

Memorandum by Mr. Warburg
Submitted to the Board at
its meeting on December 3

448.

Washington, December 2, 1915.

To the
FEDERAL RESERVE BOARD
Washington.

Sirs:

I take the liberty of submitting the following statement and mamoranda with the object in view of doing my share in establishing a basis of harmonious understanding and cooperation in the Board, without which the best results cannot be achieved.

Like all of us, I regret very sincerely that the impression has been created by the press and otherwise as if there were personal differences in the Board. Personally, I cherish the conviction that differences are not of a personal nature but that we are dealing with honest differences of opinion and that the best way of removing whatever may separate members of the Board is to go to the root of these differences and to make a determined effort to agree on the essential points on which there is divergence of opinion, or, if we cannot agree, to frankly disagree upon the same and state the matter, if necessary, in the form of majority and minority reports so that it may be understood that, where differences exist, they are not of a personal nature but are based upon matters of principle. My own hope is that we may be able to agree on all of these things because, after all, that is what will best further the objects and aims of the Federal reserve Board to which we all are devoting whatever is best in us.

If I may be permitted to analyze the situation, I would

say that there are differences of opinion in the following four matters:

- (1) The problem of the general functions and the policy to be pursued by Federal Reserve Banks.

I take the liberty of submitting herewith a memorandum which I have prepared covering this problem. I have no doubt that we can reach a common ground of understanding on this question.

- (2) The question of Government Deposits.

From the very beginning of the operation of the Federal Reserve Banks there have been two different schools of thought in this respect. I take the liberty of submitting a memorandum which, if adopted, would, I believe, relieve the situation. It would, at the same time, protect both the Secretary of the Treasury and the powers of supervision and control of the Federal Reserve Board.

- (3) The examination and reports of member banks and rulings of the Comptroller.

This question, more than anything else, has produced irritation from time to time with member banks, Federal reserve Banks and in the Board. I believe that we are very close to a point now where the problem could be disposed of to mutual satisfaction. Both in the case of Government deposits and the case of the Comptroller's reports the law creates a difficult situation by preserving a dual control. The problem is, can the difficulties that no doubt exist be removed by administrative methods, or shall it be necessary to cure the situation by

amendments of the law so that, with respect to reports and examinations, there will be created a unity of action? As above stated, I strongly believe that it will be possible now to definitely agree upon some satisfactory plan or to state publicly the limited and legitimate degree to which we do not agree. This will cure the constant attempt of the press to magnify and to sensationalize the situation.

(4) The question of redistricting, and, involved in that, the question of individual powers of members of the Board.

I believe that, in the very near future, the committee can bring in a report concerning redistricting which probably will dispose of any plan of dealing with this larger question but will clearly establish the position of members of the Board as to the desirability of a redistricting process at such time as it should be practicable in case Congress should give the Board the power to do so.

It will be of great advantage for the harmonious work of the Board if, at the same time, a clear understanding could be reached as to what are the individual powers of members of the Board and how far are resolutions passed by the Board binding upon all of them. I strongly believe that if we patiently discuss these questions upon their merits and entirely disregard the personal element we shall finally reach a very satisfactory and clear understanding about all of these points.

I am somewhat taking the attitude of a surgeon who rather goes to the root of an evil than deal with the surface disturbance by means of palliatives and court plaster. The process may

be a little bit more bothersome while it lasts but I am sincerely convinced that it will bring more lasting and more satisfactory results. It is, to my mind, inevitable that this operation should be gone through because I can hardly see how we can write a satisfactory report or deal with the question of amendments unless and until we have reached a clear understanding about these pending problems.

Respectfully,

(Signed)Paul M. Warburg.

The policy to be pursued by Federal Reserve Banks must be guided exclusively by the public interest

Federal Reserve Banks must neither fail to carry out transactions and exercise functions - which otherwise would redound to the benefit of the country - for the mere reason that they entail heavy expense or loss, nor must they, on the other hand, conclude transactions and exercise functions on account of the earnings to be derived, in case these transactions or functions would run counter to the public interest, or would lessen the ultimate ability of the Federal Reserve Banks to render the largest service for the general benefit of the country.

In carrying out their policy they must neither compete for the sake of competition nor not compete for the sake of avoiding competition. In carrying out functions with which they are charged by the law they must compete or not compete as the public interest requires

If we agree on this premise, we must then ask ourselves, in what way do Federal Reserve Banks serve the public interest?

The function of Federal Reserve Banks is to provide a safe system of banking (free from our heretofore periodical collapses) and more stable and equal interest rates than we have had in the past

Broadly speaking, the problem of banking may be summed up in the following quotation

"If banks were to keep, in cash, all the money deposited with them, business would come to a standstill and a crisis would ensue. If banks were to lend indiscriminately to those who apply for loans all the money on deposit with them, a general panic and collapse would follow a short period of overstimulation. Between these two ex-

tremes lies the middle course, the finding of which is the problem, and its practise the art of banking."

To find and preserve this middle course is the particular function of the Federal Reserve Bank System.

The present maximum lending power of the entire Federal Reserve System is about \$600,000,000. The total loans and investments by national banks amount at present to about \$8,000,000,000; those of the State banks to \$7,500,000,000. It is abvious that it cannot possibly be the object of the Federal Reserve System, by competition, to substitute a lending power of \$600,000,000 for that of all the banks of the country, amounting to \$15,500,000,000. The aim of the system must rather be to keep this gigantic structure of loans and investments, which is largely carried by bank deposits, from over expanding so that, as the natural and inevitable result, it may not be forced to over contract, and, conversely, to avoid over contraction with all its hardships and the inevitably resulting over expansion.

Effectively to deal with the fluctuations of so gigantic a structure is a vast undertaking for which the resources of the Federal Reserve System are none too large at this time. If the task is to be accomplished successfully, it cannot be done by operations which are continuous and of equal force at all times, but only by carrying out a very definite policy of not only employing funds vigorously at certain times but, with equal vigor, not to employ funds at others. That during periods of actual employment the Federal Reserve Banks will make large earnings and that during periods where a restricted activity of Federal Reserve Banks is

rendered necessary by general conditions, their earnings should be smaller, are incidents which have no bearing upon the measure of their usefulness. Federal Reserve Banks, when accumulating funds, are exercising as useful a function as when they are employing the same. If safety and stabilization of rates form the soundest foundation for general prosperity, everything that the Federal Reserve Banks do in avoiding excessive rates, both too high and too low, redounds to the benefit of the nation, and the mere fact of the general confidence in this stability and the knowledge that funds are in reserve and available brings about the freest use of credit facilities at liberal rates all over the country. If the potential or actual employment of \$600,000,000 can have this effect upon loans and investments of \$15,500,000,000 (of which \$12,500,000,000 are loans and discounts) the usefulness of the Federal Reserve System has been proven. That does not mean that when once we shall have passed through a period of active money we shall ever have to contemplate conditions where the entire funds of the Federal Reserve Banks will lie idle. A certain proportion will always remain in active service, and there will be no doubt about their ability to earn their running expenses or that, when once they occupy their proper field of operations - and averaging their operations over a reasonable period - they will earn their dividends, but time must be given them for this.

If Federal Reserve Banks should find permanent difficulty in earning their dividends, remedy must not be sought by improperly using their funds but rather by carefully investigating whether or not organic defects exist which might be overcome. We must not forget, on the one hand, that the capitalization of the

bank and the prescribed rates of dividends are arbitrarily fixed and that experience only can demonstrate whether or not these are properly chosen. Personally, I am inclined to think that they are about right, provided, however, that the Federal Reserve Banks are given the same powers as enjoyed by the European central banks with respect to the note issue. The weakness of the system, as at present devised, is that, unlike the European central banks, they cannot derive their chief profit from the note circulation. In Europe, the Banque de France, the Bank of England, the Reichsbank and the other central banks have substantially a monopoly on the note issue, and balances with these central banks and their notes are considered as cash by the banks of the country. (The Bank of the Netherlands has a capital of 20,000,000 florins and a note circulation of 300,000,000 to 400,000,000 florins.)

Our difficulty is a threefold one: first, we have a note issuing power superimposed upon an inelastic currency issued to the limit of what the country can absorb, second, our notes are not counted as reserves, the consequence of which is that, at times, like the present, when additional currency for actual circulation is not required, we do not pay for our investments by the issue of Federal Reserve notes but by a loss of gold, and, third, that our inability to issue notes against gold, or gold and commercial paper, prevents us from broadening and strengthening our banking power. At present we are tied down to the maximum of the deposits of the member banks. Gold deposited for redemption purposes with Federal Reserve Agents is a most desirable

and powerful protection in case of gold withdrawals. It does not add, however, any additional banking power. It replaces but does not add. The vicious effect of these conditions is that we cannot deal boldly with the problem of Government bonds and the circulation secured by them. If we could increase our own free stock of gold, that question could be solved and, with that, the problem of our earnings.

I make free to submit a memorandum suggesting how it can be done, and apologize for the rough form of all statements, which have been dictated hurriedly without regard to form.

P. M. W.
12-2-15

It is proposed to amend Section 16, clause (2) to read as follows :

"Any Federal Reserve Bank may make application to the local Federal Reserve Agent for such amount of the Federal Reserve notes hereinbefore provided as it may require. Such application should be accompanied by a tender to the local Federal Reserve Agent of collateral in amount equal to the sum of the Federal Reserve notes thus applied for and issued pursuant to such application. The collateral security thus offered shall be gold or gold certificates and notes and bills accepted for rediscount under the provisions of Section 13 or purchased under the provisions of Section 14 of this Act. Whenever the gold deposited as collateral with the Federal Reserve Agent shall be less than 40% of the aggregate amount of the aggregate collateral deposited, the Federal Reserve Board shall establish a graduated tax," etc., etc.

The force of this amendment would be that Federal Reserve notes could be exchanged for gold and that the gold so accumulated would become the free asset of the Federal Reserve Banks. As the law stands today the gold that accumulates against issue of Federal Reserve notes accumulates in the redemption fund deposited with the Federal Reserve Agent and ceases to be the property of the Federal Reserve Banks. It can not serve as a basis for additional loans, but it renders only a service - though a most important one - in being available in case of gold withdrawals. The consequence is that at present the Federal Reserve Banks are limited in their growth to the amount of obligatory balances of member banks with Federal Reserve Banks. While the optional balance may be deposited, it is not safe to count on that.

If the law should be amended as here suggested, every note holder in the country would become an additional depositor of the Federal Reserve Banks and he would become a permanent depositor, because it is safe to say that the amount of gold certificates carried in the pockets of the people at this time would be permanently carried in Federal Reserve notes. It is safe to expect that the Federal Reserve Banks would be strengthened by several hundred million dollars of gold in this manner. If three hundred millions were added this would mean an additional loaning power of 450 million dollars.

The far-reaching effect of this process would be that the Federal Reserve Banks thus strengthened could afford to deal on a broad basis with the question of government bonds and Federal Reserve notes. At present Federal Reserve Banks are disinclined- and correctly so- to adopt a policy of purchasing hundreds of millions of government bonds and issue against them Federal Reserve bank-notes as long as the gold supply which they command is not larger than it is now. While it is true that they need only to maintain a reserve of 5% against these Federal Reserve bank-notes, it is equally true that these notes may be presented at any time for payment in gold and that, from a point of view of the Federal Reserve Banks, a 5% gold reserve would be insufficient. If notes could be exchanged freely for gold the additional loaning power which would accrue to the Federal Reserve Banks by the accumulation of additional gold, could be used to provide the necessary gold reserve against a large amount of Federal Reserve Bank-notes.

A very interesting suggestion has been made to the Board (by Mr. Perrin) to the effect that any National Bank the charter

of which would expire, should receive a renewal charter only upon the condition that its power to issue notes against government bonds should cease; but that the Federal Reserve Banks should purchase the government bonds of these banks at par at the expiration of the banks charter. In this manner all the government bonds of would fall into the hands of the Federal Reserve Banks within twenty years. A portion of these bonds would doubtless be disposed of in the market as government 3% bonds and the Federal Reserve Board and the Federal Reserve Banks would have to decide what portion they wished to carry as one-year notes and what portion as 2% government bonds against which notes could be issued.

If this plan were carried out the unelastic government secured currency would be made elastic by the Federal Reserve Banks because it would be in their power to issue these notes at times when there would be legitimate requirement for increased circulation and to withdraw them from circulation at other times. Furthermore, the question of earnings of Federal Reserve Banks would be solved, because the larger the note issue of the banks, the larger would become their revenue. This revenue would be derived from the government bonds and the more government bonds would be disposed of to the public, the more important would become the commercial business of the Federal Reserve Banks, because if we take it that a certain amount of currency is required and a large portion of this currency can only be issued against the collateral of commercial paper, this commercial paper must go in the Federal Reserve Banks. Of course, if Federal Reserve notes should be made available for reserve money of member banks (not of Federal Reserve Banks, as so many people appear to think when the question was

discussed in past years !) , this process would take place with so much more effect. There is no doubt but that Federal Reserve Banks will not find their ultimate and proper place until Federal Reserve notes receive reserve qualities. At present we have the anomalous condition that the gold that comes into this country, which should accumulate in Federal Reserve Banks, accumulates in member banks, while the gold holdings of the Federal Reserve Banks hardly have grown except where the amount of the additional reserve payments had to be made under the law. We furthermore have the anomalous condition that at this time when there is no demand for additional circulation, any investment the Federal Reserve Banks make is being paid ^{for} not by Federal Reserve notes, but by a loss of gold.

While it is most gratifying to see that the bankers who so violently opposed as unsound any thought of counting Federal Reserve notes as reserve, are now of their own accord coming around to the opposite view; it still may be that Congress would not yet be prepared for such a step. It might in that case be more advisable to proceed slowly and to ask at this time only for the amendment as above outlined.

My own suggestion would be to increase the gold covered from 40% to 60% and begin to tax at 60%, though beginning only with a very low tax and increasing only very gradually, increasing more rapidly when the gold cover falls below 40%. The effect, however, would be that Congress and the country would see that it is expected normally to have a gold cover in excess of 60% rather than in excess of 40% and while we would expect to issue more Federal Reserve notes in this case, we would, on the other hand, expect to issue them normally on a higher basis of gold protection. This

effort may ultimately be helpful in persuading Congress to permit these notes to be counted as reserves. As it is now there is no room for an elastic note issue for our elasticity has been tied to a frayed rubber band which is already stretched to the limit, the Federal Reserve Banks have no power of contracting under the present structure. As above stated, nothing will help Federal Reserve Banks more in finding their proper position and in securing sufficient earnings without being forced to use their reserve money in a way which at times would be unsafe and improper, than an effective and sound note issuing power.

P.M.W.
11-2-15

MEMORANDUM ON QUESTION NO. 2.

It is suggested that the Treasury develop gradually its accounts with the several Federal Reserve Banks. After a reasonable period of actual operation the nature and the volume of Treasury business at each point can then be ascertained as can also the expense of the Federal Reserve Banks involved in the operation of accounts. It may then be possible for the Secretary of the Treasury to determine the amounts which he proposes to carry as fixed free balances with the several banks in order to sustain these accounts.

As a matter of convenience he may arrange to have a weekly or bi-weekly settlement with the Federal Reserve Banks, by which any amounts in excess of the agreed balance be paid into the gold clearing fund for the credit of the Treasury and conversely, deficiencies below the agreed balance would be made good through the gold clearing fund.

There would then remain the free funds in the Treasury, which will vary from time to time according to the receipts and disbursements of the United States Government.

Broadly speaking, the writer doubts the wisdom of permitting these additional funds to be deposited with the Federal Reserve Banks without the control and supervision of the Federal Reserve Board.

While the own resources of Federal Reserve Banks and the bulk of their deposits may be considered as "fixtures", upon which it might be safe to base a definite policy in granting loans or issuing currency, the funds of the Government, ac-

According to the wishes of Congress, may be of gigantic size and may be reduced to zero.

These Government deposits must therefore be treated from a different point of view from that of the deposits of member banks. At times, when the Government is apt to withdraw these funds, the Federal Reserve Banks should not employ them at all and keep the funds practically intact (that is the same as carrying a 100% reserve against them), at times, particularly when the general banks are crowded and the Treasury balances are large, or when for other reasons it may appear advisable, it may be proper policy for Federal Reserve Banks to use freely the Government deposit and maintain a reserve against these deposits of only 35% as against their other deposits. With the staggering size of our deposit structure (of 18 billion) and the limited power of expansion of Federal Reserve Banks (at present 600 millions figured on a 40% basis and on the last statement of the Federal Reserve Banks) it will be wise to keep an anchor to windward. Experience has shown that the one has always been reached or is quickly reached when a catastrophe occurs, and that it is of the very greatest value to have some large gold funds in actual reserve. For there is never enough gold in such circumstances and the value of the free treasure in the Julius Tower has been fully vindicated. It would greatly add to the strength of our system if we could keep the free treasury funds as a secondary reserve to be drawn upon after the rediscounting power between

districts has been brought into full play to the highest degree compatible with safety and conservatism and at the same time with the best interest of the country.

But there must be a certain latitude in applying this rule and this elasticity would be assured if it were left to the discretion of the Federal Reserve Board from time to time to fix the reserves to be kept by the Federal Reserve Banks against Government deposits other than the fixed balances agreed upon. The Treasury could then, through the gold clearing fund, automatically deposit in the Federal Reserve System its free funds, which would be allotted to the several banks upon a certain key (based upon capitalization or capital and deposits) and be subject to special reserve requirements. In this manner the Federal Reserve Board could undertake the responsibility of supervising the employment of these funds so that the Secretary of the Treasury may be certain of his ability of withdrawing these funds when required without creating a disturbance. The power and duty of the Board of directing rediscount operations is involved in this matter. These transactions may be necessary in order to withdraw government funds from some districts and for the safety and efficiency of the system it is necessary that the Board exercise a control over these funds in the Federal Reserve Banks.

Legally there can not be any objection to a stipulation by the Secretary when making Government deposits to the effect that the deposits shall be subject to such reserves as the Board from time to time shall determine. The Board, when

studying this question some months ago, was advised by counsel that even without such stipulation by the Secretary it could, by its power to tax the note issue, secure compliance with any suggestions that the Board might see fit to make to the Federal Reserve Banks in this respect.

From every point of view, however, it would appear more desirable that the stipulation, as above suggested, be made by the Secretary of the Treasury.

Memorandum by Counsel is attached.

P. M. W.
12/2/15

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FEDERAL RESERVE BOARD
WASHINGTON

October 15, 1915.

SUBJECT: Interest Charges on
Federal Reserve Notes.

My dear Mr. Warburg:

The question whether the Federal Reserve Board may impose different rates of interest on the Federal reserve notes issued by the various Federal reserve banks involves a construction of that portion of Section 16 of the Federal Reserve Act which reads as follows:

"The Board shall have the right, acting through the Federal reserve agent, to grant in whole or in part or to reject entirely the application of any Federal reserve bank for Federal reserve notes; but to the extent that such application may be granted the Federal Reserve Board shall, through its local Federal Reserve agent, supply Federal reserve notes to the bank so applying, and such bank shall be charged with the amount of such notes and shall pay such rate of interest on said amount as may be established by the Federal Reserve Board, and the amount of such Federal reserve notes so issued to any such bank shall, upon delivery, together with such notes of such Federal reserve bank as may be issued under section eighteen of this Act upon security of United States two perccentum Government bonds, become a first and paramount lien on all the assets of such bank."

It will be observed that this paragraph provides in effect that any individual Federal reserve bank which has been granted an application for notes whether in whole or in part, "shall pay such rate of interest on said amount as may be established by the Federal Reserve Board".

This provision clearly indicates that the Board may charge such rate of interest as it deems advisable on any particular or individual issue of notes, and there is no intention on the part of Congress, either express or implied, which demands that the Board fix a universal flat rate of interest on all Federal reserve notes, In other words, each separate issue of notes, whether to the same or a different Federal reserve bank, may be subject to a different rate of interest.

A contrary result would defeat the obvious intent of Congress to enable the Federal Reserve Board to control, as far as possible, the conditions governing the demand for credit and to enable the Board to adapt not only rediscount rates but also the volume of Federal reserve notes to the varying needs of different sections of the country. There would not seem to be a more effective way of checking an undesirable inflation of credits than to enable the Board to impose different rates of interest on the various issues of Federal reserve notes. The paragraph quoted above clearly authorizes the Board to control not only the issue of notes to a particular bank but also to fix or determine the pressure to be put upon any particular bank to retire such notes when issued.

The fact that the authority to fix such rate of interest is in precisely the same sentence as that empowering the Board to regulate the amount of notes issued to any individual bank, indicates that Congress had in view a method of controlling the circulation of Federal reserve notes in each individual district.

The wording of this Section is broad enough not only to permit of different interest rates in the different districts but also clearly authorizes the Board to charge each Federal reserve bank such rate of interest as it desires on each separate issue of notes made to that bank. The Act says that the Board may grant the application of any Federal reserve bank for Federal reserve notes, either in whole or in part, but to the extent that such application is granted, "such bank shall be charged with the amount of such notes and shall pay such rate of interest on said amount as may be established by the Federal Reserve Board". In other

words, Congress specifies, in discussing the application of any Federal reserve bank for notes, that the Board may grant so much of that particular application as it sees fit and shall charge such bank with the amount of notes issued and may establish such rate of interest as it sees fit "on said amount".

It seems clear, therefore, that the Board may, at the time of granting any application for Federal reserve notes, fix such rate of interest as it sees fit to be paid on the notes issued in compliance with that particular application, and this rate is in no way dependent upon any previous rate charged to that Federal reserve bank or to any other Federal reserve bank.

It is not to be supposed, however, that, should the Board at the time of granting an application fail to fix any interest rate whatever, it is precluded from imposing any interest charge in the future, because the Act provides merely that the bank "shall pay such rate of interest x x x x x as may be established by the Federal Reserve Board," and it may be established either at the time of issue or at any time subsequent thereto that the Board desires.

There may be considerable practical difficulty if the Board fixes different rates of interest on different issues of notes made to the same Federal reserve bank, because of the question of determining when notes of the different issues are redeemed, but such a difficulty can in no way limit or restrict the legal rights of the Board in this connection. And it may be very easy to devise a method whereby, under mutual agreement, any notes retired by a Federal reserve bank will be assumed to be those on which the highest rate of interest is charged.

Respectfully,

(Sgd) G. L. Harrison,

Hon. Paul M. Warburg,
Federal Reserve Board.