MINUTES OF MEETING

of the

FEDERAL ADVISORY COUNCIL

November 16-17, 1936

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November 16, 1936.

The fourth statutory meeting for 1936 of the Federal Advisory Council was convened in Room 836 of the Mayflower Hotel, Washington, D. C., on Monday, November 16, 1936, at 10:15 A. M., the President, Mr. Smith, in the Chair.

Present:

Mr. Thomas M. Steele	District No. 1
Mr. James H. Perkins	District No. 2
Mr. Howard A. Loeb	District No. 3
Mr. Arthur E. Braun	District No. 4
Mr. Charles M. Gohen	District No. 5
Mr. H. Lane Young	District No. 6
Mr. Edward E. Brown	District No. 7
Mr. Walter W. Smith	District No. 8
Mr. Theodore Wold	District No. 9
Mr. J. J. Thomas (Alternate for Mr. W. T. Kemper)	District No. 10
Mr. Joseph H. Frost	District No. 11
Mr. M. A. Arnold	District No. 12
Mr. Walter Lichtenstein	Secretary

On motion, duly made and seconded, the minutes of the Council meeting of September 9-10, 1936, copies of which had been previously sent to the members, were approved.

It was decided that the Council should discuss first of all the subjects presented by the Board of Governors of the Federal Reserve System, dealing with Subsections (E) and (F) of Section 1 of Regulation Q.

Mr. Young presented a memorandum on the desirability of the adoption by the Board of Governors of the Federal Reserve System of a definition of interest in accordance with Subsection (F) of Section 1 of Regulation Q. This memorandum was accepted and made a part of the records of the Council.

Mr. Young presented a resolution covering Subsection (F). After a lengthy discussion it was moved and seconded to adopt the resolution which appears as the first paragraph of Recommendation 2 attached to these minutes. Mr. Loeb asked to be recorded as voting no, all other members voting in the affirmative.

At 11:30 A. M. Dr. Goldenweiser, Director, Division of Research and Statistics, appeared before the Federal Advisory Council and discussed the business situation and also in some detail the recent agreement entered into between this country, Great Britain and France regarding their respective currencies, etc.

The meeting adjourned at 1:00 P. M. for luncheon at which Chairman Marriner S. Eccles was present.

The meeting reconvened in Room 836 at 3:30 P. M.

The Council discussed the answers to be made to the Board of Governors to the queries presented to the Council in connection with Subsection (F) of Section 1 of Regulation Q. The answers appear as part of Recommendation 2 which is attached hereto and made a part of these minutes.

The Council entered upon a discussion of Subsection (E) of Section 1 of Regulation Q and voted unanimously to adopt a recommendation to the Board of Governors of the Federal Reserve System which is attached hereto and made a part of these minutes as Recommendation 1.

Mr. Arnold presented his views on the competition of government lending agencies in the farming sections of several of the western states. It was agreed to discuss this problem with Governor Davis and with Governor W. I. Myers of the Farm Credit Administration.

At 4:30 P. M. it was decided to discuss Mr. Frost's memorandum which is attached to these minutes as part of the records.

After some discussion Mr. Loeb submitted letters of Professor F. Cyril James, of the University of Pennsylvania, and Mr. Sienkiewicz, of the staff of the Federal Reserve Bank of Philadelphia, commenting upon Mr. Frost's memorandum.

Mr. Steele submitted letters from Professor Ray Bert Westerfield, of Yale University, also commenting on Mr. Frost's memorandum.

Mr. Steele desired to be recorded as in general accord with the statement presented by Mr. Frost, although not in agreement as to all of its details.

It was voted to thank Mr. Frost for his work in preparing the memorandum which was accepted and ordered to be made part of the records of the Council.

It was decided to ask President Smith to inform the Board of Governors that the Council had discussed inflation and wished to be informed as to the methods which the Board contemplated employing to check such a movement if this became necessary.

The meeting adjourned at 6:30 P. M.

WALTER LICHTENSTEIN,
Secretary.

MINUTES OF JOINT CONFERENCE OF THE FEDERAL ADVISORY COUNCIL AND THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

November 17, 1936

At 10:00 A. M. a joint conference of the Federal Advisory Council and the Board of Governors of the Federal Reserve System was held in the Board Room, Washington Building, Washington, D. C.

Present: Members of the Board of Governors of the Federal Reserve System:

Chairman Marriner S. Eccles; Vice Chairman Ronald Ransom; Governors Joseph A. Brokerick, Chester C. Davis, John McKee, and M. S. Szymczak; also Messrs. Chester Morrill, Secretary of the Board; L. P. Bethea and S. A. Carpenter, Assistant Secretaries of the Board; Lawrence Clayton, Assistant to the Chairman of the Board; Walter Wyatt, General Counsel for the Board; Dr. E. A. Goldenweiser, Director, Division of Research and Statistics, Board of Governors; Carl E. Parry, Chief of Division of Bank Loans, Board of Governors; Leo H. Paulger, Chief of Division of Examinations, Board of Governors; George B. Vest, Assistant General Counsel of the Board of Governors; and Elliott Thurston, Special Assistant to the Chairman of the Board of Governors.

Present: Members of the Federal Advisory Council:

Mr. Walter W. Smith, President; Mr. Howard A. Loeb, Vice President; Messrs. T. M. Steele, J. H. Perkins, A. E. Braun, C. M. Gohen, H. Lane Young, E. E. Brown, Theodore Wold, J. J. Thomas, J. H. Frost, M. A. Arnold, and Walter Lichtenstein, Secretary.

The Secretary of the Federal Advisory Council read the recommendation made by the Council in respect to Subsection (E) of Section 1 of Regulation Q which is attached hereto and made a part of these minutes.

Vice Chairman Ransom of the Board of Governors discussed the problems involved at some length.

The Secretary of the Federal Advisory Council read the recommendation respecting Subsection (F) of Section 1 of Regulation Q which is attached hereto and made a part of these minutes as Recommendation 2.

Vice Chairman Ransom discussed this regulation after which a general discussion took place.

The President of the Council raised the question of inflation and asked what means could be used to check the drift.

In response to a question of Chairman Eccles as to what the Council recommended, the President of the Council called on the various members of the Council to state their views.

After this was done, Chairman Eccles stated that he believed:

(a) This country should not lend money abroad.

(b) Foreign funds should not be accepted in this country.

(c) Foreigners should not be allowed to purchase American securities.

He expounded these theses at some length and upon his request Dr. Goldenweiser discussed the matter somewhat further.

At twelve o'clock Governor Myers of the Farm Credit Administration joined the meeting and discussed the whole problem of rural credits. He left the meeting at 12:45 P. M

In answer to a question raised by Governor McKee several members of the Council stated that they did not believe that increasing reserve requirements in August had affected the market price of securities.

The meeting adjourned at 12:50 P. M.

WALTER LICHTENSTEIN,
Secretary.

RECOMMENDATIONS OF THE FEDERAL ADVISORY COUNCIL TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

November 17, 1936.

TOPIC No. 1. Regarding Subsection (E) of Section 1 of Regulation Q.

RECOMMENDATION: The Federal Advisory Council would prefer that the regulation governing savings accounts stand as it is now since most American banks have become adjusted to it. If, however, there is to be a change, the Council prefers that it be in the direction of greater liberality, and in that case recommends the adoption of the more liberal interpretation omitting, however, the third clause reading as follows:

"a corporation, association or other organization which is organized and operated for the mutual benefit of its members and transacts more than half of its business with or for its members, and in respect to which deposit . . . ."

TOPIC No. 2. Regarding Subsection (F) of Section 1 of Regulation Q.

RECOMMENDATION: The Federal Advisory Council recommends to the Board of Governors of the Federal Reserve System that it put into effect subsection (F) of Section 1 of Regulation Q as proposed by the Board in the memorandum submitted to the Federal Advisory Council under date of October 27, 1936.

The Federal Advisory Council answering the queries of the Board in its memorandum of October 27, 1936, addressed to the Council, states the following:

1. If made operative, what effect, if any, would the Board's definition of interest have on:

   (a) Membership in the Federal Reserve System?

The Federal Advisory Council is of the opinion there would be no material effect; there might be a temporary one resulting in the withdrawal of some banks from the System but it is the belief of the Council that in the long run the Federal Reserve System would be strengthened by putting into effect the proposed regulation.

   (b) Correspondent bank relationships?

The Federal Advisory Council believes there would be no permanent adverse effect.

2. Assuming for the purpose of the question in this paragraph that the prohibition against the payment of interest on demand deposits is in the interest of sound banking practice, does the Council feel that the Board's definition of interest would effectuate the purposes of the statutory provision that such interest shall not be paid, directly or indirectly, by any device whatsoever?

The Federal Advisory Council replies in the affirmative.

3. Two opposing views have been presented to the Board on one question connected with this definition. It has been stated that making the definition effective will cause nonmember banks now remitting at par to leave the par list, thus increasing the cost of banking service to the public. It has also been stated that it will have exactly the opposite effect, and that non-par banks would be forced to remit at par and such banks would be deprived of an important source of revenue. The views of the Council are asked as to which, if either, of these suggested consequences they would anticipate if the definition were made effective.

The members of the Federal Advisory Council are divided in their opinion. Some members of the Council believe that the regulation would drive nonmember banks on to the par list while some are of the contrary opinion.

4. It has come to the attention of the Board that some nonmember banks have withdrawn or are contemplating withdrawal from the par list in order to obtain additional revenue from exchange and collection charges. The Board would appreciate the Council's comments as to the extent to which member banks are bidding competitively for accounts of banks or others on the basis of the absorption of exchange and collection charges and its opinion on the question whether the making effective of the definition of interest contained in Regulation Q would correct this situation or whether the Board should take some additional action.

In a very few of the Federal reserve districts some banks are bidding for accounts on the basis of absorbing exchange and collection charges; in most of the districts, however, there is no such competition. The Federal Advisory Council believes the proposed regulation will put a stop to the practice of competitive bidding for accounts of banks or others on the basis of the absorption of exchange and collection charges.

The Desirability for the Adoption by the Board of Governors of the Federal Reserve System of a Definition of "Interest" in accordance with Regulation "Q", Section 1, Sub-Section F.

Since the adoption of the Banking Act of 1933 Member banks of the Federal Reserve System have been prohibited from paying any interest, directly or indirectly, by any device whatsoever, on any deposit which is payable on demand (Sec. 11-b, Banking Act of 1933). The issue was then presented as to whether the absorption of out-of-pocket expenses incurred in the collection of non-par items by a bank for its depositors constituted an indirect payment of interest which was prohibited. Although the Banking Act of 1933 contained no definition of the term "interest", that term generally signifies compensation paid by a borrower for the use of money (Bouvier's Law Dictionary). Some of the Member Banks, being of the opinion that the absorption of out-of-pocket expenses incurred in the collection of non-par items constituted an indirect payment of interest, discontinued that practice upon the effective date of the Banking Act of 1933. Other Member Banks, possibly feeling that a fixed percentage on the amount of deposit would have to be paid to constitute interest, or that the amount paid would have to be paid direct to the depositor, continue the practice of absorbing out-of-pocket collection expenses. It is submitted that such absorption is more detrimental to sound banking practice than the payment to depositors of interest under a specific contract and that the language of the Banking Acts of 1933 and 1935 prohibits both practices with respect to demand deposits. To illustrate, interest is paid at a specified rate on collected balances (collected balances being those remaining after deduction of reserves and outstanding items), while exchange that is absorbed, although bearing a relation to balances, is not controlled completely by the amount of the collected balance, and the practice of absorbing exchange may result in the payment of interest or consideration at a greater rate than would ordinarily be considered good business practice.

As though for the express purpose of remedying this lack of uniformity of practice the Banking Act of 1935 conferred express authority upon the Board of Governors "to determine what shall be deemed to be a payment of interest" (Sec. 324, Banking Act of 1935). Regulation Q, Sec. 1 (f) as originally written is sufficiently broad in its language to compel all Member Banks to adopt the practice of refusing to absorb out-of-pocket collection expenses. To fail to define interest under the authority conferred by the Banking Act of 1935 is to penalize Member Banks which endeavor wholeheartedly to comply with the restrictions imposed in the Banking Acts of 1933 and 1935. Failure to adopt the regulations defining interest to include the absorption of out-of-pocket expenses will have the probable effect of postponing the date on which par clearance becomes universal.

It has been suggested that the postponement of the effective date of sub-section (f) of Sec. 1 of Regulation Q was caused by the failure of F.D.I.C. to adopt a similar regulation which would have been applicable to insured non-member banks. It has also been stated that F.D.I.C. contended that it lacked authority to adopt a regulation as broad in its scope as sub-section (f). Let it be said here that the authority of the Board of Governors to determine what shall be deemed a payment of interest is entirely independent of any authority conferred upon the Board of Directors of F.D.I.C., and that the Board of Governors is vested with authority to act whether or not F.D.I.C. promulgates any regulation upon the subject. It is submitted, however, that the authority of the Board of Directors of F.D.I.C. is sufficient to enable it to adopt a regulation identical in language with the proposed subsection (f) of Section 1 of Regulation Q, and that even though F.D.I.C. should adopt a regulation different from that adopted by the Board of Governors, the adoption of sub-section (f) by the Board of Governors would ultimately have the effect of causing all non-member banks to cease the practice of absorbing out-of-pocket expenses involved in the collection of items on non-par points.

We will deal first with the authority of the Board of Directors of F. D. I. C. Under Section 101 (v) (8) of the Banking Act of 1935 the Board of Directors of F.D.I.C. was directed to prohibit "by regulation * * * the payment of interest on demand deposits in insured non-member banks" and for such purposes the Board was given express authority to define the term "demand deposit". If Congress had not intended to confer upon the Board of Directors the authority to define the term "payment of interest" it would not have directed the Board of Directors of F. D. I. C. to prohibit by regulation the payment of interest on demand deposits. It would be meaningless for Congress to confer any authority upon the Board of Directors in this respect to prescribe regulations if any regulation which the Board might adopt could prohibit nothing which was not prohibited by the language of the Act itself. Nor could Congress have intended that the Board of Directors might at its option prohibit payment of interest on demand deposits since the language of the Statute states that such Board "shall by regulation prohibit" such payment of interest. That the Board of Directors of F.D.I.C. construes the Statute in question to give it authority to define the term "interest" is evident from their Regulation 4, sub-section 1 (f), in which is found this language, "the term 'interest' includes any direct or indirect payment by the bank of the purchase price of premiums given to depositors or prospective depositors in connection with obtaining deposits". If the purchase price of a premium given to a new depositor constitutues a payment of interest, is it not obvious that an agreement on the part of a bank soliciting new deposit accounts to absorb out-of-pocket expenses in the collection of non-par items deposited in the account is also a prohibited payment of interest?

Suppose for the moment that F.D.I.C. should fail to adopt a regulation similar to the proposed sub-section (f) of Regulation Q. What would be the effect of the adoption by the Board of Governors of the Federal Reserve System of sub-section (f) as originally drawn? Small insured non-member banks in outlying communities which habitually collected non-par items through a member bank, the latter absorbing out-of-pocket expenses in connection with the transaction, would find themselves faced with the question of either absorbing such expenses themselves or of passing the expense on to their depositors since the member banks, by regulation would have been prohibited from continuing such absorption. It might be argued that the small non-member banks had in the past been able to absorb such charges without ill effect. However, in the majority of instances the insured non-member bank did not itself absorb such costs, but was able to pass such charges on to its collecting bank. It is felt that the increased burden of absorption which would be placed upon the insured non-member banks would be sufficient in most instances to compel them to discontinue the practice of absorbing out-of-pocket expenses incurred in the collection of non-par items and to pass such charges on to their depositors.

It might further be argued that the adoption of sub-section (f) by the Federal Reserve Board and not by F.D.I.C. might affect injuriously a member bank located in a town in which there is found an insured non-member competing bank, in that depositors of the member bank would at once transfer their accounts to the non-member bank in order to avoid the payment of collection charges. This action, if it occurred, would only have the effect of further reducing the net earnings of the non-member banks or of compelling them to discontinue the practice of absorbing out-of-pocket collection expenses. If individual depositors of insured non-member banks actually felt the financial burden incident to the collection of items on non-par points it would tend towards a wider recognition of the advantages of universal par-clearance and the ultimate attainment of that goal.

It is respectfully urged that sub-section (f) of Section 1 of Regulation Q by the Board of Governors of the Federal Reserve System should be made of full force.

J. H. Frost

Now that the National elections of November 3 have been past, and considering the fact, further, that this is the final meeting of the Federal Advisory Council for its 1936 term of office, it would seem to be an appropriate and a desirable time for a clear, although dispassionate and non-partisan, statement by the Federal Advisory Council to the Board of Governors of the Federal Reserve System of the views which the Council entertains with respect to the present position of the money or currency structure of the nation, which serves as an actual medium of exchange for the people of the country and which further serves under federal banking laws as the basis upon which all bank credit is superimposed.

The Council believes then that it is desirable, and that probably indeed there is an obligation upon it, to make recommendations to the Board concerning the general policy which the Board may adopt for the future with respect to these matters.

In order that the reasons for the recommendations which the Council will make may be more clearly apparent, it may be advantageous, as a preliminary step, to briefly refer to certain basic principles with regard to a sound currency which seem to have been observed in connection with the legislation creating the Federal Reserve System.

In the first place, the Council has decided to accept as being as nearly satisfactory a definition of sound money as may be found that which is used by A. Barton Hepburn in his "History of Currency in the United States," and which is as follows: "Sound money means money of (or unquestionably redeemable in) a commodity which has a stable value in the markets of the world independent of fiat. Sound money as applied to coin means money wherein the commercial value of the bullion equals its coinage value. Sound money as applied to paper or token money of any kind means that which is redeemable in money wherein the commercial value of its bullion equals its coinage value."

The Council believes that there would be very little likelihood of any disagreement on the part of any student of money with the suggestion that, in so far as it is reasonably practical, it would be desirable for the United States and, for that matter, for any country in the world, to operate its economy upon a basis of sound money admitting, of course, that circumstances and conditions may from time to time arise which could justify, or indeed make absolutely essential, some variation from such requirement, but bearing in mind always the desirability of reverting, at as early a date as it may be accomplished without serious damage, to a sound money such as described in the definition above.

Without attempting to go into all the reasons therefor, we may further assume that practically all sound economists will agree that gold, or its equivalent, is indisputably the material commodity which most nearly fulfills the purpose. In other words, an ideal money for the United States or for any country would be all gold, or paper currency redeemable at all times in gold and representing an actual holding by the Treasury Department of a corresponding amount of gold available for the redemption of the currency, with, however, machinery available to facilitate necessary or desirable expansion and contraction on a safe basis and with the least possible disturbance.

At the time that the Federal Reserve Act was originally enacted into law in 1913, this basic idea seems to have quite definitely prevailed in the minds of Congress and all those who played any material part in bringing about the legislation. It is true, of course, that for practical purposes it is necessary, in order to facilitate cash transactions of small amounts and for the purpose of making change, to maintain an adequate amount of subsidiary money, with which this country was at that time, and since then has continuously been, well supplied.

At the time of the passage of the Federal Reserve Act, the fiat quality of the approximately 340 millions of United States notes, or greenbacks, and the at least theoretical desirability of eliminating them from the currency structure, was generally recognized. On the other hand, it was evidently believed that this was not a sufficiently large amount to endanger the ability of the Treasury Department to redeem in gold, it being further recognized that there might still be a sentimental feeling in connection with the greenbacks which it would be better not to disturb unless absolutely essential. Unquestionably, those responsible for the Federal Reserve Act must also have recognized that the 566 million of silver included in the circulation in 1913 contained a fiduciary element, to the extent that it did not represent a commodity having a value in the markets of the world equal to its face value. Probably this amount was likewise considered to be not of such great magnitude that the ability to redeem in gold would be endangered, and, further, it may have been feared that any attempt to eleiminate this silver and silver certificates would have invited a strenuous opposition to the whole reform program on the part of the "silver bloc".

In addition to these above-mentioned fiduciary elements, constituting a portion of the entire money stock deemed to be of sufficiently moderate volume as not to endanger the ability of the Treasury to redeem in gold at all times, there were in circulation slightly over 750 million of National Bank Notes secured by Government bonds, which, of course, do not represent any commodity whatever. These notes, however, were additionally secured by a first and paramount lien on the assets of the issuing banks, so that it is reasonable to assume that there was no doubt of their solvency. Nevertheless, due to their inelasticity, the Federal Reserve Act made perfectly clear the view of Congress with respect to the desirability of eliminating this form of currency, inasmuch as a definite method for its gradual elimination was devised, but which method it is not necessary for our present purposes to describe here. With the exception of the National Bank Notes, the silver coin and certificates, and the United States Notes, we were on an actual gold basis, but without that essential feature - elasticity.

The experience of 1907, when hoarding of currency on a very large scale took place, was very fresh in the minds of Congress and of all bankers and monetary experts, and undoubtedly there was likewise present the realization of the seasonal shortages in the currency supply for the purpose of moving crops and meeting sudden or unusual movements of gold out of the country. Clearly, it was desirable to have an auxiliary currency of an extremely and automatically elastic nature which would smoothly, and without strain, increase to meet such demands. Obviously, such an auxiliary currency could not be gold, for the simple reason that the international movement of gold does not take place with sufficient rapidity to meet such requirements, although, in the long run, gold will move to the country where it is necessary for the purpose of carrying on the business of such country, provided there are no interferences such as tariff walls, embargoes, quotas, and such other contrivances.

The question then was to provide a mechanism by which the currency supply would automatically increase as needed, but which would just as automatically decrease when the need had passed, so that it would not become redundant and thus bring about an unsound credit expansion and rise in the price level. The plan worked out was as nearly perfect as human ingenuity has ever yet devised, and it is the firm conviction of the Council that it will, under wise administration, function efficiently and properly at all times. The method of increasing the currency supply by means of rediscounting assets of member banks is simple, smooth and facile in its operation, and the reduction of the currency supply after the need for the increase has passed is just as smooth and automatic, provided, of course, that the rediscount rate is above the market rate for funds. The Council is of the opinion that the general practice under normal conditions should be that the rediscount rate should be slightly above the market rate instead of below, as has been the practice in the past. There would then be, of course, always two forces operating upon the banks which would induce the reduction of rediscounts and thereby the reduction of the supply of currency ro reserves created by rediscounts - namely, the perfectly natural desire on the part of bankers to avoid the contingent liability of their endorsement upon rediscounted paper, and, secondly, the more impelling desire to avoid the payment of interest to the Federal Reserve System at a higher rate than the prevailing open market rate. It is of great significance, as indicating the realization of the desirability of extreme elasticity, that Congress provided a method for the elimination of the National Bank Notes, a perfectly solvent currency, for no other reason than their absolute lack of elasticity.

The Council now desires to direct the attention of the Board to certain important actions which have been taken, with correspondingly important results. The first of these activities which the Council desires to mention was the accumulation by the Federal Reserve

Banks of Government obligations among their assets. These purchases, of course, resulted either in the issuance of an equivalent amount of Federal Reserve notes or in a deposit on the books of the Federal Reserve Banks to the credit of the reserve account of the member banks. The Board doubtless will recognize the analogy which exists between Federal Reserve notes and the member bank reserve deposits, since they either serve as a medium of exchange in the hands of the public or as a base upon which bank credit may be issued. The Council does not wish to criticise the purchase of Government bonds or bankers' bills by the Federal Reserve System in order to ease conditions of an emergency nature where such action seems to be imperative and where it is used with moderation, but the Council is of the opinion that great care should be exercised in order to avoid the creation of a redundancy of currency or an enlargement of the credit base beyond the actual requirements of the moment. The Council believes that there would be universal agreement with the opinion that there is at this time a sufficient quantity of gold in the United States to support any credit expansion which is conceivable as a desirable one, or even a possible one within any reasonable length of time, without making use of any of the credit base created by the holdings of Government obligations by the Federal Reserve System.

Next, the Council wishes to direct the attention of the Board to the further impairment of the quality of the money structure by the increase of the holdings of silver by the Treasury Department, against which there are outstanding at this time approximately a billion and a quarter dollars in silver certificates. It is the understanding of the Council that these certificates are issued against silver on the basis of \$1.29 an ounce, whereas the present market value of silver is approximately 44½¢ an ounce, thus making almost two-thirds of each silver certificate dependent solely upon the promise of the Government. Further, it should be borne in mind that the price of 44½¢ an ounce now prevailing in the world markets for silver is probably considerably above what it would be if the United States had not embarked on their huge program of silver purchases, so that an even larger percentage of the silver certificates might properly be regarded as dependent upon Government promise. It should also be borne in mind that the silver purchases (if the mandate of Congress is carried out with regard to the requirement of accumulating a stock of silver equal to one-third of our gold holdings) have only just begun. Further, it is the understanding of the Council that there is a very large amount of silver bullion in the hands of the Treasury Department consisting of the seniorage on silver which has been coined or against which silver certificates have been issued, and that this bullion is available, at the discretion of the Treasury Department, for issuance in the form of silver dollars or silver certificates at the rate of $1.29 an ounce. The Council is not informed as to why the amount of this silver bullion held by the Treasury Department has never been clearly revealed to the public, even though it may be possible to approximately estimate it from the price and volume of silver purchases made.

The next matter to which the Council wishes to direct the attention of the Board is the stabilization fund in the hands of the Treasury Department, which is the balance of the so-called "gold profit" after the retirement of all National Bank Notes, and which, it is understood, amounts now to approximately two billion dollars. It is true that this fund has not yet gone into the actual money structure, in that it is in the hands of the Treasury Department and not yet available for use in meeting the operating expenditures of the Government. It is, however, available for the purpose of purchasing Government bonds, which would definitely put the whole amount into the money structure. It is hardly conceivable that two billion dollars can always remain in the hands of the Treasury Department without some Administration finding the temptation too great for them to resist using this tremendous amount of money for some purpose. Assuming that it should be used for any purpose whatever, it will end up in the money structure, which, of course, includes money in circulation and reserves of member banks in the hands of the Federal Reserve System. Even though this would be gold and sound money, it could be the basis for an inordinate and wild credit inflation.

The Council does not wish to take the position that everything which has been done in connection with our monetary activities has been wrong. On the contrary, it desires to recognize that we have passed through an emergency, or several emergencies, and that the things which have been done have seemed to those in authority to be proper and necessary. In other words, this statement is not made for the purpose of either condemning or praising past actions, but purely for the consideration of the Board in connection with their decision with respect to future policies affecting the money and reserve structure.

In considering the future outlook, the Council is of the opinion that human nature, in its basic characteristics, has not changed and that available credit will ultimately be put to use. In other words, the banks, with returning confidence, will be willing to increase their loans and deposits to the ultimate amount legally possible on any given credit base, and the business men and public generally, with returning confidence, will avail themselves of the disposition of bankers to extend credit, so that, in the end, we can reasonably expect that a bank credit or bank deposit structure will be built up to the legal limit.

In support of this assumption, it might be worth while to call the attention of the Board to the great expansion which has already taken place in the bank credit structure, resulting to some degree from gold imports and silver purchases but preponderantly from financi~~al~~ng governmental deficits and also from other loans and investments. On June 30, 1933, total deposits other than interbank deposits amounted to $37,998,000,000.00, and on June 30, 1936, they were $51,335,000,000, an increase of $13,337,000,000.00 or 35%. Bearing in mind that complete confidence was not in evidence throughout the whole of the period, the Council believes that the tendency to put available credit to work is clearly evident.

Assuming, then, the correctness of the statement that available credit will ultimately be used, the Council wishes to point out to the Board the approximate position of the banking and reserve structure which could conceivably result. On June 30, 1920, reserve deposits of member banks were $1,839,000,000.00 and deposits other than interbank of all banks were $37,721,000,000.00 a ratio of 20 to 1. On December 31, 1923, reserves were $1,900,000,000.00 and deposits $42,163,000,000.00, a ratio of 22 to 1. On December 31, 1926, reserves were $2,210,000,000.00 and deposits $50,155,000,000.00, a ratio of 22.7 to 1. On December 31, 1928, reserves were $2,409,000,000.00 and deposits $56,766,000,000.00, a ratio of 23.5 to 1. These figures clearly demonstrate the fact that under normal conditions it is not unreasonable to suppose a ratio of deposits of all banks, excluding interbank deposits, to total reserves of member banks of at least 20 to 1. Member banks now have total reserves of $6,750,000,000.00.

Assuming no loss or gain of gold, an increase of silver dollars or certificates of $1,250,000,000.00 (the minimum if the purchase mandate of Congress is carried out), and an increase of $2,000,000,000.00 from the stabilization fund, member banks would have $10,000,000,000.00 reserves upon which a deposit structure of all banks, amounting to $200,000,000,000.00, could result. Even if the Board of Governors of the Federal Reserve System should increase reserve requirements to the maximum permitted by law, total deposits could go to $100,000,000,000.00 The first figure is nearly four times, and the second figure nearly double, the present deposit structure; but, assuming, as we have done, that available credit will ultimately be used, that the Treasury Department will perform the mandate of Congress with respect to silver, and that some Administration will make use of the $2,000,000,000.00 of gold lying unused in the Treasury, nothing less will result. In such case, it is difficult to imagine the extent of the rise in the price level, the extremely speculative activity which will prevail, the difficulty which the wage-earner will have in seeing to it that his income will increase with sufficient rapidity to enable him to maintain anything like his present standard of living. And then, at the end of it all, after the credit inflation has taken place and a new fear of the currency structure should develop, with the tremendous fiduciary element included in the silver dollars and silver certificates, and the equally tremendous government bond-holdings of the Federal Reserve System, what possible method can be taken to successfully cope with the situation?

The Council has attempted to depict above the possibilities inherent in a policy of liberal credit and low rates without regard to the risks involved in building bank credit on anything other than a sound base. The Council has no vote of disapproval for a policy of low interest rates or liberal credit, provided the underlying base is sound and provided, further, that the bank credit expansion be not induced at such a rapid rate that an unsound and speculative rise in the price level is a natural concomitant.

In view of all the above, the Council believes that its statutory duties require it to make definite recommendations to the Board which, if followed with wise discretion, will tend to avoid dangerous or wild credit inflation but should not in any degree whatsoever curb or interfere with sound credit expansion and recovery. In the first place, it wishes to stress the point that it does not deem advisable a drastic or sudden action in connection with any of its recommendations, since it realizes that such action could conceivably create an extremely disturbed or even chaotic condition. This very fact, that a definite movement to reduce or eliminate unsound elements in the credit base can be dangerous, causes the Council to be all the more impressed with the desirability or necessity of eliminating them in a gradual and appropriate way before a bank deposit structure imposed upon them should become an accomplished fact. The recommendations of the Council will be with respect to three elements of the credit base, each of which is essentially inflationary. (1) Government bond-holdings of the Federal Reserve System. (2) Silver. (3) Stabilization fund. The Council is of the opinion that, if there should be permitted to be built a bank deposit structure to the ultimate amount without at least partially following its recommendations with regard to these three items, we may look into the future, possibly rather distant but possibly not so far away, to a time when we can expect an economic collapse which could be inconceivable in its devastation.

Government bond-holdings.

The Council believes that these should be reduced to an amount not more than $400,000,000.00 by gradual sale or permitting them to be paid as they mature without replacing by purchase. If the Board should adopt such a policy, it could be done gradually and with such caution that no serious dislocation should result. Even after reducing these holdings by two billion dollars, some excess reserves would remain without the accumulation of any rediscounts from member banks.

Silver

The purchases of silver should be discontinued entirely, which cause no decrease whatever in the money stock or credit base. In addition, however, the silver certificates outstanding as a result of the emergency purchase should gradually be retired and the corresponding silver be sold in the markets of the world. This should not and could not be done precipitately, but should be done as gradually as might be necessary to avoid serious disturbance and shock. Even completion of the operation would leave some $600,000,000.00 of silver dollars and certificates in the money structure exclusive of subsidiary coin.

Stabilization Fund

Realizing the practical certainty that two billion dollars in gold cannot permanently be locked up in the vaults of the Treasury, and believing that an injection of such an amount of additional money into the credit base would produce a very dangerous and extreme credit inflation, even though based on gold, the Council believes that it would be in every way desirable to revalue upwardly the gold content of the dollar to such an extent that the entire stabilization fund would be absorbed into the money structure without increasing or decreasing the volume of the money structure as expressed in dollars.

such action would be in no way deflationary or inflationary, but would eliminate a potential source of credit inflation and it would leave the country with a gold stock of nine billion dollars but would neither increase or decrease the present credit base.

Assuming that these three recommended operations could in time all be successfully completed, the member bank reserves would be reduced two billion dollars by the first, seven hundred million by the second, and nothing at all by the third. There would remain reserves of member banks amounting to four billion dollars, enough to support a deposit structure of all banks in the amount of more than eighty billion dollars, or an increase of twenty-five billion dollars, nearly 50% above the present volume, which is now approximately the maximum for all time in the past. It would seem that this would be more than enough reserve structure to support any desirable credit expansion. Further, it should be borne in mind that the base will be a comparatively sound base containing only a reasonably moderate amount of Government bonds, greenbacks and silver, so that if we should have such credit expansion as could be supported upon it, then, if the balance of international payments should turn against the United States, causing gold exports and thus making necessary a reduction of outstanding bank credit, the blow could be cushioned by liberal rediscount privileges being extended by the Federal Reserve System - or even a repurchase of such amount of Government obligations as might seem to be essential.

Now as to the means available to the Board for bringing about favorable action upon the recommendations of the Council. The Board already has complete authority to act upon the first recommendation, concerning the holdings of Government obligations, but the Council realizaes that action on the second and third recommendations, concerning silver and the stabilization fund, respectively, can only be brought about by legislative action of Congress. The first recommendation therefore needs no further comment from the Council, other than to repeat that action should be taken with great care and that the process should be gradual. Even though action on the second and third recommendations can only be through the medium of congressional legislation, the Council desires to call the attention of the Board to the fact that the soundness of the currency and reserve structure of the nation may become of paramount importance in connection with preserving the safety of the savings of the people, and the Council believes that it is the duty of the Board to give consideration to any matters which may have an effect thereupon.

The Council is of the opinion that there should always be the closest relationship and the fullest co-operation between the Board of Governors of the Federal Reserve System and the United States Treasury Department, and it believes that the Board of Governors in their relations with the Treasury Department should, in whatever way may seem appropriate to them, give the benefit of their views to that Department, as well as inquire into the views of the Treasury Department upon such important subjects as those mentioned above. The Treasury Department in turn, or even in conjunction with the Board of Governors of the Federal Reserve System, in the opinion of the Council, may with entire propriety make representations to the appropriate committees of Congress, with a view to effecting legislation appropriate to sound and desirable ends.

The essence of the thought which the Council wishes to convey to the Board is that the Board should work to the end of accomplishing so much of the objectives embodied in these recommendations as may be possible, and the Council suggests collaboration with the Treasury Department as the most natural and feasible procedure. The Council, however, believes that the reduction of the credit base involved in the gradual disposition of Government obligations held by the System is of paramount importance, and, while at all times close co-operation with the Treasury department should be maintained, the Board cannot afford to fail to take sound, independent measure if it should be necessary to do so in order to preserve the safety of the money and banking structure.

C O P Y

Ray Bert Westerfield
Professor of Political Economy
Yale University

New Haven, Connecticut,
November 10, 1936

Mr. Thomas M. Steele, President,
The First National Bank & Trust Co.,
New Haven, Connecticut.

Dear Tom:

I have gone over the Frost manuscript and will comment paragraph by paragraph rather than attempt a complete restatement of the prouncement. It is, as I said in my earlier letter, an admirable statement which I could scarcely improve upon.

Page 2. Par. 2: - I repeat my statement of the fact that Frost passes from Hepburn's definition of "sound money" in this paragraph. Hepburn was content that the "paper money" or "token money" was sound if it was "redeemable in money wherein the commercial value of its bullion equals its coinage value"; but Frost interprets this to mean "paper currency redeemable at all times in gold and representing an actual holding by the Treasury Department of a corresponding amount of gold available for the redemption of the currency. Now this underscored portion is in addition to the Hepburn definition, and means that only "gold certificates" are sound. I do not believe that Hepburn meant that limitation; he did not say so; he did not say that he wanted 100% reserve against all paper money. All he wanted, and all that was or is necessary is that a reserve surely sufficient to provide for redemption in gold be kept. The very federal reserve notes which the new Federal Reserve Act provided for were to be protected, not by 100% reserve, but 40% in ordinary times, less in emergencies.

Page 3, Par. 1: - I repeat my statement that the reason for the elimination of the greenbacks was, not that they did not have 100% gold reserve, but that they were elastic and that they were promises of the Government, putting the government into the position of banker and requiring the Treasury to redeem them and thus upsetting the regimen of treasury administration and threatening the government credit. It was desirable to shift the note-issue function to a central bank, and to provide for the ready expansion or contraction according to business need.

The Federal Reserve Act did intimate how the framers expected the greenbacks would be eliminated from the money of the country, for it provided that the Secretary of the Treasury might use the government's share of the profits of the Federal Reserve banks to pay off the greenbacks.

The criticism of the silver certificates was quite like that of the greenbacks. The government's promise to redeem was in this case written on a piece of silver (weighing 371.25 grains pure silver) or on a piece of paper (a silver certificate having 100% silver reserve and circulating instead of the silver dollar). The silver dollars and certificates (taken together) were a fixed amount, as coinage of the silver dollar had stopped in 1893. The Gold Standard Act of 1900 had required the Secretary of the Treasury to maintain all money at par one with another; and while no method of accomplishing this duty, it was assumed that the

Secretary would stand ready to redeem all silver dollars in gold upon demand; in other words, that the gold reserve of the Treasury was also to support the silver currency, along with the greenbacks. This also put the Treasury in the position of banker, and it was generally regarded as desirable to substitute Federal reserve notes for the silver currency, that is, shift the note issue function to the central bank. But this measure was not taken in the Federal Reserve Act for the reasons, among others, cited in the paragraph.

Page 3. Par. 2 - The criticism of the national bank notes was not that they did "not represent any commodity whatever", but that there was no gold reserve kept against them for conversion purposes and that they were almost fixed in quantity and did not vary with the needs of business.

Page 4. Par. 1. last sentence - The existence of the national bank notes, the silver coin and certificates, and the greenbacks did not in any proper sense keep us off "an actual gold basis". That is not an element of being "on a gold basis". So long as all moneys were in law and fact redeemable in gold we were on a gold basis. To be on a gold basis requires that the monetary standard unit be defined in terms of a weight of gold, that there be free coinage of gold, that there be maintained a redemption of all moneys in gold, and that gold be freely exported and imported, hoarded and dehoarded, and used in the industrial arts.

Page 4. Par. 2 - Besides the slowness of "international movement of gold" are the slow changes in gold production, in gold consumption in the arts, and in the conversion of bullion to coin and of coin to bullion. Moreover, since the amount of gold money is the resultant of so many factors, independently determined, it would be more or less fortuitous if the monetary demand for gold was answered always by an equal supply of monetary gold. These are the factors that prevent gold from answering well the requirement of being "elastic".

There could be no certainty that each country would even in the long run have the amount of gold "necessary for the purpose of carrying on the business of such country". For instance, new countries were chronically crying for more gold; their adverse balances of payments made it almost impossible to maintain a gold reserve; they lived beyond their means and were borrowing from the older countries, and gold left quite as soon as it arrived.

Page 5. Par. 1 - I previously called attention to the fact that the scheme of regulating the volume of federal reserve notes through rediscounting of commercial paper was not allowed to work long in a way untrammeled by the direct issue of federal reserve notes for gold and by the use of paper collateraled by government bonds and by the use of non-liquid (so-called) commercial paper. Except for the seasonal variation, there is no consistent and dependable relation between the volume of federal reserve notes and the volume of rediscounting. The volume is highly variable, but the variation is not always in the direction of business activity. Furthermore, there is nothing sure in the capacity of rediscounting to check a business boom; for as the price level rises the face value of the volume of commercial paper can be pyramided.

The whole purport of my comments on page 5 of the Frost MSS is that it pictures the federal reserve note and rediscounting as more perfect instruments than they are or have been in actual fact. Maybe the language might well be tempered to avoid criticism.

Page 9, Line 7. Typographical error: "financing", not "financial".

Page 11, line 8 from bottom and page 12. - Title to first section. Should say bond-holdings of the federal reserve banks, rather than of the federal reserve system. The system includes the holdings of the member banks. (also on page 15).

I believe it would be wise to make some pronouncement on the desirability of the member banks gradually eliminating a considerable portion of their government securities; or at least of not piling up further purchases.

There are split infinitives on pages 1,7,10, and maybe others. Maybe Frost will want to eliminate these in the final draft.

I have no particular criticisms of the latter part of the MS. I still think the Council should add to their statement their position on International Stabilization of the Currency, on the Gold Bullion Standard as against the Gold Coin Standard, on the present scheme of having gold certificates rather than gold the reserve of the federal reserve banks, on the matter of currency management through open-market-gold-purchase or through other methods advocated by monetary experimenters. A strong declaration against management, manipulation, experimentation, etc. might be helpful in obviating such experiences.

Sincerely yours,

(Signed) Ray

COPY

New Haven, Connecticut,
November 11, 1936

Ray Bert Westerfield
Professor of Political Economy
Yale University

Mr. Thomas M. Steele, President,
The First National Bank & Trust Co.,
New Haven, Conn.

Dear Tom:

I just reread the Frost MSS and have a few more suggestions, some awfully minute:

Page 6 line 10	Federal reserve <u>banks</u>, not <u>system</u>
Line 21	Ditto
Page 7 line 6	<u>Its</u> instead of <u>their</u>
Page 8 line 1	The present situation is that $200,000,000 only are set aside for the purchase of exchange, gold, and government bonds. Of course, the government might jump this to $2,000,000,000 at its discretion.
" " line 6	for <u>it</u> rather than for <u>them</u>
Page 10 line 6	This calculation does not keep in mind that reserves required are not the same as formerly. They have recently been jumped a half above what they were between 1920 and 1928. Neither the $200,000,000,000 nor the $100,000,000,000 is correct therefore.
	The figure $80,000,000,000 on page 12 line 10 should also be restated for same reason.
Page 13 line 7	from bottom. Federal reserve <u>banks</u> rather than <u>system</u>.

Sincerely yours,

(Signed) Ray

CRITICISM OF THE MEMORANDUM REGARDING PROPOSED ACTION BY

THE FEDERAL ADVISORY COUNCIL

The suggestions contained in the memorandum are subject to criticism from two angles; (a) from the angle of the general policy involved and (b) from that of the detailed suggestions embodied in it.

As to the general purpose, there is some reason for suggesting the desirability of returning to an international gold standard at the present time and this matter is dealt with in the attached proposals. The ability of the United States to restore a gold standard, however, is conditioned by the willingness of other countries to take similar steps, since it is impossible to conceive of an international gold standard unless the United States, England and France, at least, should participate in it. Moreover, the restoration of such a standard requires the abolition of quotas and embargoes that now restrict international trade and a revision of tariff policies such as to permit increased international trade in commodities and services. Increased provision for international capital movements would also be a necessary prerequisite, and these conditions should be emphasised in the memorandum suggesting the international gold standard as an aim of monetary policy.

Assuming that, in the light of all these facts, it was still thought desirable to recommend an international return to gold, the suggestion that the gold in the Stabilisation Fund might be eliminated from the monetary picture by an upward revaluation of the dollar is impossible, both theoretically and as a matter of practical politics. Under any form of international gold standard the foreign exchange parities between the different currencies must measure both the relative gold content of the monetary units and the purchasing power over commodities of those units in their respective countries. Thus, before the war, a pound sterling was worth approximately $4.86 because the pound contained nearly five times as much gold as the dollar by weight, and also because it would purchase in England about five times as much as would the dollar in the United States. This must naturally be so since gold normally moves freely from one country to another and would naturally move to the country where it would purchase most. All of this is simply another way of pointing out that any attempt at restoring the gold standard cannot succeed unless the ratio established legally among the several currencies corresponds to the purchasing power parity.

While minor corrections may be necessary in one or other of the countries involved, it is reasonable to suggest that at the present time the exchange rates between the dollar, the franc and the pound correspond approximately to purchasing power parities. With a dollar weighing 1/35 of an ounce of gold, the pound is today worth approximately five dollars when measured by price levels in the two countries. Naturally if all the countries concerned should revalue their currencies upward, the exchange relationship would not be disturbed. Such a proposal, however, is impracticable and if the United States alone should do it, American business would be placed in the position that British business occupied in 1925. Either a decline in the American price level or a rise in foreign price levels of gold standard countries would be necessary to restore equilibrium, and the experience of England from 1925 to 1931 suggests that equilibrium is not easily restored.

If the three nations above mentioned should agree to return to the gold standard with specific gold contents for their several monetary units corresponding to the existing purchasing power parities, and if there were reason to expect that such a restored gold standard would endure for some time to come, it would be possible to use the gold in the Stabilisation Fund for the purpose of retiring some of the outstanding Government bonds. This is what France did with the profits from devaluation in 1928.

Regarding the other two proposals of the memorandum, the discontinuance of the silver purchase program would arouse no objections from any economist, although it might be politically inexpedient at present. This latter point is not of economic significance however and, in view of the fact that the acquisition of silver by the United States Treasury does nothing to strengthen the American monetary system, the immediate cessation of such purchases has very much to recommend it.

The suggestion that the Federal Reserve System reduce its holdings of Government bonds to $400,000,000 is somewhat more controversial. If the Administration should balance the budget so that it did not depend upon the capital market for immediate financing, and if it should be willing to refund some of the short term issues outstanding on the basis of somewhat higher interest rates, it is probable that the Reserve System might safely and wisely over a period of time reduce its present holdings by a policy of open market sales. Such a policy, however, would need to be carried out very gradually in order to prevent any sudden rise of interest rates in the money market. If the Administration should not be willing to adopt the fiscal policies suggested above, it is manifestly impossible for the Federal Reserve System to adopt any policy requiring substantial open market sales. Such sales would weaken the market for Government bonds and, whatever may be the letter of the law, it is obvious that no government will allow its central bank continuously to pursue policies that run counter to its own.

<u>Minor Points of Criticism</u>

Some question can be raised regarding the definition of "sound money" that appears on pages 1 and 2 of the outline. While Hepburn's definition is suitable for his purpose and for the time at which he wrote, it is not theoretically defensible. More accurately, sound money would have to be defined as any type of money that satisfactorily serves as a standard of value and a medium of payments, thereby facilitating the normal operations of business. It is theoretically conceivable that an inconvertible paper currency might qualify as sound money if it were perfectly managed by an omniscient and omnipotent authority, and all that can be said in favor of Hepburn's statement is that, in the light of human weaknesses and ignorance, it is probably better that the United States should base its money upon gold and so limit the need for management. Perhaps this is not an important criticism, because it is probable that Hepburn himself would have agreed with the above statement, but the method in which the definition is presented in the memorandum tends to color the whole discussion.

The second technical point of some considerable importance arises in connection with the suggestion on page 5 of the memorandum regarding the rediscount rate. While it is a standard principle of English central banking practice that "Bank Rate is normally above Market Rate", it must be remembered that the phrase <u>market rate</u> applies specifically to the rate of discount on first-class bankers' acceptances. Even in the United States the market rate on acceptances might conceivably be below the Federal Reserve buying rate (although it usually is not), while in England the rate charged by a commercial bank on customer loans is always at least two percent <u>above</u> the Bank of England rediscount rate. The difference in the type of paper rediscounted by the Bank of England and the Federal Reserve Banks makes it impossible to make any such general suggestion as the one that Federal Reserve rediscount rates should be above market rates, because in this country, where most of the paper presented to the Reserve Banks consists of single name customers' notes, it would be intolerable to have central bank rates above the rates charged in every part of the country.

November 14, 1936
FCJ:ABR

<u>ALTERNATIVE MEMORANDUM CONCERNING RECOMMENDATIONS OF POLICY</u>

Improvements in the volume of business activity and substantial increases in the prices of commodities and securities indicate that a business revival is well under way in the United States. Since these improvements have all the earmarks of a regular cyclical expansion in business, it may be expected that business will continue to expand of its own momentum if nothing is done to interfere with normal business operations in industry and commerce.

Such a condition of affairs would tend to indicate that the easy money policies, adopted by the Reserve System in 1933 to encourage business revival and price-increases, have served their purpose and should now be gradually discontinued. Naturally no sudden change of policy is desirable, since sudden change might undermine the confidence of the money market, induce sharp increases in interest rates, and retard the continued expansion of business activity. The change of policy must necessarily be very gradual, but it does seem that the time has now come when it is necessary to turn our attention to the problem of the methods by which the Reserve System can prevent an undue expansion of credit and a dangerous speculative boom.

This problem is not easy in the light of our present circumstances and of the limited experience that we have of monetary management, but an effort must be made to find a solution since a continued expansion of business for two or three years might produce a very dangerous expansion in the volume of bank deposits even if no increase occurred in the stock of money in the United States and the present volume of member bank reserves.

If the Reserve Board should raise member bank reserve requirements to the maximum amount permitted by law at present, the problem would not be completely solved because substantial deposit-expansion might still occur on the basis of excess reserves and the aggregate volume of reserves would be continually increased by the silver purchases of the Treasury under the present program. Moreover such a step would make it impossible for the Board to raise reserves further without special legal enactment (which would be difficult to obtain promptly at a time when further increases were considered necessary and desirable.)

Something might be done by raising rediscount rates, but this step is probably undesirable at present since it would undoubtedly produce an early rise of interest rates in the market and check the revival. Nor are substantial open market sales of government bonds a practical possibility until the government has balanced the budget and refunded its short-term issues. As long as the government depends upon the capital market for current financing it is inconceivable that the Board should, by raising rediscount rates or substantial open market sales, follow policies calculated to make the task of financing the government more difficult.

Several of these problems arise out of the peculiar characteristics of our monetary system, and they also exist to a greater or lesser extent in several other countries. Joint international action in restoring a gold bullion standard, at least in the United States, England and France, would go a long way towards providing us with an effective solution, and, in view of the recent international monetary agreements negotiated by the United States Treasury, it would appear that such a step is possible as well as desirable at this time.

If the gold standard should be restored in the three countries mentioned, with gold value for the dollar, franc and pound appropriate to the present purchasing power parities between these monetary units, and suitable collateral measures were taken to encourage the international movement of goods and of capital, the problems of credit control would more closely resemble those with which we have had experience in the past. Moreover such a policy would make possible the cessation of silver purchases (for the time being at any rate) and would make it possible to use the gold in the stabilisation fund for the purpose of repaying some of the government bonds now held by the banking system - removing two of the potentially inflationary factors in our monetary system.

Naturally, it is assumed that if such a policy were followed, the Reserve Board (in consultation with the Bank of England and the Bank of France) would continue to study the methods by which credit control could be made more efficient and the general level of monetary management improved. Moreover, if such a policy were adopted now - when the danger of speculative inflation is not urgent - it would provide an ample opportunity for adjustment to the new scheme of things and enable the Reserve System to perfect its control technique before the need for retarding the rate of deposit expansion should become urgent. To postpone action until such a time arrives may have the effect of seriously impairing the efficiency of the Federal Reserve Board in performing the tasks that have been placed upon it.

November 14, 1936
FCJ:ABR

Confidential

COPY

November 14, 1936

TO: Mr. Sinclair

FROM: CAS

SUBJECT: REVIEW OF THE FROST MEMORANDUM RELATING TO CURRENCY IN THE UNITED STATES.

This statement attempts to set forth certain basic principles relating to our currency and to make definite recommendations with respect to the policy to be adopted concerning the present holdings of government securities by the Federal Reserve System, buying of silver and issuing silver certificates, and the so-called stabilization fund. The memorandum calls for a critical appraisal rather than alternative suggestions. What follows therefore is mainly in the nature of a critique based on established facts.

1. The statement starts out with Hepburn's definition of sound money and suggests that the Council accept this definition and thus its implications. Hepburn's "A HISTORY OF CURRENCY IN THE UNITED STATES" was first published in 1903, then revised in 1915 and in 1924. No later edition has appeared, though one is planned to be issued in December this year. The definition, therefore, was formulated some years ago when conditions were different from what they are now. But this fact does not necessarily impair the validity of basic principles, though Hepburn himself states in the second paragraph to the one quoted in the memorandum that: "The test of sound money varies with different periods, and is determined by varying conditions. The term has, however, a general significance easily understood, is concise, cogent and seems to have found a permanent place in our economic literature." Apparently this "general significance" varies according to prevailing conditions over long periods. The implication is that the static definition is not to be adhered to literally and that is precisely what the memorandum does.

Moreover, it is not true that all students of money today accept Hepburn's definition of sound money, largely because of the difficulty of knowing the meaning of the phrase unless it may be taken literally in connection with the testing of coins which, when dropped, ring true or false. Then, too, fundamental conditions have changed very greatly since the definition was formulated. Probably the best test of sound currency is when the people believe in it and accept it in their ordinary transactions and when that currency has a standard of value which makes it also acceptable in international payments.

The definition gives a clear implication that sound money is "unquestionably redeemable in" gold. It also refers to the gold coin standard such as existed in this country until a few years ago. Obviously, it is not applicable to the standard we now have. Does it then mean that the Council would suggest the return to the gold coin standard, making our currency convertible into gold coin on demand? For that is the meaning implicit in Hepburn's definition of sound money. If it does, the statement should say so, otherwise this definition is beside the point and should not be a basis for further development of the case.

2. Reference is made to certain basic principles observed in connection with the legislation creating the Federal Reserve System in 1913. In general, it should be remembered that the original Act was the result of many compromises, attempting to adopt the best banking system possible for this country. It was also intended to be a living and working organism. While it may not have met all the exaggerated expectations of its sponsors, it has been adapted to changing conditions either through administrative measures or through legislation, to wit: changes in reserve requirements, real estate loans, discounts and advances, discount rates and other changes relating to measures of control and administration of bank credit. In its efforts to meet changing conditions the reserve system has gone a long way from both the conditions and the thoughts prevailing at the time

when it was founded. The historic argument thus is hardly convincing. If some hold that we have departed too far from the original intentions, this is beside the point in any consideration of conditions as they now exist.

3. An emphasis is placed on the fact that the Treasury should be able to redeem in gold at all times a large portion of currency so that it would be possible to maintain full confidence in such fiduciary elements as are implicit in the subsidiary or representative money. But it should be noted that by far the greater part of our currency supply at present rests on the gold base. The United States notes amounting to about $340 millions have back of them a gold reserve fund of $156 millions established under the Gold Reserve Act of 1900. Federal reserve notes in actual circulation as of November 10 amounted to over $4.1 billions and the collateral held as security for these notes consisted of: $4,396 millions in gold certificates, $5 millions eligible paper and $93 millions United States government securities, making a total of $4,494 millions.

Silver certificates, Federal reserve bank notes, and national bank notes, of which about $1560 millions were outside of the Treasury, have no direct gold base. But it must be remembered that all forms of money are legal tender and must be kept at a parity in relation to gold.

In pointing out the presence of such elasticity on the side of the reduction in the currency supply, the statement injects a controversial feature by saying "provided, of course, that the rediscount rate is above the market rate for funds". This rule of thumb is of British origin, often resorted to without realizing the essential differences between the money market structures in England and this country. For example, the British banks make advances to their customers largely through overdrafts and do not require promissory notes as is done in this country. A British bank does not borrow directly from the Bank of England but adjusts its position through bankers' and Treasury bills as well as its loans to bill brokers. Whenever necessary these brokers sell bills to the

Bank of England at the discount rate or borrow from the Bank on bills. The rates at which the British banks lend to their customers are usually somewhat above the Bank of England rate.

The discount rate in the United States applies to promissory notes, which member banks present with their endorsement to the reserve banks, or to the member banks' own notes secured by their customers' notes or by government obligations. "If a member bank lends its commercial customer on his note at 5 per cent, the value of this note with a bank endorsement may be represented by a rate not far from 3½ to 4 per cent. If at that time the Federal reserve bank rate is 4 per cent it is really equal to or above the rate which represents the paper's true value." These explanations are taken from the latest study by W. R. Burgess of the Federal Reserve Bank of New York (The Reserve Banks and the Money Market).

The principle back of this controversial rule is that banks should not be able to make money by borrowing at reserve banks and that by being above the market rate the discount rate should be in the nature of a penalty rate. This is a subject that requires much closer study than the mere qualifying proviso used in the memorandum.

The truth of the matter is that by virtue of the fact that cash on hand does not count as reserve in the hands of member banks there is always a strong tendency for currency to return to the reserve banks, thereby avoiding redundancy. Whenever member banks have large excess reserves this may be less pronounced than at a time when they are forced to borrow in order to maintain their required balances. If banks must borrow, then naturally they will return currency not needed to the reserve banks in order to pay off their indebtedness, since by doing this they save interest charges. This should hold true whether or not the Federal reserve discount rate is above the rate charged customers. Regardless of the backing of the currency, therefore, it appears that elasticity has been imparted to the whole currency structure in so far as elasticity may be construed to mean responsiveness of money to the needs of trade and industry. There is no question as to the ability of the reserve banks to meet the current demand for money needed for such important items as payrolls and retail trade.

In any discussion of our currency problems it should not be forgotten that probably about nine-tenths of all current payments for goods and services are made by the use of checks drawn against deposits at banks. A check is a means by which a deposit credit is utilized for domestic exchange purposes. In practice, therefore, deposit credits perform much larger functions as media of exchange than do actual currencies, subsidiary coins and representative notes.

4. An attempt is made to build up an argument against the present holdings of government securities by the Federal Reserve System. Generally speaking, it goes without saying that it would be much better if the distribution of government debt could be widely made among our population but apparently this has not been the case, as it is in other countries. This is probably due in part to the adventurous temperament of the American people to take risks and either lose or realize more than the yield from government securities. The largest concentration in holdings of government securities in this country thus is in financial institutions and large estates. Maybe this is a question of long education, built up gradually on the basis of enduring confidence in our credit system generally and in government credit particularly.

Specifically, the memorandum states that the purchases of government obligations by the Federal reserve banks have resulted either in the issuance of an equivalent amount of Federal reserve notes or in reserve balances. The first part of this statement is not true, since the Federal reserve notes at present are secured practically 100 per cent by gold certificates. The second part is true but is not necessarily alarming, particularly since holdings are at the discretion of the Federal Open Market Committee; in fact it may be quite desirable to hold the present amount as an instrument to be used in case of any undue credit expansion.

It must be recalled that after a very sharp increase in purchases of governments by the Federal reserve banks in the early part of 1932 and the latter part of 1933 there has been virtually no change in the volume of these securities held by the reserve banks. It must also be remembered that so far there have been no definite convincing signs that bank credit is being used to any large extent in either the security or commodity markets.

If the reserve banks should sell $2 billions of their holdings of government securities the effect on the market for these securities unquestionably would be drastic; even a gradual reduction might easily result in an extreme construction of the policy by those who watch the markets. Unless the Treasury would counteract such a step, as it readily can, the effect on the capital account of all banks at present might be exceedingly serious. Another effect, of course, would be a reluctance to buy governments at present yields, so that higher rates of interest would have to be offered. While Treasury refinancing within the next year or so appears to be relatively small, about $8.7 billions of Treasury notes will mature between 1937 and 1941. This is an important factor to be considered from the standpoint of both banking and Treasury financing. Close cooperation between the two is essential.

5. Little or nothing favorable could be said by any thoughtful student with respect to our position as to silver. Largely under the pressure of special interests we have got ourselves into insuperable difficulties and now it is probably a question of how to get out of them legally and gracefully. Use of the method proposed in the memorandum at this time would be questionable. In the first place it would require legislative action to modify the present law. To retire a large part of the silver certificates and attempt to sell silver in the world markets would seem to be doubtful expedients at present. Can the world absorb the silver so offered? What would be the effect on prices, exchanges and trade? It would lead to even greater disorganization in the silver markets of the world than it did at the

time when we were buying silver. It would certainly affect the silver interest in our own country and this would produce another political howl. In effect it would mean jumping out of the frying pan into the fire and the fire would indeed be white hot.

The best way out for the time being probably would be to make our silver program passive, if this is possible under the law. Certainly it would be advisable to resist any attempt to issue notes against seigniorage. The content of the silver dollar also may be increased, thereby changing the monetary value of silver as the President can do under the present statute. But whatever is done the foremost question should be: is now the time to do it without embarrassing the administration and bringing adverse criticism from the silver bloc? Would not time help to expose the folly of the existing measures and eventually help do something about meeting this problem rationally?

6. The position taken in the memorandum with respect to the stabilization fund seems peculiar to say the least, particularly in view of the latest monetary developments. In its remarkable simplicity, singularly unperturbed by the monetary events that are now taking place, the statement takes no cognizance whatever of the recent cooperative agreement entered into by the United States, France and Great Britain as well as several other commercial nations to bring order out of chaos in world exchanges and trade. All these nations have established stabilization funds for the purpose of moderating exchange fluctuations and ultimately attaining some workable level of currency relationships so that trade and payments can once more become sanely operative.

After a most troublesome period, the leading industrial nations show a strong desire to relax and gradually remove the trade-choking folly of controls, restrictions, tariffs, quotas and other trade impediments. Surely this would be to our interest. We could then sell more freely such of our surpluses as cotton, automobiles, diverse manufactures, and many farm and animal products; we could also buy more freely such essentials as manganese, rubber, tin, silk, tea and coffee. What the world needs today is stability and until the present undertaking shows definite signs of success it is necessary that we retain the means provided by the stabilization fund for safeguarding the position of our currency in the international markets. Is it the intention of the memorandum to disregard the facts of this trend, assume a fatalistic attitude, or expose ourselves to certain hazards that may not be foreseen at the moment?

Complete monetization of our large gold stock in one way or another may be possible, though not probable, and might be considered as undesirable. But is the presence of foreign capital in this country to be ignored? One of these days might not the political and military situation abroad change suddenly and might not the owners of this capital become shaky in their faith with respect to our own situation and to our dollar? Such things happened not so long ago. What effect would it have on our excess reserves if we had to part with a considerable portion of our gold? Those in authority already are conferring with the Executive on this very subject. The fact that the Secretary of the Treasury could stop shipment of gold from this country would be of small consolation; rather it would be an admission of monetary short-sightedness and consequent inability to cope with the problem. Practical wisdom and financial statesmanship would seem to indicate that, if anything, the present stabilization fund should be continued beyond January next, at least until world stabilization becomes more assured than it is at present.

Certainly our monetary position would be made doubly vulnerable if we revalued the dollar upward, as the memorandum proposes to do, in order to absorb the two billion dollars gold or the so-called "gold profit". By undoing the former act of Congress at this time only confusion and great harm can be the result. Even such conservative monetary economists as Professor Kemmerer deny the advisability of going back to the former weight of the gold dollar. One wrong cannot right another, any more than misbehavior in one nursery means a like misbehavior in another nursery. Much as some may like to return to the old gold coin standard, one cannot soberly disregard the stark realities of the present situation. No pious wish or spectacular public statement can remedy it without producing immeasurable damage internally and externally. No degree of assurance that "this statement is not made for the purpose of either condemning or praising past actions . . ." is a convincing and effective safeguard against self-exposure and the justified criticism that would inevitably follow should the memorandum in its present form be given out to the country.

7. In considering the future outlook, the memorandum expresses grave misgivings with respect to the immutability of human nature and the willingness of bankers and business men to expand their credit operations to the legal limits when confidence returns. In support of this statement, the memorandum shows an increase in total deposits (other than interbank deposits) of 35 per cent from June 1933 to June 1936. This comparision tends to exaggerate this expansion at least to the extent that the low point reached by deposits in the middle of 1933 probably was due in part to the fact that many banks at that time were still on the restricted basis and were licensed after that date. But it cannot be denied that deposits since 1933 have increased very greatly, reflecting in large part emergency expenditures, financed by the issue of new government securities which were acquired in substantial amount by the banks. Two things must be remembered, however; the use of bank credit by business and the stock market so far has not been large, as shown by loans of all types; and the continuous improvement in business is resulting in larger incomes to corporations, individuals and consequently to the government, which is to say that relief expenditures are declining, employment is increasing and the prospects for curtailing government expenditures may become more hopeful.

The memorandum points out that in other years, from 1920 to 1928, the ratio of deposits to reserves fluctuated within a range between 20 to 1 and 23.5 to 1. From this the memorandum assumes that it would be reasonable to expect a ratio of deposits of all banks to member bank reserves of 20 to 1. Adding to the total of reserves now held, a possible $\$1\frac{1}{4}$ billions through additional issues of silver currency and $2 billions through the use of the stabilization fund, it arrives at $10 billions of reserves; applying the 20 to 1 ratio this would indicate possible deposit expansion to $200 billions. Of course 20 to 1 was based on reserve requirements as they stood between 1920 and 1928. Since then an increase of one-half in requirements has been made and the memorandum admits that if the full powers of the Board of Governors were used, deposits might expand to $100 billions only. This figure is much less startling than the memorandum apparently intends to convey in first arriving at $200 billions.

This portion of the argument clearly implies that at present we are face to face with a definite possibility of tremendous credit inflation and that there is no possible method of controlling it under present conditions. This assertion would be quite serious if it could be borne out by established facts, including some heedless attitude of the authorities toward this problem.

There is at present no clear evidence of any undue use of bank credit in speculative channels or in trade and industry for their legitimate requirements, as has been indicated before. But is there anything necessarily harmful in credit expansion as a result of cyclical improvement in business which seems to be now in progress? It should be remembered that the volume of accumulated shortages in durable and semi-durable goods during the depression appears to be still very large indeed. Neither has the obsolescence of consumers' goods been as yet fully met, disregarding for the moment the new wants of our growing population. We have thus a long way to go before reaching anything like a saturation point. True, the time may come when credit begins to pyramid upon itself and cease to foster actual business expansion along healthy lines. This of course must be watched and controlling means applied in time to prevent the downward spiral. It is also true that our credit base is unprecedently large, even if allowance is made for possible foreign withdrawals which would involve a reduction in our monetary gold stock.

It is not to be forgotten, however, that very definite efforts already have been made to check any untoward developments with respect to injurious credit expansion. It will be recalled that as early as January this year the Federal Reserve Board raised the minimum margin requirements on loans by brokers. Regulation U, applying to banks, also went into effect in the first half of this year. Another evidence is afforded by the action of the Treasury when it shifted a portion of its balances from the commercial banks to the reserve banks, resulting in the reduction of excess reserves. The latest proof of steps taken in the same direction is that of the Board of Governors in raising the legal reserve requirement of member banks by 50 per cent, effective August 15. This act reduced excess reserves by about $1,470 millions. It would thus seem that the authorities are aware of the potential dangers and are prepared to act at the time deemed proper.

Neither must it be forgotten that the Executive consistently refused to use the inflationary powers granted him under the so-called Thomas amendment, that he vetoed the Patman soldiers' bonus bill calling for the issue of $2 billions in "greenbacks", and that he likewise fought the Frazier-Lemke Farm Mortgage bill calling for the retirement of the mortgage debt of farmers by an issuance of fiat currency. This attitude was significant then and most likely continues to be so now. Would it therefore be wise to create an aggravating situation precisely at this time, just before the Congress meets? Prudent statesmanship does not necessarily mean a sacrifice of principles; it may mean a speedier solution of trying problems through wise counsel and cooperative efforts.

In making the three-fold recommendations relating to the government bond holdings by the Reserve System, silver and stabilization fund, the memorandum makes a considerable point of the fact that the action should be gradual so as not to disturb the existing conditions more than necessary. Naturally this procedure would have to be followed under any circumstances. The objectionable feature of giving out a statement such as contained in the memorandum is the very suggestion of what is proposed to be done. The question is: what can be accomplished at this time by taking the suggested steps at all? Would the action of the kind proposed be timely or premature?

The sole purpose of this critique is to give an honest appraisal of the Frost memorandum with utmost frankness. Lack of time prevents its revision which would undoubtedly result in greater precision and comprehensiveness than it now has.