The members of the Federal Reserve Board took the oath of office on August 10, 1914, immediately after the outbreak of the European war. The almost complete collapse of the world's machinery of credit forced them to give their immediate attention to the acute problems facing the country as a consequence of this catastrophe. In spite of these tasks, which absorbed their time and taxed their energies, the members of the Board, after two months, had completed the preliminary work and in particular the task of selecting the thirty-six Class "C" Directors, thus completing the boards of the Federal Reserve Banks and placing in their hands the charge of opening their respective institutions. It is hoped that, with the high spirit of public duty which inspires all those directors and the governors chosen by them the banks will open on or about November sixteenth.

It is a source of great satisfaction to the Federal Reserve Board to be able to state that the most acute phase of the emergency appears to have passed and that the main clogs in the wheels of commerce and trade have been removed. But a conflagration embracing almost all Europe must of necessity leave this country in a condition where it is our duty to organize and make available to the highest degree our own resources so as to enable us to meet our own needs and to replace the facilities suddenly withdrawn from us by the closing of the old and customary channels of credit and trade. It is the consideration of these sides of the problem that has lead the Federal Reserve Board to urge the immediate opening of the banks even though it necessitated a reduction to the smallest possible scope of the program to be adopted for the opening of the banks. The Board considers it as its prime duty to set in motion the machinery for bringing the gold reserves of the

country under a strong organization capable of centralizing available reserves, of absorbing as rapidly as possible gold wastefully circulating, and generally to increase the basis of our credit facilities.

The almost exclusive function of the Federal Reserve Banks when opening will be the receipt of the reserve deposits payable in lawful money and discounts. It is to be hoped (and all possible pressure should be brought upon member banks to that effect) that the largest possible amount of cash and preferably gold will be transferred to the Federal Reserve Banks when opening and that rediscounting operations at the start will be comparatively unimportant. Except in Districts 6 and 11 (and to a certain extent 5 and 8) where, owing to the congestion of cotton, immediate relief will be necessary, rediscounts with Federal Reserve Banks should not be encouraged, and it is thought that it will be a good policy for the Federal Reserve Banks, when opening, to fix their discount rates high enough to secure this result. It ought to be borne in mind that, for the time being, there is still a heavy cash balance due to Europe for which gold may be demanded and that Europe holds many billions of our own securities which may be sold back to us. We must furthermore remember that we have issued more than $300,000,000 of additional emergency currency which gradually ought to be reduced.

The entirely unprecedented condition of the European markets will render advisable the greatest caution in dealing with our own. It is impossible at this time to foretell how long the disastrous wars will continue or to predict what will be the financial and commercial conditions when the day of final settlement will come. Our own country has been developed largely with the help of European capital and we have been accustomed annually to place in Europe hundreds of millions of dollars of securities. The old countries were glad to take

these because the rates of interest offered by our investments were more attractive than those to be received from their own. It is impossible to predict what the ultimate effect will be, but it is to be apprehended that at the end of this war investment returns in Europe will be higher than they were in the past. The great destruction of property and the unparalleled expense to which those nations have been put will not only render their savings unavailable for our country but, instead of buying new securities from us, they may be willing to sell back to us securities now held on the other side. This tendency will be the stronger the lower our money rates will be and, inversely, it will be lessened if our interest rates and investment returns are fairly high.

The problem of the Federal Reserve Banks is then a two-fold one: on the one hand to grant credit facilities, particularly where the abnormal conditions now prevailing have created emergencies calling for prompt relief, and, on the other hand, to protect the gold holdings of this country and to enable it to stand all possible demands for gold to be made upon us by Europe. It would appear that this can best be done by supplying credit facilities liberally where there is a legitimate and urgent demand but at rates sufficiently high so as to reduce the pressure upon the Federal Reserve Banks and at the same time to discourage too large a back flow of securities to our shores. This policy must be adopted, not only by the Federal Reserve Banks, but also by the member banks which, when the new reserve requirements go into effect, should employ a substantial part of the amount of cash and reserve money set free in redeeming Aldrich-Vreeland currency and to increasing their cash balances with the Federal Reserve Banks.

While happily our international trade is improving by leaps and bounds and

the hope appears to be well grounded that this country will turn in its favor the scales of the balance of trade, a period of conservatism and watchfulness is required until our new banking system will have been firmly established and until we can safely control the influences that may have an adverse effect on our own development. When this point is reached, the Federal Reserve Bank System will enable us to pass from a period of conservatism into one of conservative liberality in the granting of credit facilities.

The Federal Reserve Board, under Section 13 of the Federal Reserve Act, has the right to determine or define the character of "notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes."

Bearing in mind the requirements of the present situation, the Federal Reserve Board has reached the conclusion that it would be inadvisable at this time to issue any narrow regulation governing discount operations. It is from this point of view that it has been decided not now to enter upon the question of single or double name paper but to admit both forms of bills to rediscount with the Federal Reserve Banks. The Federal Reserve Board wishes, however, to establish the following rules and principles to be observed by Federal Reserve Banks and member banks.

Beginning by stating the case negatively, the rule is hereby established that, for rediscount with Federal Reserve Banks, no bill is to be admitted the proceeds of which have been or are to be applied to permanent investment.

It is the established principle of central banks to invest only in obligations maturing within a short time. The rule is generally observed not to

purchase paper having more than ninety days to run; furthermore, that within these ninety days the maturities of these notes and bills should be so well distributed that it should be possible for these banks within a short time to increase their hold on the general money market by collecting at maturity, or reinvesting at an increased rate only, a very substantial portion of their bills owned. Acting on this theory, the Federal Reserve Banks should be able to practically liquidate whenever called upon to do so, one third of all their investments within thirty days. It is in following this principle that safety lies for the entire system and, at the same time, the justification for member banks to count balances with Federal Reserve Banks as a cash reserve. But safety not only requires that bills held by the Federal Reserve Banks should be of reasonably short and well scattered maturities, but in addition they ought to be of such character that, when they mature, it is certain that they can be collected. They ought to be (to use the term now so often applied) "self-liquidating". The basis of the bill drawn ought in every case to be some step in the march of goods from producer to consumer; or, to state it in another way, in the gradual process of distribution. The nearer this process reaches the final consumer the smaller will be the amount involved in each transaction as represented by the bill, and the more self liquidating will be its character. Double name paper drawn against the sale of goods on the purchaser is, from the economic point of view, the clearest evidence of the legitimate character of a bill. Single name notes, as used in our country, may represent the very same character of a transaction though the firm having sold the goods will sell its own note to finance collectively a number of sales of this kind. Inasmuch, however, as the single name paper does not show on its face the character of the

transaction against which it has been issued - a serious defect in this form of paper - it is incumbent upon each Federal Reserve Bank to insist that the character of the business and the general status of the firm offering its paper should be closely investigated and that the discounting bank be assured that the single name paper has not been issued for investments of a permanent nature or of a longer duration than should be safely financed by the sale of ninety-day notes. Only careful scrutiny as to these characteristics would render it safe for the Federal Reserve Bank to consider such paper investment as self liquidating at maturity.

At this point we reach then the conclusion that bills, in order to be eligible for rediscount by Federal Reserve Banks, should not be drawn against permanent investments; they should be drawn against some temporary process in the general advance from producer to consumer; they should essentially be self liquidating, and a statement should have been given to the bank purchasing the paper. It is most desirable in the beginning of the operation of the banks to simplify matters as far as possible and it is, therefore, thought unnecessary to exact that a statement of condition should be attached to each bill when sold to the banks, nor is it thought necessary to embarrass the member banks by subjecting them to new regulations with which, at the time of opening of the Federal Reserve Banks, they cannot possibly comply since they own large amounts of paper purchased before these rules were established. The Federal Reserve Board, however, believes it safe and equitable to establish the rule that, at the expiration of forty-five days after the opening of the Federal Reserve Banks no paper shall be rediscounted by them that does not bear on its face the evidence

that it is eligible for rediscount under the broad rules and definitions above outlined, and that the party selling the paper has given a statement to the member bank. A rubber stamp saying in substance:

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x-------------------------------x
:  Eligible for Rediscount with  :
:     Federal Reserve Banks      :
:       CREDIT FILE NO. ....     :
:       DISTRICT NO. .......     :
:     (Name of Member Bank)      :
x-------------------------------x
```

would be considered sufficient evidence to this effect. It would be understood that the Federal Reserve Bank could at any time call for this credit file and it may well be expected that these credit files, particularly of more important firms and of those rediscounting larger amounts, will be assembled in the Federal Reserve Banks and form the nucleus of a credit bureau which in turn eventually may lead to a central credit bureau. For the time being certified statements shall not be required, this is to be left open for further regulation at a later date. The statement should contain a short general description of the character of the business, balance sheet, profit and loss account. Assets should be divided into fixed investments, slow investments and quick investments; on the liability side should be shown capital, long time borrowing and borrowing on short term. Short term borrowings ought to correspond to quick assets and the statement should be convincing that short term paper is not being sold against permanent investments or slow assets. The statement should furthermore contain the maximum amount up to which the firm issuing this paper expects to borrow in the aggregate on short credit or sale of its paper, and the firm giving the statement should obligate itself to inform the bank and secure its consent before exceeding this limit. The affixing of the stamp stating such paper to be eligible for rediscount will be con-

sidered as an affidavit by the member bank that the statement has been examined from this point of view and that the paper bought complies with the requirements as above outlined.

No Federal Reserve Bank should make any engagement with any member bank to renew paper at maturity at its then existing governing discount rate or otherwise, and it is urged that member banks abstain from pledging themselves to renew from their customers ninety day paper and thereby practically making it six months paper. It is apparent that, for certain branches of trade and manufacturing, it is impossible to liquidate a transaction within three months and that a credit of six months would be necessary to carry to its end either the process of production or manufacturing or the conclusion of the liquidation of the entire stock. While it is proper for borrowers to rely to a certain extent upon their ability to renew their paper, it would appear conservative that borrowers in need of a six months credit for the completion of their business should either be encouraged to provide a larger proportion of working capital of their own than those who are able to liquidate within a ninety day period or to force them not to carry too extensively their finished product. Producers forced by the nature of their business to renew their ninety day borrowings should be impressed with the fact that they are taking this risk. The banks should not take it for them and the more the period of temporary borrowing and production be brought into closer proportion the safer will be the entire banking system.

The law provides that the Federal Reserve Board shall fix the percentage of the capital (by which is understood capital paid in) up to which a Federal Reserve Bank may discount "notes, drafts, and bills drawn or issued for agricultural purposes or based on live stock and having a maturity not exceeding six

months". The law gives latitude to the Federal Reserve Board to deal with each Federal Reserve Bank individually in fixing this limit. The Federal Reserve Board hereby fixes this limit generally, and until further notice, at twenty per centum of the capital paid in from time to time. For those districts in which, during certain seasons, six months paper is particularly required to carry through agricultural and farm operations, the limit will be increased from time to time. It would appear that, particularly in the cattle raising districts where the output is a continuous one it will not be difficult for the banks purchasing six months paper to scatter their maturities in such a way that a substantial amount of their paper could always have run off and be reduced to ninety day paper so as to give these banks a fairly continuous and ample supply of paper eligible for rediscount with the Federal Reserve Banks. In other districts, like the cotton growing ones, where requirements for six months paper are based on seasonal operations and therefore will be made upon the banks to a large extent at the same time, it is suggested that, as heretofore, these banks will find it convenient to place the most substantial part of their six months paper with other banks of the country and carry themselves a certain amount. The Federal Reserve Banks cannot, under the law, and should not for their protection and safety, invest beyond a certain limit in six months paper.

The law does not limit the aggregate amount of rediscounts to be granted by the Federal Reserve Banks to each member bank and the question has been raised as to whether any member bank should be entitled to hand in for rediscount at the bank rate then governing any amount of paper, provided the quality of the paper would appear satisfactory to the Federal Reserve Bank. This ques-

tion is to be answered in the negative. It is true that, on the one hand, it is the object of the law to make balances lying idle in one part of the country, or in one part of a district, or in any one bank, available for the other where bank accommodations may be legitimately required. But, on the other hand, it would be unfair to depositing banks not having called upon the Federal Reserve Banks for any rediscounts, to use their reserves to such a degree that their own legitimate demands could be met only upon more onerous terms because the weaker or less conservative banks would already have absorbed all the readily available credit. The policy of the entire system will have to be one of equalizing and guiding the ebb and flow of available resources, but until a free and country-wide discount market will have been established, which will be the most effective means of equalizing, it will be necessary for the directors of the Federal Reserve Banks to use their discretion in granting rediscounts. They will have to make careful examinations of their own status and that of the other Federal Reserve Banks and it will be their duty to form as accurate as possible a judgment as to the aggregate facilities which they can safely supply and to form an estimate of the probable demands and the directions whence they would be likely to come. After carefully weighing these two factors in the light of conditions existing in the other Federal Reserve Banks and reviewing the position of the entire country in its relation with the other nations of the world, they will have to reach conclusions as to what would be a fair share to be allotted to applying member banks. In the beginning it will be an extremely difficult task both for the directors and for the Federal Reserve Board on whom they will call for guidance. After a few years of actual experience and compiling of statistics showing to some extent the

normal supply and demand of each district, the task will be much easier, and the further a free discount market develops the easier will be the means of handling the situation, but in starting a system entirely new to our country it will be necessary in many respects to feel our way carefully and learn by experience.

Bank Acceptances

The free use of American bank acceptances in financing transactions involving our imports and exports will be a great factor in establishing an American discount market. The American bank acceptance must become a popular investment all over the world. It must compete with those of England, Germany and France, and, in order to achieve this end, it must have a regular and reliable home market and the discount rate at which it can be placed must, as far as possible, meet that of the competing countries. This is all the more necessary as the bank acceptances of these other countries are well known all over the world and foreign nations are thoroughly familiar with the methods of disposing of these bank acceptances. A concerted effort will be necessary to establish a full and equal standing for the American bank acceptance in the world's market. It follows from this and other considerations (which it would lead too far to enlarge upon) that the discount rate for American bank acceptances must be lower than that for single name paper endorsed by member banks, and it will be, therefore, from the point of view of return, a poor investment for the Federal Reserve Banks. From the national point of view, however, it will be necessary that the question of return be disregarded by Federal Reserve Banks when acquiring bank acceptances. The larger question involved should be the guiding factor.

(12)

The report by the Committee on Commercial Paper, approved by the conference of Federal Reserve Bank Directors at Washington on October 22, recommended that this question of bank acceptances be dealt with on a joint plan and for the joint account of the Federal Reserve Banks and that the Executive Council of Governors of the Federal Reserve Banks should, from time to time, regulate the method and the rates to govern the transactions in bank acceptances. It would appear as if it might be advisable to adopt a plan that these acceptances should be purchased for joint account, on a pro rata basis of capital or deposits, by those Federal Reserve Banks which, from time to time, have the lowest bank rate.

The Federal Reserve Board is in full accord with these recommendations and urges that prompt steps be taken by the Executive Council of Governors to establish a basis for dealing with bank acceptances.

Under Section 14 (d) power is given to the Federal Reserve Banks "to establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank for each class of paper". This would permit the Federal Reserve Banks to establish different rates of discount for single name paper, for double name paper, for bank acceptances and different rates also for various maturities. It is natural that there should be a rate for six months paper different from that governing three months paper, and at times it may prove very advisable to have a different rate for thirty day paper from that for ninety day paper. From the point of view of a Federal Reserve Bank, desirous of securing the greatest possible liquidity, paper having to run not to exceed thirty days is a most

desirable investment, and this in itself might warrant, at times, the lower rate. But, in addition, there is the further consideration that it is desirable to train the member banks to use less extensively the call loan market of the stock exchange as the means of equalizing daily balances, but rather to use their short paper for this purpose. It is, therefore, advisable to encourage the habit of even the strongest banks to rediscount their [illegible] maturities when necessary for their daily requirements.

It appears advisable, however, to move slowly in this respect, and the suggestion is made at this time to serve as a topic for further careful consideration of the Executive Council of Governors.

P. M. W.
10-30-14