First Draft. Washington, D. C., June 16, 1916.

A CONSIDERATION OF THE MERITS OF THE QUESTION AS TO WHETHER FEDERAL RESERVE NOTES SHOULD OR SHOULD NOT BE ACCEPTABLE AS RESERVE MONEY.

I

The Federal Reserve Act provides that Federal Reserve notes should not be accepted as reserves for national banks. Presumably the reason the framers of the Act had for making this restriction may be briefly stated as follows:

(1) Federal reserve notes are intended to exist solely as an elastic credit currency which shall expand and contract in volume with the demands of commerce. There is no question whatever about the goodness of Federal reserve notes.

(a) They are good because they represent 100 per cent of high-grade commercial paper, endorsed by a member bank;

(b) Because there is carried by the issuing bank a reserve against them of at least 40 per cent of gold;

(c) They are a first and paramount lien against all the assets of the issuing bank, which bank is guaranteed by its stockholding members by a provision for double liability upon their stock;

(d) The notes are guaranteed by the United States Government; that is, they are an obligation of the Government.

Notwithstanding these reasons, the framers of the Act might very properly say that though the notes are amply protected, there should be no confusion of ideas between the goodness of the notes and their availability as reserve;

(2) The view of those who believe in authorizing the Reserve Banks to issue a <u>credit currency</u> is that the reserves of the issuing banks must be absolutely above and beyond reproach; that is, to say, they must be metallic reserves, either in coin, or the representative of coin.

(3) The only guarantee against a possible inflation of a credit currency rests upon its redeemability when it is no longer required.

II

On behalf of those opposed to the above views, that is, the opponents of this provision of the Act, and those who believe that it is proper to let Federal Reserve notes be counted as reserves by member banks, the following statements may be made to epitomize the arguments:

1st: They concede the desirability of having the currency elastic; but they say that because Federal Reserve notes have been emitted by a bank in times of currency demand does not in any way prevent a contraction of the currency, when the reverse is true, even though the notes emitted remain in circulation. Indeed, it may be argued that the framers of the Act had this very thing in mind. Suppose, for example, $100,000 of notes are issued for $100,000 worth of three months' commercial paper: at the expiration of the three months the member banks who endorsedthe paper, and received the credit, pay it off at the Federal Reserve Bank. There is no certainty, however, that the $100,000 worth of notes put into circulation would thereupon return to the issuing bank simultaneously, and the issuing bank is indifferent whether they return or not, provided it has received $100,000 in gold or the equivalent, which it may hold as an offset to its own notes still in circulation;

2nd: The opponents further argue that, granting all the arguments of the framers of the Act, they will say that they are confronted by a condition and not a theory. Let us consider what these conditions are at the present time! National banks, represented in round figures by 7600 individual banks, about one-third of the total number of banks in the country having deposits equal to about one-half of the total of bank deposits, are permitted at the present time to count as reserves the following:

(a) Gold or gold certificates;

(b) Silver or silver certificates. (Silver may be considered to be from forty to fifty per cent Government fiat).

(c) Greenbacks; (the direct obligation of the Government, supported by thirty-five per cent of gold; therefore, representing sixty-five per cent fiat).

On the other hand, State banks are permitted very generally to count as reserves Federal Reserve notes and National bank notes. It is therefore argued that if it is proper for National banks to count as reserve silver and silver certificates, which are from forty to fifty per cent Government fiat, and greenbacks, which are sixty-five per cent Government fiat; or, if it is safe and proper to permit State banks to count National bank notes, supported wholly by the direct obligations of the Government (U. S. bonds), it is rather absurd to say that National banks shall not be permitted to count as reserve Federal Reserve notes which are not only better supported than any other currency except gold and gold certificates, but are, in addition thereto, the direct obligation of the United States Government.

3rd: Viewed from the standpoint, even of credit currency, it is illogical to permit a National bank to count as reserve a credit obtained through the rediscount of commercial paper, entered upon the books of the Federal Reserve Bank as a deposit and as such transferrable anywhere and convertable at the will of the depositing bank into cash or gold, while not permitting them to count as reserve a similar credit taken in the form of Federal Reserve notes;

4th: If the experience of the last fifty years of American banking means anything, it means that member banks will generally take credits from their rediscount operation in the form of book credits, rather than in the form of currency. The smooth and successful working of a general clearing system will certainly aid greatly in bringing this about;

5th: It must be borne in mind that the Federal Reserve Banks do not control the situation. It is to be hoped that they will in time do so, but as yet, and so long as the National banks only represent one-third of the total number of banks numerically and one-half of the total deposits, it is obvious that they will not control and therefore that we must take into consideration the existence of the State banks. So long as Federal Reserve notes and National bank notes can be counted as reserve by State institutions, it must be admitted that that fact alone gives a great advantage to those institutions, while it throws upon the Federal Reserve System the burden of printing and emitting the notes and the responsibility of sustaining the credit of the country;

6th: Furthermore, there is a condition which applies to all National banks which is open to serious objection; to wit! the constant sorting out of different classes of currency. For example, a National bank keeps at the base or foundation of its reserve fund gold and gold certificates. Next above this will come the silver and silver certificates. Next, the greenbacks. These three kinds of money, or substitutes for money, may be all classed as legal reserves, but, in addition to this, the bank may find it necessary to use three other forms of currency: National bank notes, Federal Reserve Bank notes, and Federal Reserve notes. In times of active demand for money, when banks are holding little, if anything, in excess of their minimum of reserves it becomes obviously necessary to push out this other currency, which can not be legally counted as reserves. If squally times come the effect of this policy is at once to cause the general public to differentiate between the various kinds of currency, and some times this differentiation goes to the extreme of <u>hoarding</u> the lawful reserve money, and pushing out currency which is not reserve. It is in times like these that State banks, while having the advantage of calling any kind of currency reserve, may at the same time, serve the useful purpose of enabling National banks to get rid of the currency which is not reserve - at least an anomalous situation.

7th: Those who are strongest in favor of counting Federal Reserve notes as reserves, even if it is only to a limited extent, point out that it is not proposed to let Federal Reserve notes be counted as reserve by the issuing Reserve Banks nor by any other Federal Reserve Bank. They admit that such a policy would be bad and would run counter to the general principles of credit currency. They further argue that to permit Federal Reserve notes to be counted as reserve to a limited extent by National banks in the Districts where issued is not dangerous because the Federal Reserve Board has, through its control of the rediscounting privilege, an absolute control of the emission of such currency. If, instead of only twelve banks of issue, there were 100 or more, it is quite conceivable that the issue power might lead to enormous inflation, but considering that this power is limited to 12, at the most, and considering the control of the Federal Reserve Banks over the rediscounting privilege, it is, they argue, perfectly safe to permit member banks to count as reserve to a limited extent Federal Reserve notes of their own Districts.

8th: It is a notorious fact that in ordinary times all forms of currency pass readily as of equal value and it is only in times of stress that <u>real money</u>, such as <u>coin</u>, becomes of special value as the basis of credit currency. Based on this fact it is urged that it is wise for the Central or Regional Banks to accumulate or impound gold. Thus a Reserve Bank which may have emitted one million of Reserve notes may at the end of three months have its rediscounts paid off in gold or the equivalent. It is wiser, it is argued, for the bank to keep out its notes and hold the gold than to pay out the gold and retire its notes, for the reason that the gold is of greater potentiality in times of trouble.

9th: For obvious reasons it is most important that everything in reason should be done to strengthen the regional banks, as reserve institutions. As has been often said, the Aldrich-Vreeland Act was an adequate scheme for the issuance of currency in times of stress. The Federal Reserve Act, on the other hand, aims to accomplish far more than that and not simply to act as an emergency bank even though amply endowed with currency issuing functions. It seeks among other things to accomplish the important function of steadying and equalizing interest rates and fortifying the country in advance against possible or sudden market fluctuations or heavy withdrawals of gold, due to changes in trade balance. If you permit the Federal Reserve Banks, it is argued, to reinforce themselves with gold in times when maney is abundant, they will be the better able to act as shock absorbers in times of stringency, or great demand.

III

In conclusion, after giving the matter very full consideration, it is believed that Congress may safely grant National banks the right to count Federal Reserve notes of their own district as reserves, to the extent of say one-quarter or one-third of the reserves required to be held in their own vaults.

It is believed that the effect of such a provision will tend to strengthen the Federal Reserve Banks and cause a gradual flow of gold to them.

It is further believed that in times of actual demand for credit, when National banks are running close on reserve, they will not hesitate to take Federal Reserve notes; whereas, if they are not permitted to hold Federal Reserve notes as partial reserve, there will be a disposition to regard Federal Reserve notes as inferior to other forms of currency.

Furthermore, if, in the opinion of Congress, it is desirable gradually to replace National bank notes with Federal Reserve notes, it can be accomplished far more easily if Federal Reserve notes can be counted as reserve.

F. A. DELANO.