiefly to a consideration of the characteristics of the Federal reserve note as a bank note, the primary causes of its issue by a Federal reserve bank, its relation to the expansion and contraction of deposits, the relative effects of notes and deposits upon price inflation and, lastly, the methods of controlling the issue of Federal reserve notes suggested by the Federal Reserve Board as contrasted with the necessity for controlling the

demand for credit itself.

John Stuart Mill, in his "Principles of Political Economy", says:

"I apprehend that bank notes, bills, or cheques, as such, do not act on prices at all. What does act on prices is credit, in whatever shape given, and whether it gives rise to any transferable instruments capable of passing into circulation, or not."

That the object to which we should direct our energies is not the demand for either deposits or notes, but the demand for credit itself, it will be the purpose of this paper to show.

I. INTRODUCTION.

(b) Inflation.

The Oxford Dictionary defines the verb "to inflate" as-

"To swell or expand artificially or unduly; to expand beyond proper or natural limits; to raise above the amount or value which sound commercial principles would fix."

Generally speaking, inflated prices result from a disproportionate increase in the volume of the purchasing power in terms of dollars as compared with the vol-

ume of goods available for purchase. While gold and bank credits (whether deposits or notes) all constitute "purchasing power" and while abnormal supplies of any one or all of them tend to promote an increase in the price of goods, assuming that the volume of goods remains stationary, nevertheless, the real problem for consideration is the proper method of controlling the demand that results in the increase of any one of the elements constituting "purchasing power."

II. THE FEDERAL RESERVE NOTE.

In order to advance to clarify the discussion which will follow, it is necessary to define in some detail the essential characteristics of the Federal Reserve note; how it is issued and the reason for its issue.

(a) Its Standing Under the Law.

Under the terms of Section 16 of the Federal Reserve Act it is provided that Federal Reserve notes are "obligations of the United States and shall be receivable by all national and member banks and Federal Reserve Banks and for all taxes, customs and other public dues. They shall be redeemable in gold on demand at the Treasury Department of the United States, in the city of Washington, District of Co-

lumbia, or in gold or lawful money at any Federal Reserve Bank."

While the notes are, therefore, not legal tender for all purposes, they are, because of their character, generally acceptable not only throughout the United States itself but in many nearby countries as well. Their safety and goodness cannot be questioned since, in addition to being a direct obligation of the Government of the United States, they are fully secured either by the pledge of gold, commercial paper, or notes secured by obligations of the United States. Furthermore, they, together with Federal Reserve Bank notes, are a first and paramount lien on all of the assets of the Federal Reserve Bank of Issue. The aggregate assets of the Federal Reserve Banks are now about double the amount of their note liabilities. The law provides also that each Federal Reserve Bank shall maintain a gold reserve of 40% against the amount of its outstanding notes, thus insuring for all practical purposes their ready convertibility into gold. While technically they are redeemable in either gold or lawful money at any Federal Reserve Bank, regardless of whether or not it is the bank of issue, all Reserve Banks as a matter of practice

have established the policy of paying both their notes and their deposits in gold on demand. As long as notes, therefore, are not issued in such volume as to impair the confidence of the public in the ability of the Government to pay its obligations in gold on demand, and as long as the Federal Reserve Banks which issue the notes are able to prevent undue exports of gold, there seems to be no reason to doubt the ability of the United States to maintain its gold standard and to insure the convertibility of Federal Reserve notes into gold on demand.

II. THE FEDERAL RESERVE NOTE.

(b) Its Elasticity.

The Federal Reserve System was devised to overcome specific shortcomings in the organization which preceded it. In 1863-5 the National Banking System was evolved to provide, among other things, a note issue which would be of undoubted acceptability and goodness, of instant redeemability, and which would circulate at par throughout the entire country. During the period from 1908-13 the Federal Reserve System was evolved to provide, among other things, a note issue which, in addition to the foregoing characteristics, would be specifically

convertible into gold, would expand and contract with the emergency or seasonal requirements of the business community and would be interchangeable with deposits. Elasticity of credit, whether in note or deposit form, is the essential basis of the Federal Reserve System.

The law imposes no arbitrary limit upon the issue of Federal Reserve Notes, either absolute or with relation to capital. The only limitation upon the character of their deposits or notes is a prescribed and fixed relation to gold or lawful money reserve. In each case the limit is the same, except, for slight differences in amount and composition. The limit may be suspended by the Federal Reserve Board but in that event the law prescribes that in the case of notes a brake shall be applied through the motive power of higher discount rates, which shall increase progressively as reserves against notes decrease.

The power to expand credit has already been amply demonstrated. The fact that Federal Reserve notes have expanded faster than Federal Reserve deposits is not of itself any indication that they have expanded unduly, for reasons which will be discussed later, but is merely a result of the normal functioning of the system under

which a normal relation between the aggregate volume of the two different kinds of credit, hand-to-hand currency and deposits, must be maintained. The readiness with which Federal Reserve notes decline in volume after holidays gives clear evidence of their elasticity. The fact that their tendency in the main has been to increase with the increase of credit and prices does not justify an assumption that given declining credit and declining prices, the volume of Federal Reserve notes will not decline proportionally.

Reduction of the volume may be expedited by discount rates sufficiently high to discourage the taking of credit. Ready redemption is assured by the provision forbidding one Federal Reserve Bank to pay out the notes of another under penalty of 10%; and by the Federal Reserve Bank policy of paying the costs of shipping coin and currency to and from member banks. This practice facilitates the easy flow of hand-to-hand currency to and from its source. Besides, as coin and notes in the vaults of a member bank can no longer be counted as a part of its lawful reserve, it provides a direct incentive to carry no more than minimum till money requirements.

II. THE FEDERAL RESERVE NOTE.

(c) The cause of its issue.

Federal reserve notes originally found their way into circulation in exchange for gold. Later they were issued when required by member banks virtually in exchange for commercial and government-secured paper. The member banks required them to accommodate customers wishing to convert their deposits into a generally acceptable form of hand-to-hand money. A typical transaction might be described as follows:

1. The business customer of the member bank needing credit takes his promissory note to his bank and receives a deposit credit.
2. He checks the bulk of this deposit out to pay for goods, etc.
3. He converts the remainder of his deposit into circulating currency for use in the payment of wages. As the custom of paying wages by check increases, the necessity for the use of Federal Reserve notes in this connection will decrease.

In just the same way the member bank obtains Federal reserve notes by checking against its balance with its

Federal Reserve Bank. If that balance itself be inadequate, the member bank replenishes it by rediscounting eligible paper which it originally discounted for its customer, or by offering its own note secured by obligations of the United States. Since member bank reserve balances are themselves replenished mainly through rediscounts it will be seen that no Federal reserve note is placed in actual circulation with the public unless the Federal Reserve Bank has first made a discount for some member bank, (except notes issued as a mere exchange for gold already in circulation). But it is not the Federal Reserve Banks themselves who decide what proportion of notes shall be issued; it is the credit needs of the customers of the member banks, varying greatly in different sections of the country and at different seasons of the year, which determine the amount of notes issued and the proportion between note and deposit liabilities. That proportion is shown later to be fairly uniform.

II. THE FEDERAL RESERVE BANK.

(d) Who Holds the Outstanding Notes?

The volume of Federal Reserve notes outstanding is about \$3,300,000,000. Of these it is probable that

about \$300,000,000 are circulating in other countries, mainly those adjacent to the United States in the Caribbean area. It is estimated that about \$525,000,000, or about one sixth, are held by the banks of the country; \$215,000,000 by national and \$310,000,000 by state institutions. The balance, or about \$2,475,000,000 are in general circulation as till and pocket money. The extent to which they are carried in either tills or pockets in excess of actual requirements it is of course impossible to estimate, but it is quite probable that the volume thus employed could be somewhat reduced by an appropriate educational campaign.

III. THE RELATION OF NOTES TO DEPOSITS AND THEIR RELATIVE EFFECT UPON INFLATION OF PRICES.

The theoretical relationship between notes and deposits has been stated by no one more clearly than by Dunbar, who says, in his "History of Banking":

"The notes of a bank are a liability, distinguishable in form, but not in substance, from its deposits." --- "The question whether notes shall be issued or not is one which in modern banking is not settled affirmatively by the bank, but is settled by the creditor." --- "Banks cannot extend their lia-

bilities of either sort except in response to a demand from the public; it is true that in certain states of business this demand may be unduly stimulated by their action, and that issues made in response to an unhealthy demand are in excess of the proper needs of the community. In any such period of general expansion of bank credit, however, bank notes play the least important part."

In Appendix A will be found a number of quotations from other economists expressing similar views.

In the evolution of modern banking the use of circulating bank notes preceded the use of deposits operated on by checks. In most countries they are still the greatly preponderating element. But the advantage of check or deposit currency, as it is often called, are being increasingly appreciated. In France, for example, the Bank of France during the war issued a pamphlet describing and urging the economy of the use of checks. In England, Canada and the United States where deposit currency is very highly developed its use has increased progressively.

In England in 1820 the ration of Bank of England notes in circulation to Bank of England deposits was

about 575, in 1844 it was 154%; now it is only about 100% even after the tremendous substitution of notes for the gold in circulation which accrued during the war. Today the total notes (Bank of England notes and currency notes) are about 18% of the total deposits of English banks. Chart B, showing the relative growth of deposits and notes in England from 1914-1920, indicates that during the war notes increased faster than deposits.

In Canada where notes are issued by the individual banks, the ratio of their notes to their deposits is about 10% and the ratio of bank notes and Dominion notes to bank deposits is about 15%. Chart C shows that during the war bank notes and bank deposits expanded almost proportionally, the notes a trifle the faster.

In the United States, just prior to the Civil War, when bank notes, gold and silver constituted the entire hand-to-hand circulation, the ratio of notes to deposits was about 100. Today all forms of coin and notes held outside the Treasury and the Federal Reserve Banks are about 15% of all bank deposits, excluding Federal Reserve Bank deposits.

Thus it will be seen that in these check-settling

countries the note is a dwindling element of the total volume of circulating credit.

And even within the United States the relative use of notes and deposits varies with localities and seasons. Fewer notes in proportion to population are used in the cities and commercial centers and more in the country districts; and more are used at harvesting and holiday periods than at others. While notes are still used by all for pocket and till money, the number of those who keep checking accounts is constantly increasing and the number of those whose entire finances are conducted by notes is constantly decreasing. Even many payrolls to wage earners are now disbursed by check, and were it practicable for all such wage earners in turn to maintain checking accounts at their local banks, further very considerable reductions in the use of notes could be effected. The standardization of check currency through the development of the par collection system and the superior facilities for the transfers of funds which the Federal Reserve Banks have created are effecting material economies in the use of notes.

We have seen, then, that the demand for credit pre-

cedes the extension of credit in the form of either deposits or notes; and that a deposit is the usual form in which the credit is first extended, the conversion of a portion of the deposit to the note form being usually a subsequent transaction.

We have the usual relationship between the two kinds of credit summed up by Professor Irving Fisher in his "Purchasing Power of Money" as follows:

"The quantity of circulating credit tends to hold a definite relation to the quantity of money in circulation; that is, deposits are normally a more or less definite multiple of money."

And we have seen that in the two other great check using countries, even under the stress of war, Professor Fisher's statement has been fairly well substantiated.

We know that Federal Reserve notes while not legal tender have been kept convertible into gold and that none of them have been forced into circulation.

And our credit and prices being in a generally expanded condition, we are interested in ascertaining whether our recent experience justifies Professor Dunbar's statement that

"In the general expansion of bank credit, bank notes play the least important part."

Dunbar would presumably expect our notes to expand less than bank deposits, and Fisher that the expansion had been proportional. The actual experience is set forth in Chart D, showing from 1914 to 1920

- (1) national bank deposits (which reflect accurately the course of all bank deposits).
- x(2) aggregate amount of coin and circulating notes outside of the Treasury and the Federal Reserve Banks.
- (3) Bureau of Labor price index.

It will be seen that the lines representing the expansion of deposits and prices are almost precisely parallel, while the line representing hand-to-hand currency expanded less. It may fairly be questioned whether owing to the organization of the Federal Reserve System during the period covered by the chart, and the transfers of large amounts of gold from the member banks to the Federal Reserve Banks, the figures used accurately represent the actual increase of our hand to hand currency. But if we deducted from the figures used, the amount of coin

and notes held by all the banks of the country, we should certainly eliminate every element tending on the chart to slow down the rate of expansion of hand-to-hand currency. The currency line, thus adjusted, is not drawn on the chart, but it parallels precisely the line of deposit expansion, which in turn parallels the line of price expansion.

The conclusion, therefore, seems justifiable that in the general expansion of credit and prices the expansion of notes has not been undue but has been either proportional or less than proportional to the expansion of deposits. If this be true it does not seem reasonable to charge our note issue with any undue influence on the present inflation of prices.

NOTE: x The figures showing the total amount of money of all kinds in circulation other than money in the Treasury and the Federal Reserve Banks are used rather than the figures for Federal Reserve Notes alone, because during 1915 and 1916 there was a considerable increase in the amount of gold and gold certificates in circulation, and because the figures for Federal

Reserve Notes alone, starting at zero in 1914, would indicate an absurd ration of increase. In the same way during 1915 and 1916 about \$50,000,000 of national bank notes were retired while during 1918, 1919 and 1920 some \$350,000,000 of silver certificates were retired and their place partially taken by the issue of Federal Reserve Bank notes. The important comparison in the discussion of the relative influence of deposits and notes on inflation is the expansion of deposits as compared with the total hand-to-hand medium, rather than as compared with one of its elements; especially since prior to April 1917 Federal Reserve Notes were issued almost entirely against gold.

IV. RELATION OF THE FEDERAL RESERVE NOTE TO BANK CREDIT AS A WHOLE.

As we look at Federal Reserve credits for the past six years, projected upon Chart A in the bold lines which the war expansion traces, we can see far more clearly than was possible earlier, the relation of the Federal Reserve Note to the credit structure as a whole. We see that

the expansion of discounts is almost identical with the expansion of Federal Reserve notes, and bears little relation to the expansion of Federal Reserve deposits. The reason for this is clear.

Member and other banks may expend their deposits subject to no limitation other than that of maintaining the required reserve. In the case of member banks, this reserve, maintained with the Federal Reserve Bank, ranges from 7% to 13%. It may be built up by means of rediscounts equal to the amount of the reserve required, which in its turn is only a small fraction of the amount of credit granted by the member bank to its customers in the form of deposits.

On the other hand, to grant credit in the form of hand-to-hand currency member banks must obtain Federal Reserve notes, which are substantially their sole source of additional note supply, since they themselves may issue no further notes, (except national bank notes which have but small expansive possibilities). And to obtain Federal Reserve notes, member banks must rediscount a full 100% of the amount of the credit they desire to extend and must pay the discount rate on the entire sum. (x)

x (If the specific deposit with a Federal Reserve Bank which is converted into notes arises from a transfer from the Federal Reserve deposit account of some other member bank, the net result is the same, since in any period of expansion the other account must have been built up in the first instance by means of rediscounts.)

The rate thus paid to obtain notes ^{xx} is not unlike the tax imposed by some countries on their banks of issue in respect of excess or emergency issues, or that imposed by the Aldrich-Vreeland Act, under which notes secured by the pledge of paper or securities were issued by various currency associations to their members upon the payment of a tax to the Government, starting at 3% on the notes outstanding and progressing to 6%. In the case of both Federal Reserve notes and deposits the discount rate operates as a tax upon the extension of credit, but while the tax applies 100% against the amount of notes issued, it applies only, say, 10% against the increased deposit credits granted by member banks to their customers.

NOTE: xx In the case cited in the foregoing note the tax may not be paid by the bank actually receiving

the notes but the constant interchange between notes and deposits cannot obscure the fact so clearly brought out by the chart that rediscounts in the main are made for the purpose of obtaining and maintaining the necessary volume of hand-to-hand currency.

V. METHODS OF CONTROLLING EXPANSION OF CREDITS THROUGH NOTE ISSUES.

Before undertaking a consideration of the proper method of controlling the demands for credit in the United States, it may be of interest to review briefly the ways in which note issues are controlled in other countries.

(a) In Foreign Countries.

In Appendix B are stated in summary form the legal limitations or devices prescribed in the leading countries to control the volume of note issue. It should be remembered that in most of these countries the note is still the predominant element, with deposits as yet very little developed. Some countries have a reserve percentage; others leave it to the judgment of bank managers. Some countries have a flat tax on the note issue; others a progressive tax; others no tax at all. In some the

tax is on the entire issue; in others only on the uncovered portion. Some of the taxes are for revenue only; others represent an attempt to penalize the bank on its uncovered note issues. In some countries the security behind notes is specified; in others they are secured by the general assets of the bank. In some countries redemption in gold is required; in other countries, it is not. In some countries a limit is placed on the amount of the issue; in other countries there is none. In some countries the notes of the central bank are legal tender; in other countries they are not. Some of these restrictions arise from a definite desire to control the issue of credit. Others are mere revenue measures, or find their origin in attempts to prevent the unsound methods and faulty administration which prevailed in the earlier days of banking. In practically every country the banking system has been an evolution and must be studied in its historical as well as its theoretical aspects, in order to understand the provisions prevailing today

From this brief outline it will be apparent there is no generally accepted formula for the control of credit

expansion, whether in the form of notes or deposits. The fact is that, whatever the legal limitations were, a fairly satisfactory note issue was normally maintained in all of these countries by the exercise of human foresight, judgment and courage on the part of those responsible for administering the issue. But during the war most legislative restrictions and artificial or automatic controls, as well as the controls customarily exercised by men, were swept away by the inexorable pressure for inflation.

V. METHODS OF CONTROLLING EXPANSION OF CREDITS
THROUGH NOTE ISSUES.

(b) The Board's suggestions for this country.

The Federal Reserve Board has suggested for our consideration, as means of controlling credit, certain specific proposals by which the issue of Federal Reserve notes might be indirectly or mechanically checked. These will now be discussed in the order suggested by the Board.

A. Should the Federal Reserve Board impose an interest charge or tax upon the notes issued to a Federal Reserve Bank?

Under the terms of Section 16 of the Federal Reserve

Act, the Federal Reserve Board is authorized to require Federal Reserve Banks to pay such rate of interest as it may fix on the uncovered amount of then outstanding Federal Reserve notes. The question is whether the Federal Reserve Board should exercise its authority to require Federal Reserve Banks to pay an interest charge and whether, if that were done, it would tend to reduce the amount of Federal Reserve notes outstanding. It is not believed that any Federal Reserve Bank desiring or needing Federal Reserve notes would consider the payment of an interest charge as a hindrance to the maintenance of the interchangeability of its notes and deposits, particularly as the only immediate effect of the payment of such a charge would be to transfer to the Treasury at once funds which would come to it later in the form of a franchise tax. If the Federal Reserve Bank did consider the interest charge a hindrance to paying out Federal Reserve notes its only alternative in meeting the withdrawal of member bank deposits would be to pay out reserve money or suspend payment entirely.

At present, surplus earnings when transferred to the Treasury may only be used to add to the gold reserve

behind United States notes or to retire Government bonds. A transfer accomplished through the imposition of an interest charge would augment the general fund of the Treasury and thus serve as a basis for Congressional appropriations. The danger of the political pressure for large earnings which might thus arise seems apparent.

The question of imposing an interest charge for the purpose of forestalling the desire of member banks for larger dividends does not seem germane to the present discussion.

- E. That a currency limit should be established for each member bank and a charge imposed upon notes issued to a member bank in excess of this limit.

It may be questioned whether a Federal Reserve Bank has any legal authority to impose a charge upon the amount of notes issued to a member bank in excess of a specified limit, unless it were accomplished by means of the progressive discount rate which would be applicable not merely to the issue of Federal Reserve notes but to the creation of Federal Reserve deposits. Mechanically the establishment of such a limit does not appear to be feasible, since it would be extremely difficult to keep an

accurate record of, or identify the notes issued to any one individual member bank and remaining outstanding. Furthermore, should the Federal Reserve Board try to limit the amount of notes a member bank could receive, the member bank, having obtained through rediscount or otherwise a deposit credit at its Federal Reserve Bank, would proceed to draw gold or other lawful money rather than to pay the proposed charge on an excessive issue of Federal Reserve notes, and failure of the Federal Reserve Bank to respond to the exercise of this right would place our entire banking system in collapse.

Another feature of this question is worthy of consideration. If it is expected that ultimately the Federal Reserve note will be the main circulating paper currency in the country, nonmember banks, as well as member banks must procure Federal Reserve notes for the conduct of their business. Presumably, certain city member banks who have numerous out of town correspondents will be called upon to furnish them with notes and will become the distributing media for these notes to nonmember State banks, eligible and ineligible. It would be unfair to assess those city banks for excessive issues of Federal Reserve notes when

the excess demands come from their nonmember correspondents.

- C. The Federal Reserve Board suggests discontinuing the payment of postage or express charges on currency shipped to member banks.

The theory on which Federal Reserve Banks pay the charges on incoming and outgoing coin and currency for member banks, while having its origin in the development of the collection system, is one of equalization. It is to make available the facilities of Federal Reserve Banks to the country banks on the same terms, as to expense, as to the banks located in the same city as the Federal Reserve Bank or any of its branches. Time and distance, of course, cannot be equalized. To require member banks to absorb the expenses on all outgoing shipments of currency would merely penalize the country banks, as compared with banks in Federal Reserve Bank or branch cities who would still be able to obtain their currency without any charge whatsoever. The purpose would presumably be to check the demand for Federal Reserve notes. The result would be to check the demand of the country banks and not the demand of the city banks. It would be a measure of uncertain

result and of unjust and inequitable application.

D. The Federal Reserve Board suggests that a limit should be fixed upon the amount of Federal Reserve notes issued to each Federal Reserve Bank.

Mechanically, this limit could probably be put into operation, but it could not be a rigid one, unless it were desired to compel Reserve Banks which have heavy seasonal currency requirements in their respective districts to pay out their reserve money. If the limit were one which might be exceeded upon payment of a penalty in the nature of a tax, we should have a condition not very different from that which exists today in regard to rediscounting between Federal Reserve Banks, the rate of rediscount being the tax which the debtor reserve bank pays. Normally, each member bank is supposed to live within its own resources and only when its requirements for credit exceed its resources to seek at a penalty, a rate or tax, the additional credit from its Federal Reserve Bank. So is each Federal Reserve Bank supposed to live within its own resources and only when these are insufficient, to seek additional credit-making power from other Federal Reserve Banks, which it does at a penalty, a rate or a

tax. And by rediscounting and paying a penalty, a rate or a tax, a Federal Reserve Bank obtains the gold which may serve as a basis of an additional note issue.

Furthermore, suppose a limit were fixed today at about the present level of Federal Reserve notes, and suppose next year the United States should again become a participant in a great war and was able to effect about the same degree of self-restraint among its people as prevailed during the European War. Does anyone believe that in the light of the experience of this and other countries in the European war such a limit would stand? With the further inflation of deposits and prices which would inevitably follow, a repetition of our policy in 1917 - 18 would inexorably sweep such a limit away just as would have been the case had we attempted on January 1, 1918, to set a fixed limit on Federal Reserve notes at about the amount then outstanding. France has followed the policy of fixing a limit to the note issue of the Bank of France, but even before the war the limit had to be raised by the Government from time to time as the limit was approached. In other words, to enable the banks to function normally, the limit would have to be so high that it would not

be an effective means of credit control the purpose for which it would presumably be imposed. If it were low enough to be effective it would merely result in the Reserve Bank's paying out reserve money.

E. The Federal Reserve Board inquires whether member banks' collateral notes or customers' notes secured by Government obligations should continue to be taken as collateral for Federal Reserve Notes.

The question is presumably asked with a view to ascertaining whether declining to accept Government obligations as security for Federal Reserve Notes would reduce the volume of these notes. Such a decision would disqualify about \$1,200,000,000 of paper now held by the Federal Reserve Banks. But it would leave them with sufficient commercial paper and gold to cover the present note issue, so that at present such a measure might not of itself restrict the volume of Federal Reserve notes.

If it were desired to accelerate the elimination from the Federal Reserve Banks of Government secured paper, the ratio of which to total Federal Reserve Bank discounts has in the past twelve months decreased from 71% to 39%,

this could be substantially and promptly effected by establishing a rate higher than the commercial paper rate for the discount of paper so secured. Except in the case of those few member banks which have not other eligible paper, Government secured loans would thus be withdrawn almost over night. Their disappearance, however, would not change the general banking condition of the country, would not bring either the banks or the Federal Reserve Banks any nearer a more normal credit volume, nor would it change the volume of hand-to-hand circulating medium or the need for it. The fact is that through the use of the purchasing power which the Government derived by the sale of bonds we are in a position of expanded credit and expanded prices, both of which require an expanded note issue. (x)

(NOTE x. The Federal Reserve Board said, editorially, in the November, 1919, Bulletin, "Were the differential rate which now favors war-loan paper to be reversed so that it would favor commercial paper, it is likely that the portfolios of the Federal Reserve Banks would change in character. Member banks would select their commercial paper as a basis of rediscount, and in

consequence Federal Reserve Bank portfolios might consist primarily of commercial bills rather than of war-loan paper. A true appreciation of the credit situation, therefore, can be obtained only by considering the portfolios of Federal Reserve Banks and those of member banks as an aggregate."

One of the purposes of the Federal Reserve Act was to substitute bank notes secured by commercial paper for bank notes secured by Government bonds. The war not only interrupted this process but resulted necessarily in the issue of more notes secured by Government bonds than ever before. The process, as we have seen, is reversing itself automatically and really with remarkable rapidity. That it should continue until all Government bonds have disappeared from Federal Reserve Bank portfolios every one will agree.

But a little analysis will make it clear that there is a great difference between the present bond secured Federal Reserve note and the bond secured National Bank note, and this difference justifies patience in dealing with a situation not altogether to our liking. The

reason we desired to get away from notes secured by Government bonds was not because such a note issue was not good, but because experience showed that it neither expanded nor contracted promptly in accordance with changing conditions. None of these conditions obtain with respect to that portion of our Federal Reserve Note issue which is secured by Government paper. The Federal Reserve Banks are not, like the National Banks, required to buy Government bonds. The Government paper which they pledge as collateral for Federal Reserve notes is all short paper bearing the obligations of member banks. Most member banks are anxious to pay off these loans with the Federal Reserve Banks. The experience of the Federal Reserve Bank of New York shows that its loans on Government securities are not only the shortest dated, but the most flexible of all its loans, expanding or contracting in huge swings at the quarterly tax periods or at times of other large movements in Government finance. It may be of interest also in this connection to observe that the portion of the Bank of England notes which is uncovered by gold is covered mainly by Government securities. The same is true of the currency notes issued by the British

Treasury during the war which it is proposed presently to consolidate with the Bank of England notes.

It has been suggested that the potentiality of the \$20,000,000,000 of Government securities in the hands of the public as a basis for further note issues is a menace. But the likelihood that these \$20,000,000,000 of Government securities will be presented as collateral to new note issues seems less immediate than the presentation of the immense unused lines of credit which the merchants and manufacturers maintain at their banks, or the many billions of eligible commercial paper which the banks already have in their portfolios. The media for potential credit and note expansion are vast and their use will depend upon two factors, the pressure for credit and its control through the Federal Reserve Bank rates and discount policies.

The conclusion to be reached is that to disqualify Government war securities as collateral for Federal Reserve notes would be ineffective as a method of reducing the volume of notes and is unnecessary from the point of view of either the safety or the elasticity of the note issue.

Their disqualification would not seem to be in accordance with the spirit of the Act, which specifically states in Section 15 that notes issued for carrying bonds and notes of the Government of the United States are among the kind of paper eligible for discount, and in Section 16 that the collateral security for notes shall be gold and notes, drafts, bills of exchange or acceptances acquired under Section 13. Their disqualification would also, in my opinion, be an unnecessary and unfortunate discrimination against the securities of our Government.

VI. GENERAL REVIEW OF DISCUSSION.

With respect to the Board's questions concerning the practicability and advisability of exercising credit control through directly or indirectly limiting the amount of notes issued, we have seen.

- (a) that it is the extension of credit, rather than notes or deposits which acts on prices.
- (b) that there is no essential difference between bank notes and bank deposits.
- (c) that our note issue is functioning as the Act intended it should, additional incentives to its redemption when not needed having been developed by the Federal Reserve Banks.
- (d) that relative to deposits our notes have not expanded unduly.

Under these conditions, I am strongly of the opinion that it would be inadvisable at present to attempt to exercise credit control by placing checks and limits upon the issue of notes. We should attack not one of the forms which Federal Reserve credit takes,

but the transaction which precedes the creation of Federal Reserve credit in either of its forms; namely, Federal reserve rediscounts. We should attack credit inflation at the root and not attempt to deal with it among the limbs and leaves.

The method of control adopted by practically all central banks, which is merely an adaptation of the law of supply and demand, is the use of the discount rate and the exercise of discretion in the granting of credit. For us, the intent of the Act seems clear, and in addition it specifically prescribes that in case the reserve against notes falls below 40% a progressively increasing discount rate shall be established. The effect of this would be to decrease the volume of the discounts which, in any period of expansion, must precede the granting of credit in either deposit or note form. If it had been intended that credit control was to be exercised through throwing limitations around the note issue it is fair to assume that these would have been prescribed in the Act, since the various limitations prevailing in other countries were well known to the

framers of the Act.

It seems to me that the only reason which could justify placing arbitrary limitations on the issue of notes which would result in the paying out of reserve money would be that such limitations might thus make it easier for the Federal Reserve Banks, at times, to establish high discount rates. As such limitations would approximate the workings of the Act under which the Bank of England issues notes, this thought will be discussed at the end of the next section, which deals with English experience.

VII. ENGLISH EXPERIENCE AND VIEWS.

In connection with the consideration of our note issue problems, the Board has asked that English experience and English views be discussed. They are of special interest to us at present, because the growth of deposits and the use of checks in England is comparable with their development in the United States, and because England from 1821 to 1914 always permitted bank notes, and through the medium of notes bank balances as well to be withdrawn freely in gold--- a condition which the Federal Reserve System has under-

taken to maintain in the United States.

To ascertain the meaning of the Act of 1844, establishing the principles on which the Bank of England operates today, it is necessary to understand the conditions prevailing at the time the Act was passed.

Specie payments in England were resumed in 1821 after 24 years of suspension. A period of great industrial and speculative activity ensued culminating in the crisis of 1825 in which 76 banks failed. These failures, following some 250 which had occurred in the years preceding, led to legislation in 1826 encouraging the country bankers to incorporate and forbidding the issue of notes in denominations less than 5 pounds. The purpose of this limit was that fewer notes might find their way into the hands of the laboring classes who would thus avoid the losses from bad notes from which they had so frequently suffered. It was also felt that overissues of £1 notes had tended to drive out gold sovereigns and facilitate inflation. In 1833 Bank of England notes

were made legal tender. Another crisis occurred in 1839 during which the Bank of England's Reserve fell below 2,500,000 pounds. In the following four years 83 banks failed, of which by 1843 17 had as yet paid no dividend. The experiences of the 22 years following the resumption, a period of great industrial expansion, had convinced the government, though not the country bankers, of the unwisdom of permitting every bank to issue notes, and had gradually crystallized opinion in favor of fundamental currency reform.

The movement for reform provoked a violent controversy between the two schools of thought which believed, respectively, in the "currency principle" and the "banking principle."

The "currency principle" called for "a constant supply of paper equal in value to coin, and so varying in amount as to insure at all times immediate convertibility into coin." Thus the circulation would "fluctuate precisely as it would have fluctuated had the currency been purely metallic."

The "banking principle" under which notes had

previously been issued by the banks, and on which the Act of 1844 turned its back, provided no such limit. It assumed that "as notes are only issued in discounting or making advances on securities, the amount of the issue depends, not on the wishes of the bank, but on the needs of the public." It was maintained "that an overissue could involve no danger either for the issuing bank or for the public so long as the notes remained convertible."

Against the supporters of the "banking principle" Peel argued "that the nominal convertibility of paper into gold, where there is unlimited competition as to its issue, does not insure the value and practical convertibility of the paper; that the Bank has more than once been exposed to great danger in respect to the exhaustion of its treasures, and for the purpose of averting it has been compelled to make sudden and violent contractions of the currency." He further asserted that the Bank of England had such imperfect control over note issues that other issuers had sometimes increased their circulation at a time when the bank's circulation was being contracted,

thereby aggravating the ultimate pressure upon the country.

The "currency principle" won, and among the plans which were considered to carry it into effect were the establishment of a new institution to issue notes, or their issue by the government; but Sir Robert Peel remarked that "the true policy of this country is to work, so far as it be possible, with the instruments you have ready to your hand." The plan finally adopted was gradually to restrict the note issuing privilege to the Bank of England, and to require it to maintain a separate note issue department in which all notes issued in excess of a fixed minimum should be covered by gold.

Its effect was expected by Peel to be "such a degree of control by the bank over the general issues of the country as to enable it to regulate the currency by gradual contraction and gradual expansion according to the state of the exchange."

The act accomplished two things:

1. It assured beyond question the goodness and convertibility of bank notes:

2. And by far the more important, it related additional note issues directly to gold and gave control of future note issues, which were and still are the recognized medium for obtaining gold for export, directly into the hands of the Bank of England, so that by its discount rate it could exercise control not only over international movements of gold but over domestic expansion as well.

Hardly had the reform become effective when the panic of 1847 occurred, resulting in such heavy withdrawals from the Bank of England as almost to exhaust its reserve against deposits. In this extremity reassurance was brought by a letter from the Chancellor of the Exchequer advising the bank that he would propose to Parliament a bill of Indemnity in the case of any notes issued in excess of the limit of 1844, provided the bank would increase its discount rate to 8 per cent. Although no excess notes were issued the panic thereupon ceased and confidence was restored. In 1857 and 1866 the same situation arose and the Act was suspended with a like result, except that in 1857 2,000,000 pounds excess notes were actually issued.

During the years following the passage of the Act the directors of the Bank of England and the British public generally had been gaining experience with the operation of their banking system under the new rules. The responsibility of the Bank of England for the maintenance of adequate reserves and a sound credit position is discussed and emphasized in Bagehot's "Lombard Street," which was published in 1873 and made a deep impression. From 1866 until the outbreak of the European War in 1914, the Bank of England so conducted its business and adjusted its discount rates that no further suspension of the Bank Act was necessary, and a free gold market was maintained at all times.

Bank of England deposits are convertible into its notes and its notes are convertible into gold at its issue department. Thus deposits are convertible into gold, and thus the Act of 1844 established a direct connection between international movements of gold and the reserves which the Bank of England maintains against its deposits. Except for the uncovered issue, now 18,450,000 pounds the reserve against notes

is fixed at 100% while the reserve against deposits is not fixed by law but is customarily much lower.

This makes export demands for gold act much more vigorously against the deposit reserve than would be the case if the deposit and the note reserves were merged and rose or fell together. It was this more prompt action on the banking reserves upon which the framers of the Act relied to cause the Bank to take steps earlier to correct adverse situations and thereby lessen the severity of commercial convulsions.

The step which the bank takes is to raise its discount rate sufficiently to bring about the desired result. The following paragraphs, paraphrased from the 1918 report of the Parliamentary Committee on Currency and Foreign Exchanges after the war, of which Lord Cunliffe, the Governor of the Bank of England was chairman, describe the effect of such action.

If the balance of trade became unfavorable, raising the discount rate retained money in England which would otherwise have been remitted abroad and attracted remittances from abroad to take advantage of the higher rate, thus checking the outflow of gold

and even reversing the stream.

If the unfavorable balance threatened to become permanently adverse the maintenance of the higher discount rate and the steps taken to make it effective led to a general rise of interest rates and a restriction of credit. New enterprises were, therefore, postponed, and the demand for constructional materials and other capital goods was lessened. The consequent slackening of employment also diminished the demand for consumable goods, while holders of stocks of commodities carried largely with borrowed money, being confronted with an increase of interest charges if not with actual difficulty in renewing loans, and with the prospect of falling prices, tended to press their goods on a weak market. The result was a decline in general prices in the home market which, by checking imports and stimulating exports, corrected the adverse trade balance which was the primary cause of the difficulty.

If credit at home threatened to become unduly expanded, and by forcing up prices, to create an increased demand for legal tender currency both from the

banks in order to maintain their normal proportion of cash to liabilities and from the general public for the payment of wages and for retail transactions, the raising of the rate of discount resulted in the same chain of consequences as have just been described and speculative trade activity was similarly restrained.

There was, therefore, an automatic machinery by which the volume of purchasing power in England was continuously adjusted to world prices of commodities in general and domestic prices were automatically regulated so as to prevent excessive imports.

The sudden outbreak of the European War in 1914 and the accompanying commercial chaos required an immediate expansion of credit, particularly in the form of hand to hand currency. The legal prohibition against the issue of bank notes in denominations less than 5 pounds was doubtless one of the reasons which led to the issuance of the 10 shilling and 1 pound currency notes by the British Treasury. Under an emergency Act these notes were to be issued to banks and bankers, through the Bank of England, as an

advance at the current bank rate. But the constantly increasing volume of bank deposits enabled banks to pay for the Treasury notes by drawing checks on their balances at the Bank of England. They thus converted these balances into legal tender currency without the customary withdrawal of notes from the Bank of England's banking reserve, which would ordinarily have compelled the Bank to raise its rate and apply the normal safeguards against excessive expansion of credit.

The first report of the Committee on currency and Foreign Exchange, above referred to, was published before the armistice. After studying the situation and listening to many recommendations for a more elastic organization of bank credit the committee recommended the maintenance of the existing plan for the complete separation of the banking and the note issuing departments of the Bank of England, modified only to the extent that the permission granted in the Act of 1914 to issue temporarily additional notes not covered by gold, with the consent of the Treasury, should continue. But all profits from such excess

issue should accrue to the government and a high discount rate should be maintained during the existence of such excess issue.

The committee also recommended, and their recommendation has been adopted, that, following the precedent set by the Act of 1844, a definite limit should be placed upon the amount of currency notes unsecured by gold, and that this limit should be progressively decreased so that the actual maximum of one year should become the legal maximum of the following year.

What was the purpose of the limit? The proposal for a limit upon the currency note issue was made, not for the sake of the limit itself, but to restore to the Bank of England its control over note expansion, of which the continued issue of these currency notes during the war had effectually deprived it. By placing a limit to the amount of the uncovered issue, any further currency notes beyond this limit could be obtained only by placing gold or Bank of England notes behind them; and these would have to be drawn from the banking reserve of the Bank of

England. This would again exert the usual impulse upon the Bank of England to protect its reserve by raising its rate, thereby bringing credit pressure, and a reduction of the credit volume. It is quite clear from Cunliffe's report that the limitation of the Treasury notes was not an end in itself, but merely a means to what in their minds was the all important end of reestablishing the principle of the Act of 1844 and putting the Bank of England in a position to control effectively the issue of legal tender money. The report also opened the way for the Bank of England, merely with the consent of the Treasury, and without waiting for its banking reserve first to be drained to the bottom, to issue its own notes uncovered by gold.

The limit does not apply to currency notes in the aggregate but merely to uncovered currency notes. The volume of these notes, to meet the need for more currency of small denomination, increased from 348,000,000 pounds on January 1, 1920, to 367,000,000 pounds on August 4, 1920. This increase of 19,000,000 pounds, however, was covered by gold or Bank of England notes.

With regard to the final disposition of the currency notes, the Cunliffe committee recommends that when the portion of the issue covered by government securities "has been reduced to the amount which experience shows to be consistent with the maintenance of a gold reserve of 150 million pounds in the issue department of the Bank, the outstanding currency notes should be retired and Bank of England notes of low denomination substituted, the Bank of England fiduciary issue being simultaneously increased by an amount equal to the then issue of currency notes covered by Government securities.

VIII. CONCLUSION.

It has seemed worth while to present English conditions and views at such length because of the successful credit control the Bank of England has exercised, and because after the greatest of wars a most able commission has recommended that its organization, unique and rigid as it is, should be maintained.

The difference between the organization of the Bank of England and the Federal Reserve System is in

some respects the difference between the "currency principle" and the "banking principle" so thoroughly discussed in 1844. English bank notes follow in volume the movements of gold, while Federal reserve notes are credit instruments moving commensurately with deposits. The very rigidity of the method of issuing Bank of England notes, adopted at a time when deposits were relatively unimportant, compelled English banking to develop the use of deposit banking. As Hartley Withers, Editor of the Economist, says, "The cheque has freed banking from the fetters of the Bank Act." The Federal reserve banks, on the other hand, were established at a time when deposits were the overwhelming element in our currency. But in the organization of the Federal Reserve System there have been eliminated many of the elements of weakness in the Banking Principle in the form in which its proponents in 1844 wished to see it perpetuated in England:

First, our right of issue is confined to a group of 12 noncommercial banks instead of being extended to all commercial banks;

Second, this makes possible an effective central control of the issue;

Third, overissues, if any, among commercial banks are due to desire for profits, whereas in the case of the Federal reserve banks the temptation to make profits is at a minimum, and in this respect they are unique among central banks of issue;

Fourth, the right to proceed without limit to extend such credit and issue such notes as business requires, which was contended for in 1844, is limited by the required reserves which the Federal Reserve Banks must maintain.

Several of the banking systems of continental Europe are organized on modifications of the Banking Principle, resembling in many respects the basis on which the Federal reserve banks are organized, but in none of them does the Banking Principle operate freely as it did in England before 1844, and as its adherents then wishes it to continue to hold sway.

We may also note, parenthetically, that in spite

of the abandonment of the "banking principle" by the English, this principle, is successfully operated, with certain modifications, in Canada. There, many individual banks issue notes without specific security, without required reserves, and in normal times under a tax which is a pure revenue measure. Although in Canada, as in other countries, the war has necessitated special measures, including a government re-discounting agency not unlike our Aldrich-Vreeland currency plan, the Canadian banks normally have provided a most acceptable hand to hand currency, capable of rapid expansion and equally rapid contraction in accordance with agricultural and business requirements. While the amount of notes issued on the general security of the assets of a bank is limited to the amount of its capital, plus an excess issue equal to 15% of capital and surplus combined at a tax of 5% on the excess, these limits up to the time of the war proved more than adequate.

In considering the English and American systems we should not lose sight of the fact that the Bank of England's lack of experience, coupled with its

dilatoriness and its failure to realize the extent of its responsibility played a large part in creating the necessity for banking reform. Even after 1844, what the Cunliffe committee describes as "an automatic machinery" broke down several times, largely through the same sort of short-comings on the part of the Bank as were exhibited prior to the act. Sir Robert Peel, addressing Parliament in December 1847, said:

"We did hope that after the panic of 1826, after that of 1836, after that also of 1839, we did hope that the Bank of England would have confined itself to those principles of banking which their own directors admitted to be just, but from which they had admitted their own departure, though prescribed in part by their own regulations. In that hope I am bound to acknowledge that we have been disappointed.---It was in the power of the Bank, had it taken early precautions, if not to prevent all the evils that have arisen, at least greatly to diminish their force. If the Bank had possessed the resolution to meet the difficulty of a contraction of its issues

by raising the rate of discount, by refusing much of the accommodation which they granted between the years 1844 and 1846---if they had only been firm and persevering in those precautions, the necessity for any extensive interference with their operations might have been prevented."

The outstanding change of the past fifty years seems to be the realization by those in responsibility that, however automatic its note issuing provisions may be, the Act can be administered satisfactorily and the banking position of England protected only by the exercise of the maximum of human judgment, foresight and courage.

This, it seems to me is the lesson we should learn from English experience since 1844 and from the available reviews of that experience in the light of the great war. We should also realize the even heavier responsibilities which lie upon us than upon the governors and directors of the Bank of England. These responsibilities are heavier (1) because, by our substantially merged reserved against deposits and notes,

both domestic inflation and gold exports act less abruptly on our reserves than the same influences act on the reserves of the Bank of England and are therefore not apt to lead to such early or vigorous protective measures, (2) because of the infinitely greater, more diversified and less concentrated banking and business position we have to protect, and (3) because our protecting agency, The Federal Reserve System, is itself decentralized and wisely so. United action is therefore more difficult and the method of securing it is as yet only in course of evolution. The principles underlying the English System were fully considered by committees of Congress and the segregation of the note-issuing function with a fixed limit to the uncovered note issue were not adopted. Yet, in the last analysis, the two Systems are not very dissimilar, for both depend upon the discount rate to control credit in the form of either notes and deposits, and while ours permits notes customarily to be issued against less than 100% gold, the English System permits this occasionally as an emergency measure, and the Cunliffe Committee

recommends that the Treasury be authorized to consent in any time of stress to the issue of uncovered notes.

The arbitrary limit recently placed on the issue of British currency notes had no special significance for us since its purpose was to relate the issue of additional amounts of this currency to Bank reserves, while issues of Federal Reserve Notes are already so related. In a period of lessening credit requirements, such as we believe is about to begin, the establishment of a limit at the present level would presumably be of no effect. If a limit were established at a lower level, as we have already shown, gold and other legal tender would be paid out from Federal Reserve Bank reserves and put into circulation, since there is no legal method of issuing two kinds of Federal Reserve notes, one with 40% or larger reserves and one with 100% reserves.

In favor of this course it is urged that we in the United States are accustomed to viewing banking conditions in the light of fixed legal reserves; that being optimists we are prone to feel that reserves in excess of the legal limit are to be used in further

credit extension; and that we are intolerant of anything resembling credit contraction; Therefore it is argued that although notes are but a small element in our total credit volume, they are nevertheless a necessary element, and we may, by limiting the amount of notes or by requiring higher reserves against them, automatically cause demands for notes to reduce more promptly the smaller reserves maintained against deposits and impel Federal reserve banks to raise their discount rates, when necessary for protection earlier than would be done under the present arrangement.

This argument is based on one or both of the following assumptions,

- (1) That the Federal Reserve Banks will have neither the foresight nor the courage on their own judgment to raise discount rates, and
- (2) That the American people will not countenance raising the discount rate at a time when the reserve may happen to be considerably above the legal minimum.

The fact that it took the English so many years to gain the necessary experience to exercise proper credit control during years when the idea of central control was a new one, and when the larger responsibilities of the Bank of England were not fully recognized, furnishes no reason why in the light of English and other foreign experience and with a full realization of our responsibilities, we should not be expected to act with both foresight and courage. Whether public opinion will sustain our actions depends upon our ability to educate it as to their purpose, meaning and necessity. I am sanguine that this can be done, and believe that a broad base of understanding public opinion is a greater safeguard for our system than a more automatic and rigid note issuing note control without such a state of public opinion.

Furthermore, such limiting restrictions as the Board proposes would be tantamount to a most important amendment of the Federal Reserve Act, and the introduction of a principle contrary to the theory of the Act, which was that credit in the form of either notes

or deposits was to expand or contract in accordance with the requirements of the country and to be controlled in general by the discount rate and as to any particular member bank by the exercise of judgment on the part of the Federal reserve bank.

I am convinced that we should not at present establish limits or impose taxes or set other arbitrary restraints upon the movements of our note issue. While notes are the predominant element of Federal reserve bank liabilities, because we have to furnish note expansion for all the banks of the country, they are a diminutive and constantly diminishing element of the entire volume of bank credit which we are charged with the duty of supporting and keeping convertible into gold.

We have a banking system established upon principles which have been approved by our soundest banking and economic minds---the latest great national system to be established. The war demonstrated the ability of the system to provide the necessary credit expansion in both its forms. We have shown our ability during the last eight months, through methods

which have been tested and proved effective in central banks abroad and in our commercial banks at home, to control the expansion of credit. Lately, we have seen a lowering of commodity prices all over the world. We all hope that deflation has set in, but the Federal Reserve Board in its last annual report said:

"Too rapid or too drastic deflation would defeat the very purpose of a well regulated credit system by the needless unsettlement of mind it would produce and the disastrous reaction that such unsettlement would have upon productive industry."

Do not let us be impatient and depart from the method of credit control by discount rates, tested in many countries and fully indicated in the Act; and by trying some new plan, risk ruining the elasticity of our new system. At present through the almost world wide suspension of gold payments, our problem of credit control is reduced to its simplest domestic form. Let us devote our energies and our earnest thought to ascertaining what elements in our commercial and financial structure must be reckoned with in effecting credit control when gold payments are

resumed among the leading nations, to inaugurating effective methods of ascertaining accurately the movements of these elements, to evolving unity of action in meeting them, and to creating such a public understanding of our operations as will support and approve our actions when taken. Meantime, and until our System is proved wrong in theory or impracticable to operate, let us have faith and steadiness and patience to see it through on the theory laid down in the law and on accepted lines of credit control, which are, the application of discount rates and the exercise of proper discretion in the extension of credit.

APPENDIX A

QUOTATIONS FROM ECONOMISTS REGARDING
RELATION OF DEPOSITS TO NOTES.

MONEY, CREDIT INSTRUMENTS, AND PRICES.

By Professor E. W. Kemmerer, p. 74.

"The nature and influence of checks upon prices is not essentially different from the influence of convertible government notes or bank notes."

Treatise on Money and Essays on Monetary Problems,

By Professor J. S. Nicholson.

pp. 73-4.

"The competition of those who buy on credit, so long as that credit is accepted, obviously affects the demand for commodities and raises the prices just as much as when ready money is offered. A person whose cheque will be taken in payment can bid as effectively as one who brings a bag of money."

Money and the Mechanism of Exchange,

by Professor W. S. Jevons.

"Currency must be supplied like all other commodities according to the free action of the laws of supply and demand."

Monetary Economics---By Professor W. W. Carlile, p.158.

"There has been a good deal of controversy over the question whether or not credit affects prices as money does. It would, it seems to me, be more to the point to inquire whether anything else but credit has any practical effect on prices that is worth mentioning."

Money and Banking By Professor W. A. Scott, p.113.

"The amount of bank currency depends primarily upon the needs and desires of the customers of the banks.....this currency will come into circulation in the places where it is in demand and at times when it is needed.....By elasticity of bank currency is meant its capacity to adapt itself, as it were automatically, to the varying needs of commerce."

Principles of Economics, By Professor F. W.

Taussig, Vol. 1, p. 438.

"There was a long controversy, a couple of generations ago, concerning the mode in which bank notes, if they were allowed to be freely issued, affected business activity and rising prices; whether their free issue had per se a stimulating effect, or whether

an independent increase of activity was the cause leading to the larger issue. Which, in other words, was the cause and which the effect? The same question can be raised as to deposits, and it is in this form that the question is now an important one in English speaking countries. Does an increase of deposits cause greater activity and higher prices or does greater activity cause an increase of deposits and so bring in its own train the higher prices? The truth seems to be that there is an interaction of cause. When the spirit of hope is pervasive, liberal banking facilities nurture and stimulate it; without general optimism, such facilities are unused and inoperative."

Money by Professor D. Kinley---p. 367.

"The check, not the note, is today the symbol of banking progress, the instrument of large exchange. It is the deposit and the check that we must reckon with today. But the change of form of the bank function has not changed its character. To discount a piece of mercantile paper by issuing notes in payment for it, differs in no respect from discounting the same paper

and crediting its seller with a proper amount as a deposit to be drawn out by checks at the convenience of the holder.

Professor N. E. Pierson, (Dutch economist.)

"It is not true that in a country where no bank notes are in circulation, exportation of specie results in an immediate fall in prices and consequently in an alteration in the balance of payments. It would be so if bank notes were the only possible substitutes for specie; but bank deposits also serve as substitutes for specie,----Bank notes and bank deposits differ only in form, since both take the place of specie when they are not covered by a metallic reserve!"

"REPORT OF THE INDIANAPOLIS MONETARY COMMISSION."

pages 164 and 165.

"The borrower needs immediate means of payment; and the bank can give this to him in either of several forms, whichever the customer prefers. It can give him actual money from its uninvested resources (either a portion of its own capital of money left with it by others); or it can give him its circulating notes; or it can give him a credit on its books----a deposit

account. Both are equivalent demand liabilities of the bank. A note is a promise to pay on demand; so is a deposit. Either one means that its holder refrains from demanding actual money from the bank, the deposit or note answering all his purposes."

"Introduction to Economics."

Professor Henry Rogers Seager. Pages 331 & 332.

"Besides lending their credit in the form of deposit liabilities, banks which enjoy the privilege of issuing bank notes, that is, the bank's promises to pay on demand without interest the sums named on the face of the notes, may lend their credit in this form."

"OUTLINES OF ECONOMICS."

By Professor Richard T. Ely, page 250.

"Bank notes are like deposits in that both are demand liabilities of banks. Bank notes, however, circulate among persons who have no means of informing themselves as to the solvency of the banks issuing them. The holders of bank notes are accordingly usually given special protection by laws which regulate the conditions of their issue and redemption."

"ORGANIZED BANKING."

-by Professor E. E. Agger, page 34.

"Other things being equal then, and assuming the absence of any special restriction, the credit that the bank extends will take one or the other of the two forms, (either that of notes or deposit liabilities) or both, in such proportions as, in its broad relations with its clients, the opportunities for profit to the bank seem to dictate."

"Principles of Economics"

--Professor Edwin R. A. Seligman, Page 474.

"So far as the bank and the borrowers are concerned, the economic essence of the bank note is identical with that of deposits. Both are bank liabilities, because the bank must ultimately pay its note or honor a requisition on the deposit; both involve the granting of credit to the borrower who acquires the right to demand payment of a given sum from the bank. The function of issue differs in form, but not in substance, from that of deposit."

"The Theory and Practice of Banking."

Henry Dunning Macleod, Pages 289 and 290.

"A merchant brings his debts, payable some time after date, for sale, and by a flourish of his pen, the banker transmutes them into debts payable instantly, which have precisely the same effect in commerce as so many sovereigns. He reaps exactly the same profit by creating a credit in favor of his customer, as if he gave him the actual cash. And the cheques drawn against these credits, so created by the banker, circulate commodities exactly in the same manner as bank notes do, which circulate commodities exactly in the same manner that gold and silver money does."

"Principles of Money"

By Professor J. L. Laughlin --pp.117-18.

"The choice between receiving notes or a deposit rests wholly with the customers of the bank. Hence we see the reason for the well-established fact that the expansion of notes relatively to deposits, or of deposits relatively to notes, in our banking history is independent of the control of the banks, and is determined by the business habits and customs of the public."

"Money and Banking"--by Horace White.

"The form of issue, whether in checks that may

pass through one or two hands, or in circulating notes that may pass through many hands, is of little consequence; and, even if it were of much consequence, it is beyond his control. It is also beyond the control of the depositor. He will call for notes only in cases where he cannot use checks. The controlling force here is the public demand, to which both the banker and his customers conform."

"American Banking"

--by H. Parker Willis, Pages 92 and 93.

"From what has been said it is clear that the theory of note issues and their relation to the bank is identical with that of deposits and their relation to the bank. There is in fact no distinction to be drawn in this respect between the note and the deposit."

Professor O.M.W. Sprague of Harvard says:

"I do not think it possible to differentiate the responsibility for inflation as between notes and deposits. The one cannot expand far in the absence of expansion of the other, though in a check using country deposit expansion proceeds note expansion to some extent."

APPENDIX B.
REGULATIONS CONCERNING NOTE ISSUES
IN FOREIGN COUNTRIES.

THE LAWS REGULATING THE ISSUE OF BANK NOTES IN THE
LEADING NATIONS BANKS OF ISSUE AND REGULATIONS
REGARDING THE ISSUE OF NOTES.

Australia, Commonwealth Bank, Head Office Sydney:

The notes in circulation consist of Australian notes issued by the Commonwealth government, which are legal tender. The Commonwealth Bank attends to the distribution and redemption of these notes. Of the notes in circulation the banks hold 32 million pounds as assets, used as till money, and the public the remainder. Bank notes have not circulated since 1911.

Japan, Bank of Japan, (Nippon Ginko), Head Office:

Tokio: May issue 120 million yen secured by the government debt. All other notes must be collateralized entirely by gold coin and bullion. Notes issued in excess of this sum are subject to a 5% annual tax.

Denmark, Banque Nationale de Copenhagen - Denmark; Head Office, Copenhagen: Must maintain a gold reserve of 33-1/3%, the proportion not covered by cash must be secured by assets in the proportion of 150 kroner to each 100 kroner of notes. The issue may exceed the legal minimum upon the payment of a 5% annual tax.

England, Bank of England: May issue to any amount if the notes are collateralized entirely by gold, and may issue L 18,450,000 secured by government securities. The bank has issued above this amount upon the suspension of the Bank Act.

France, Banque de France; Head Office Paris: The bank pays a franchise tax to the government equal to 2% of its circulating notes, there is no required gold reserve. The notes are now legal tender by an act dated August 5, 1914. By an act of Parliament of April 14, 1920, the maximum advances the bank may make the government was fixed at 27 billion francs.

Holland, Nederlandsche Bank; Head Office, Amsterdam: A 20% reserve of gold and silver is required to be maintained against demand liabilities (bank notes, checks, and demand deposits.) The reserve is fixed by royal

decree. The law imposes no restrictions as to the proportion of gold and silver.

Italy. Bank of Italy, Bank of Naples, Bank of Sicily: The Banks of Issue are required to maintain a 40% gold reserve against notes issued for commercial purposes and $33\frac{1}{3}\%$ against notes issued on government account. During the war the bank note circulation for commercial purposes has less than doubled while the total circulation increased six fold. In addition to this reserve requirement the amount of notes which can be issued is also limited.

The so-called normal prewar maximum limit of the Bank of Italy was 360 lire, the Bank of Naples 200,000,000 lire and the Bank of Sicily 48,000,000 lire, totalling 908,000,000 lire. Banks can issue notes above these amounts, provided that they are backed by a 100 per cent cash reserve, and that they may exceed the normal maximum provided that there is a 40 per cent cash reserve covering the entire issue and that a special tax was paid on the excess of the circulation. This tax is $\frac{1}{3}$ of the rate of discount when the excess is not more than 50,000,000 lire in the case of the Bank of Italy, 15,000,000 lire

in that of the Bank of Naples and 4,000,000 lire in that of the Bank of Sicily. It is $\frac{2}{3}$ of the rate of discount when the excess is not less than 50,000,000 lire and not more than 100,000,000 lire for the Bank of Italy, between 15,000,000 lire and 30,000 lire for the Bank of Naples and between 4,000,000 lire and 8,000,000 lire for the Bank of Sicily. It is equal to the full rate of discount when the excess is respectively: between 100,000,000 lire and 150,000,000 lire, between 30,000,000 lire and 45,000,000 lire and between 8,000,000 lire and 12,000,000 lire. When the excess is above 150,000,000 lire, 45,000,000 lire and 12,000,000 lire respectively, an extraordinary tax of $7\frac{1}{2}$ per cent is levied on the additional amount over and above these figures.

When a consortium of banks was organized in the fall of 1914 to come to the aid of industry by discounting bills secured by industrial obligations, the banks of issue agreed to accept for rediscount such bills, the share to be taken up by the Bank of Italy being fixed at 75 per cent. of the total amount, the share of the Bank of Naples at 20 per cent, and the share of the Bank of Sicily at 5 per cent. Provincial syndicates for the purchase

and distribution of cereals were also organized at that time, and the banks of issue jointly came to their assistance by discounting paper secured by stocks of cereals.

Norway; Norges Bank; Head Office, Christiania: Issue of notes limited by (1) the vault stock of gold coin and bullion, (2) Available balance abroad up to 1/2 of gold stock, (3) Balances in the Bank of Sweden and the National Bank of Denmark up to six million kroner, (4) An amount of 70 million kroner in excess of gold stock. Additional notes may be issued under penalty of a 6% tax.

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Scotland, Eight Joint Stock Banks which were issuing notes in 1884-45: The Scotch banks may issue notes unsecured equal to the average during the year ending May 1, 1845. All notes issued in excess must be based on gold. The authorized circulation is now L 2,676,350; the bulk of the notes are in denominations of L5 and under the lowest denomination allowed being L 1. The bank's notes are legal tender like Bank of England notes. The elasticity and security of the notes are secured by daily exchanges through the Edinburgh Clearing House. Note holders have a prior lien on the assets of a failed bank, and the shareholders' liability for note issues is unlimited. Since 1914 the excess of the actual over the authorized circulation is backed largely by Currency notes. No reserve required against deposits.

Spain, Banco de Espana, Head office---Madrid:
The following reserves are prescribed against note issues; (1) up to 1,200 million pesetas, a specie reserve of 33 1/3%, at least 1/2 of which must be gold; (2) from 1,200 to 1,500 million pesetas a

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specie reserve of 60% of which $\frac{2}{3}$ must be gold as a minimum; (3) from 1,500 to 2,000 million pesetas a specie reserve of 70% of which $\frac{5}{7}$ must be gold; (4) from 2,000 to 2,500 million pesetas the notes must be covered entirely by specie, with no limitations as to the proportion of gold and silver; (5) from 2,500 to 4,500 million pesetas the notes must be covered entirely by gold. The maximum amount allowed to be issued is 4,500 pesetas which is fixed by legislation. The productive circulation (uncovered by specie) is taxed on per mille per annum.

Sweden, Sveriges Riks Bank, Head Office---Stockholm: The notes which are legal tender are limited by (1) the metallic reserve, including foreign and domestic gold coins and bullion in the vaults of the banks; (2) gold coin and bullion on deposit abroad or in transit, covered by a marine insurance policy; (3) amount of its funds in current account with foreign banks or banking firms. In addition the Riks Bank is entitled to an uncovered note issue not exceeding 100 million kroner which must be secured by readily realizable assets. The metallic reserve

must not be less than 40 million kroner, and in the event that the uncovered issue exceeds 60 million kroner an additional gold reserve must be maintained equal to 30% of this excess circulation.

Switzerland, Banque Nationale Suisse, Head Offices---Zurich and Berne: Must maintain a 40% metallic reserve against the notes in circulation, the remainder of the notes being collateralized by Swiss discount bills and drafts on foreign countries. With the authorization of the Federal Council, in times of stress, the metallic reserve may be lowered to 33 1/3%.

Canada, Bank Notes are issued by the 18 Chartered Banks: The issue of notes is limited by: (1) amount of paid-in-capital; (2) gold deposited with the Central Gold Reserves; (3) additional notes equal to 15% of the Capital and Surplus of a bank may be issued subject to a penalty of a 5% per annum tax.

Argentina, Caja de Conversion: There are no bank notes in circulation. Through the Caja de Conversion the government issues notes to the Banco de la Nacion on the security of rediscounted paper.

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A 40% gold reserve is maintained against these notes, which the Banco de la Nacion puts into circulation by loans to other banks.

Chili, Caja de Emision: Issues money to banks upon equivalent deposits of gold. There are a number of joint stock banks with the right to issue notes upon depositing gold, Government notes or securities in the Treasury. There are also land banks which issue scrip payable to bearer, bearing interest, secured by first mortgages.

Dr. Miller. I should like to move that a separate copy be made of Mr. Jay's paper and that every member be furnished a copy.

(The motion was duly seconded and unanimously agreed carried.)

REPORT OF PRESS COMMITTEE.

Dr. Miller of the Federal Reserve Board presented a draft of a proposed statement to be given to the press.

After considerable discussion, the statement was finally approved by the Conference to be given out in the discretion of the Federal Reserve Board.

Governor Harding. I think it is only proper to say, in closing the Conference, that we regard this as one of the most interesting and instructive conferences that has ever been held. We have taxed your time and patience, and I want to assure you Governors of the banks that your reports will be carefully digested. We have had a great deal of pleasure in having you with us, and we appreciate the great value to us that your counsel and advice and experience and practical knowledge has been, and we trust that in some measure contact with us has been profitable to you.

Mr. Ferrin. Mr. Chairman, I wish to say in behalf of the Federal Reserve Agents that it is the universal sentiment among them that this Conference has been the most valuable of any we have attended. We have come in closer touch with the minds of the Federal Reserve Board in regard to the real vital matters of the Federal Board operation than at any previous Conference, and it is my view, in which I am sure all will concur, that a conference of this kind held once a year would be of supreme value. If that conference, following Governor Harding's suggestion, could be called for Monday, so that the whole week might be available, I think it would be a good thing. We appreciate very much the courtesy which the members of the Board have extended to this Conference.

Thereupon, upon motion duly seconded, at 1:40 P M, the Conference adjourned.

