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Washington, D. C., May 10, 1916.

COMMENTS ON GOVERNOR HAMLIN'S BRIEF ON THE

NOTE ISSUE AMENDMENTS.

This is a very able, thorough and painstaking document and I would not like to have anything I say appear to show any lack of appreciation of it. I believe, however, that it is based upon some misconceptions which should be pointed out.

(1) I think there is a confusion of ideas as to the relations of two things which are not similar, but totally dissimilar; that is to say, there is a confusion between the "collateral security" for a credit given, and loan made, whether that loan be in the form of a deposit or in the form of a payment of currency, or issue of bank notes, on the one hand and the reserve which a bank is required by law to retain against either deposits or note issues on the other.

(2) Governor Hamlin's brief states in a good many different ways that the only gain in the 40 - 60 proposition is in the release of 40% of paper for use as collateral. He admits that just as much gold is used for note issues under the old plan and could be under the proposed plan; hence, that with a given amount of gold we can issue no more notes under the new plan than under the old. What he points out very clearly is that a bank with a limited supply of eligible paper could issue a good many more notes with a given supply of gold under the new plan than under the old. I believe Governor Hamlin is entirely right in this contention and it leads me to make inquiries regarding two things:

(a) Considering the fact that we are proposing to enlarge the field of eligible paper by admitting acceptances bought in the open market when bearing member bank endorsements, why should we fear that there will not be enough eligible paper ?

(b) When a member bank calls on a Federal Reserve Bank for notes it presumably offers a quid pro quo of at least 100¢ on the dollar, hence , it is inconceivable that when there is a demand for currency by member banks, the member banks will not be ready to offer eligible collateral for the currency, especially, if we enlarge the field of eligibility which we may do both by an amendment of the law and by a relaxation of our Board rules in time of stress.

(3) I am thoroughly in accord with the idea of combining the assets and liabilities of the bank and of the Federal Reserve Agent. However, I am not at all sure that this can not be done under the Federal Reserve Act as it stands. If not, I think we ought to get an amendment. My theory is that the Federal Reserve Board can publish condition reports of the banks, stating that they are combined statements of the Federal Reserve Banks and the Federal Reserve Agents, treating the Federal Reserve Agent's Department as if it were simply the Issue Division of the Federal Reserve Bank. I agree entirely that

it is all wrong that if a ten millions of Federal Reserve notes are put out against commercial paper, and at the end of a three months' period is all paid off, although the notes continue to stay in circulation, the notes should no longer appear as the liability of the bank. It seems to me obvious and proper that the outstanding notes should appear as a liability of the bank and, per contra and as an offset, the cash or collateral held against these notes ought to be written up as an asset.

(4) A fundamental proposition which seems to me must never be forgotten and, therefore, should perhaps be re-stated is that the relation of the member bank to the Federal Reserve Bank is similar in general terms to the relation of an ordinary individual, or corporation, to a commercial bank, having note issuing power. The member bank comes to the Federal Reserve Bank to borrow credit. It may need that credit in the form of a bank deposit, or in the form of currency. If it takes it in the form of a bank deposit, it may later draw out the currency, or, more likely, it will use it to meet drafts upon it for transfers to other banks in other cities. A member bank coming to the Federal Reserve Bank to borrow a million dollars, in effect, gives its note to the Federal Reserve Bank, with eligible collateral attached, for the full face value of its borrowing,

and if we assume the Federal Reserve Agent's Department is part of the bank, the bank must keep this collateral against the loan. Aside and apart from this, however, the Government which charters the Federal Reserve Bank, says to that bank, and as a condition precedent to its charter rights, " In order to compel you to be cautious and conservative, we will require you to keep a reserve against all deposit liability of 35% and against all note issue liability of 40%." This is a matter between the Government and the Federal Reserve Bank. The 35% and the 40% cannot be considered in any sense as added collateral against either the deposits or the notes. It is solely Government regulation to accomplish two purposes : First, to guarantee a reasonable amount of cash in bank to quickly redeem notes that may be presented, or repay deposits, which may be called for, and, secondly, a condition which will compel a bank, which is in the fullest sense a public service corporation, to run its business on lines of extreme conservatism.

If the above statements are correct, it isn't readily conceivable that a member bank will ever find itself in a place where it has not enough collateral from member banks to meet legitimate demands for currency, and certainly, if we wish to create a good discount market in this country, we ought to do everything we can to encourage member banks to keep in their portfolios an abundant supply of eligible paper. It is far better to liberalize the law in respect to the character of the paper which may be offered by member banks, or to let down the bars so far as our rules are concerned, than it is to weaken the fundamental provisions of the law in respect to giving the credit by Federal Reserve Banks.

(5) Governor Hamlin cites the case of the panic of 1914, and previous panics, showing that simultaneously with the rapid dimunition in business, there was an active demand for currency. He assumes, therefore, that if these conditions should arise, the Federal Reserve Banks might find themselves unable to meet demands for currency and be compelled to weaken their cash resources by issuing the stock of gold on hand. This is an important point and should be carefully studied. In the panics of 1907 and 1914, and indeed, as I understand it in previous panics, what happened was that bank deposits were very largely pyramided by reason of the reserve city and central reserve city system so that St. Louis, Chicago and most of all New York, held a large proportion of the bank deposits. Two things which brought about this evil were, first, that deposits could be counted, as reserves, in two places; second, that interest was paid upon depocits. The first of these evils has been cured by the Federal Reserve Act; the second still remains, as a more or less serious evil. If the Federal Reserve Banks paid interest

on reserve deposits, or even on excess deposits only, we might increase to this evil, but, as we do not do so, so far as deposits of the Federal Reserve Banks are concerned, the evil is non-existent. Thus it is that no member bank will keep on deposit with the Federal Reserve Bank a deposit in excess of its actual requirements. This will mean that they will keep a minimum reserve requirement, plus sufficient to meet their own needs to pay their own drafts or checks and drafts against them. Hence, in the panicky times you will not have the condition that you had in 1907 and 1914. Then country banks were calling on reserve city banks for cash, reserve city banks on central reserve city banks, and the very fact that there was a reluctance to meet these demands accentuated them and increased the alarm. Banks began calling loans, stopped making new ones, or quickly raised their interest rates. This naturally put a sharp check on business. While this same thing can happen again to a limited extent, especially if a large proportion of the state banks stay out of the System and if interest paid on bank deposits causes the pyramiding of money at the large money centers, yet because a large share of the reserves of the country are held by Federal Reserve Banks, the evil possibilities from this cause has been greatly diminished.

(6) A number of Governor Hamlin's calculations are based on the assumption of what he calls "free gold", or

as he suggests in his assumption "capital". These assumptions lead one astray because they are contrary to certain fundamental facts. The only "free gold" in the Federal Reserve Bank System that I know of is the capital paid in by the members, approximately $55,000,000, for although there is a liability against this, the law does not require any reserve to be held to protect it. The capital can therefore be used on the basis of 2½ times as a reserve for notes issued. In addition to this capital, the principal fund of the reserve banks amounts, in round figures, to $450,000,000, and will be about $500,000,000 after the 16th of May. Against this reserve deposit, however, there must be kept 35% of reserve, and only the remaining 65% can be used as a reserve against note issuing. Thus the note issuing expansion for the reserve deposit fund is upon the ratio of 1.625 to 1; not 2.5 to 1.

It may be argued that this is ultra-conservative, but I believe it is proper, and we should leave it that way. In time of stress it would be better for the Board to reduce its reserve requirements than to treat this reserve deposit, to use Governor Hamlin's expression, as "Free gold".

In conclusion, there are three amendments to Section 16 which are immediately desirable:

First: It ought to be possible to issue Federal Reserve notes directly for gold. It is conceivable, for example, that at some future date, the Government will stop the coinage of gold, or only use gold bars and issue certificates for amounts not less than fifty or one hundred dollars against them; that holders of these gold bullion certificates may frequently be glad to deposit them with the Federal Reserve Bank and get currency in more convenient denominations. This ought to be possible and when a Federal Reserve Bank holds gold against its notes it should not be required, considering the character of its collateral, to carry any reserve against it.

Second: If it is not possible under a fair interpretation of the existing law to combine the accounts of the Federal Reserve Agents and the Federal Reserve Banks, so as to show all notes in the hands of the public as a liability of the issuing bank and all assets held against them as collateral as assets of the bank, then we should recommend such an amendment of the law as would permit it.

Third: We should ask for an amendment of the law which will permit bank acceptances, or paper bought under Section 14, of the Act, when accepted or endorsed by a member bank, to be made eligible as collateral for Federal Reserve notes. This will not only very much increase the volume of paper which will be eligible for rediscount but will assist in building up our discount market.

The above three amendments, I believe, are the only amendments which it is necessary, or desirable, to make to Section 16 at the present time. Later on, I believe, at least one other amendment should be made, and that is looking toward the consolidation of the note issuing functions of the Federal Reserve Banks. It is very undesirable that there should be two kinds of notes issued by the Federal Reserve Banks. There should be only one kind and that a Federal Reserve Bank note. If that idea should meet with the approval of my colleagues and the Congress, the Federal Reserve Banks would issue notes upon any of the following plans:

(a) For gold bullion,

(b) Upon the note of a member bank, having behind it eligible commercial paper as collateral,

(c) Against the collateral of Government bonds, having the circulation privilege.

If this were done, in case (a) no reserve would be required of the Federal Reserve Bank. In case (b) a reserve of at least 40% would be required unless the Federal Reserve Board should reduce the requirement. In case (c) a reserve of 5% would be required.

If this great reform were adopted, I should perhaps go a step further and suggest that the elaborate, costly and complicated machinery of the United States Government in Washington for refunding notes should be abolished, and that, in the place of it, the Federal Reserve Bank notes should be made redeemable only at the counter of the Federal Reserve Bank of issue under the supervision and rules of the Federal Reserve Board.

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