FEDERAL RESERVE BOARD

WASHINGTON

January 4, 1915.

MEMORANDUM FOR GOVERNOR HAMLIN.

My dear Governor:

I have your letter of January 2nd and have carefully examined that part of Section 18 of the Federal Reserve Act which relates to the exchange of United States bonds with the circulating privilege for one year gold notes of the United States and thirty year 3% gold bonds without the circulating privilege.

After analysing this whole section and after considering all the circumstances, I am inclined to the view that technically the Federal Reserve Board has the right at this time to authorize this exchange and that the opening sentence of this section making certain provisions effective only after two years from the passage of the Act, does not relate to the provision under consideration.

As heretofore advised the power to purchase bonds having the circulation privilege and to issue national currency against such bonds is specifically given to the Federal reserve banks by other sections of the Act.

When Section 18 was incorporated in the Act it was originally intended, as its title implies, to provide a method for gradually refunding bonds held at the time by the several national banks. This matter was very carefully considered by the Committee of the House and the Committee of the Senate and a number of plans were submitted having for their object the ultimate retirement of national bank circulation and the substitution of other notes. At the time of the passage of the Act there was approximately $750,000,000. in national bank circulation outstanding. The bonds securing this circulation mature at the pleasure of the United States Government after thirty years from the date of issue and it was accordingly estimated that if the Federal reserve banks could acquire a minimum of $25,000,000. a year they would have in their possession at the maturity of these bonds approximately the entire issue, and the Government would have to deal

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only with the Federal reserve banks instead of with the several thousand national banks in refunding such bonds.

It was recognized, however, that unless the national banks desired to retire their circulation the Federal reserve banks would be unable to procure the bonds, and this method was provided of having those national banks desiring to retire the whole or any part of their circulation make application through the Treasurer to sell the bonds for their account and the Federal Reserve Board was empowered to require Federal reserve banks to purchase bonds so offered, and, as suggested by you, it was originally contemplated that the Federal reserve banks should thereupon be required to issue Federal reserve bank notes against such bonds.

In view of the arguments presented to the Committee that this circulation becomes redundant at certain times, it was later determined to permit the exchange of bonds thus acquired with the circulating privilege for obligation of the United States without the circulating privilege.

As stated, this section was originally intended to deal only with the bonds acquired from national banks desiring to retire in whole or in part their national bank circulation.

The section was amended, however, in conference so that is now provides -

(a) for the issuance of Federal reserve bank notes against bonds acquired under other provisions of the Act as well as against bonds acquired under this section; and

(b) for the exchange of any United States 2% gold bonds bearing the circulation privilege but against which no circulation is outstanding for one year gold notes of the United States without the circulation privilege to an amount not to exceed one-half of the 2% bonds so tendered for exchange and the thirty year 3% gold bonds, without the circulating privilege, for the remainder of the bonds so tendered.

It is significant that in the first two paragraphs of this section in referring to the bonds which the

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Federal reserve banks may be required to purchase, Congress uses the words "such bonds" manifestly referring to bonds which a national bank desires to sell through the Treasurer in order to reduce its circulation.

In the fifth paragraph of this section, however, it is provided:-

> "Upon the deposit with the Treasurer of the United States of bonds so purchased or any bonds with the circulating privilege acquired under Section four of this Act, any Federal reserve bank*** shall be entitled to receive *** circulating notes *** equal in amount to the par value of the bonds so deposited."

In this paragraph the section for the first time refers to bonds other than those acquired from banks desiring toreduce their circulation and in the following paragraph the language of the Act is -

> "Upon application of any Federal reserve bank approved by the Federal Reserve Board, the Secretary of the Treasury may issue in exchange for <u>United States 2% gold bonds bearing the circulation privilege, but against which no circulation is outstanding one-year gold notes</u>," etc. etc.

The failure therefore to restrict this paragraph by any qualifying clause the bonds which may be exchanged other than the qualification that they shall be 2% United States bonds with the circulating privilege, would seem to indicate that the Federal Reserve Board may, in its discretion, authorize the exchange of any bonds bearing this privilege acquired in any manner by the Federal reserve banks.

In this connection, however, attention is called to the fact that this exchange involves the exercise of a discretion on the part of the Federal Reserve Board and there would seem to be a strong reason, as a matter of policy, for the Board to refuse to exercise this discretion until the expiration of the two years or at least until a later date.

The two year limitation was imposed in order that the Federal reserve banks might have an opportunity to become firmly established before they shall be required

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to take over bonds from national banks and there would seem to be a still stronger reason for waiting until this time before permitting them to exchange bonds so acquired for one year gold notes. Such an exchange would require the Federal reserve bank receiving such one year gold notes to enter into an obligation to purchase new notes when those issued mature and were paid and it is only upon this condition that the Government can undertake under the Act to exchange those short term obligations for the thirty year 3% bonds. Accordingly the Federal reserve bank should not be permitted to assume this obligation until it has become firmly established.

I would respectfully suggest, therefore, that Mr. Perrin be advised that the Board cannot at this time approve the exchange suggested and that the matter be left open of whether or not the Board can legally authorize such an exchange before the expiration of two years.

Respectfully,

(Signed) M. C. Elliott

Counsel.

Honorable Charles S. Hamlin,
Governor, The Federal Reserve Board.

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