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Summary of address of
Hon. Paul M. Warburg,
Before Convention of
American Bankers' Association,
Kansas City, Mo., Sept. 29, 1916.

FUTURE OF THE FEDERAL RESERVE SYSTEM.

Changes Urged by Paul M. Warburg.

Kansas City, Mo., Sept. 29. The Federal Reserve Act has met many currency and banking problems with the greatest success and represents one of the greatest contributions ever made by Congress. But we must not stand still - and further development is necessary in a number of important respects, Paul M. Warburg, member of the Federal Reserve Board, impressed upon the American Bankers' Association today. Without this, he warned, the United States cannot hope to rise to the fullest measure of its financial and commercial opportunities created by the new world conditions.

Part of the two billions of gold needlessly and wastefully scattered all over the country, unmobilized and inert, must be mobilized and rendered effective as reserve, he declared. He explained how this could be accomplished without disturbance, and presented detailed analytical figures to prove that the desired steps could be taken without danger of "inflation," a bugaboo that had frightened some superficial critics.

Mr. Warburg also submitted reasons why there ought to be vital readjustment of the relations of the Treasury and the

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Comptroller's office towards the Board and its administration of the nation's monetary system.

"The Federal Reserve System, in its present form, is not a finality but a beginning," he said, "and should be improved as experience dictates". "Indeed," Mr. Warburg added, "the Federal Reserve Act would prove a failure if changes in the system did not become necessary from time to time."

The theory that notes may not be issued by the Federal Reserve Banks against gold without a certain reserve of commercial paper "makes all Europe laugh at us" and should be discarded, he showed.

Having described deposit banking as "the art of wisely employing the depositors' stored up purchasing power," Mr. Warburg said: "The Federal Reserve Act created a system of twelve central banks which, co-operating with one another, were from then on to exercise two important functions in relation to their member banks; first, to provide a sufficient gold cover for the country's gold obligations; and, second, to provide the machinery for turning, whenever desired, the member banks' commercial assets into available credit balances or cash.

"The law, however, continued the anomaly of requiring member banks to lock up in their vaults hundreds of millions

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of dollars, thus preventing them by legal enactment from giving additional strength to their own protective system, even if they should want to do so. It further created the anomalous situation that, while a balance with a Federal Reserve Bank could be considered as reserve, the Federal Reserve note could not be so counted despite the fact that it is a prior lien against the assets of the bank, and is the obligation of the United States, while the balance is not.

"This inconsistency - to a certain extent at least - has been cured, Congress having passed, upon the recommendation of the Board, a most important amendment authorizing the Board to permit member banks to keep any portion of their required vault reserve as balances with their Federal Reserve Bank. In passing this amendment, Congress has opened the path for great strides in advance, and it remains to be seen now, how far the bankers of the United States will be able to seize this opportunity of doubling the strength of their Federal Reserve Banks.

"Let us, in our plans for the future, try to look at the problem as a simple question of keeping a sufficient balance with the Federal Reserve Bank, and when that is maintained, leave it to the member bank to keep liquid and strong in its own way. Do not let us apply the term 'reserve' to a balance with another member bank, which may be invested in securities, or loaned on the stock exchange; nor let us count

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as reserve checks in process of collection, and yet, at the same time, treat Federal Reserve notes as an asset that cannot be counted as a banking reserve.

"What is the Federal Reserve System's lending power today? If we set aside a gold reserve of only 40% - which may do in times of stress, but it is not a proper and sufficient basis in normal times - we find that we have a free gold reserve of about \$206,000,000, or, if we include the gold now held in cold storage by the Federal Reserve Agents, about \$380,000,000. This means that, by additional rediscount operations, or purchases in the open market, for home requirements or for export, we are able to stand a loss of gold from two to three hundred million dollars. \$200,000,000 is a very large amount, but when we realize that the nation's gold holding in one year has increased by about \$500,000,000, it is well for us to consider whether or not we shall be able to hold this gold at the end of the war.

It is impossible to predict what will then be our economic and financial situation. Perhaps we may find ourselves in an over-expanded or generally unsatisfactory condition, and we may have to face a readjustment in which all our banking strength may be required. On the other hand, things may go well with us, but in the rest of the world there may be a great deal of financial distress.

"In that case (and it may be the more likely of the two)

we shall have almost boundless opportunities, but serious obligations as well. Foreign loans in the old and the new world may draw away our capital at interest rates far in excess of our own. Our exporters will have to meet the keen competition of other nations, and even though at first there will probably be a strong demand for certain of our raw materials, the purchasing power of many a country will be found materially reduced. These are conditions which, in the long run, may be the cause of heavy gold exports from the United States and which, if we remain unprepared, may seriously check our progress. If, on the other hand, we forearm, we may grasp the opportunity of taking our place as the strongest of the world's bankers and furnish our industries with the basis for a solid expansion.

"Does it not appear ridiculous that a country owning over two billions and a half of gold should not be able to mobilize a larger free gold reserve than two or three hundred millions of dollars - particularly when it is apparent that its future financial and economic growth will depend upon the extent of the 'preparedness' that it can provide in this respect?

"During the critical period following the outbreak of the war in 1914, there were issued \$386,000,000 of currency under the so-called Aldrich-Vreeland Act. Has it occurred to you that if a similar amount were needed under the Federal Reserve Act, it would absorb a gold reserve, on a 40% basis, of \$154,000,000? But financial history has shown that each

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crisis develops larger demands than its predecessor, and, with our constantly growing pyramid of deposits and loans, and with the gigantic scale upon which financial transactions are now conducted, it is our duty to be prepared for ever larger demands. The fact that we are strongly fore-armed, far beyond a limit expected to be actually reached, will be the only means of restraining these demands to safe and reasonable bounds. We ought to be able, therefore, to lose \$300,000,000 to \$500,000,000 and still have \$200,000,000 or \$300,000,000 of free gold to serve as a basis for emergency operations.

"I cannot urge you too strongly, therefore, to co-operate to the utmost of your abilities in keeping your balances with the Federal Reserve Banks high, and your vault money down to the minimum that your own till requirements will safely and conveniently permit. It is obvious that, in strengthening the Federal Reserve Banks, you are strengthening yourselves."

Having compared European banking systems with ours, Mr. Warburg added: "The bank of England issues notes only against gold. The other leading central banks of Europe issue notes against gold (in certain countries, gold and silver) and commercial paper. There may be 100% of gold, but there may not be less than a prescribed minimum gold reserve. But they do not provide that notes may not be issued against gold without a certain reserve of commercial paper. That theory,

however, is the one underlying the Federal Reserve Act. The Board urged Congress to remedy the law in this respect. The Senate responded favorably by passing a bill on these lines, but, unfortunately, it was lost in conference.

"It is hard to comprehend why if this principle has been universally and successfully adopted by the leading central banks, and has been the root of their surprising strength during these last two years of terrific strain, it should be arbitrarily condemned or disregarded by us."

The \$700,000,000 to \$750,000,000 of gold certificates and gold, in addition to other kinds of currency, at present carried in the pockets of the people and in business tills, should be gradually displaced by Federal Reserve notes, Mr. Warburg contended, thus mobilizing and bringing under control gold resources now scattered and more or less impotent.

The exchange of a \$10 Federal Reserve note for a \$10 gold certificate would not, as some writers argued, cause an increase in circulation or "inflation", but would strengthen the gold reserve position. We have now under control only about \$500,000,000, while the country at large and the banks own about \$2,000,000,000.

The \$600,000,000 or more of gold which has come into the United States since the Federal Reserve Banks opened should have gone into these banks, and Federal Reserve notes issued against it, Mr. Warburg contended; but instead of strengthening the nation's centralized gold reserve, this gold has been

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allowed, because the Federal Reserve Banks' hands were tied, to drift into member banks or go into circulation.

The ultimate aim, Mr. Warburg submitted, should be the conversion of a large part of the 2 per cent Government bonds, now securing circulation, into new 3 per cent bonds, part of which gradually will be absorbed by the people; thus reducing national bank circulation, which ought to be withdrawn, and substituting therefor Federal Reserve notes covered by a far stronger gold reserve than that behind the national bank notes.

Mr. Warburg added: "We must rid our country of the confusing multiplicity of currency with which we are now afflicted, and the Treasury will have to stop issuing small denomination gold certificates. The circulating currency ought to be silver certificates in the small denominations and Federal Reserve notes. The best place for gold and gold certificates will be in the Federal Reserve Banks."

Instead of having had to pay out gold for \$164,000,000 of investments the Federal Reserve Banks should have had the power to pay in Federal Reserve notes, secured by 40% gold, thus retaining the balance of about \$100,000,000 gold as a potential reserve for additional note issues if needed.

Other points urged by Mr. Warburg were: Our usury laws should be modernized so that Banks, under certain conditions, should be allowed to charge interest in excess of 6 per cent in dealing with large and solvent concerns.

National banks should be granted the power to operate

branches in cities where State laws do not prohibit State banking institutions from operating similar branches. The adoption of the Canadian or European branch bank system, however, would entail elements of excessive centralization.

"Self respect and public opinion will not permit the State institutions long to remain in a position of shirking their duty towards the nation. They will be expected to join the Federal Reserve System."

National banks should be allowed to accept commissions; as in Europe, for executing orders for the investment of funds of depositors.

"The administration of the Treasury funds within the Federal Reserve System," Mr. Warburg said, "should be subject to some control by the Board and emergency relief operations ought to be carried out through the Federal Reserve Banks and not directly through deposits with member banks by the Treasury.

"If at certain periods large payments are to be made by the member banks to the Treasury, there should be an easy adjustment by having the money withdrawn strengthen the Federal Reserve System, leaving it to the Board and the Federal Reserve Banks, by rediscounting short paper, to return to the member banks sufficient funds to re-establish the equilibrium.

"But this important function of balancing the scales ought to be the constant care of the Board, under a consistent plan of operation, and not the domain of the changing and

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arbitrary policies and views of each succeeding Secretary of the Treasury.

"In a similar way, the Board's authority and efficiency ought to be strengthened by providing that examinations and rulings by the Comptroller's office, and the compilation of banking statistics, should be carried on under the auspices of the Board.

"However the present members may have been able, by personal effort, to meet the organic defects of the law, the fact remains that, as it stands today, it placed the Board half way between independence and dependence. It cannot remain long in that position. Evolution will carry it either in one direction or the other. The country will have to decide which development it desires and express itself in no uncertain voice."

Concluding, Mr. Warburg said: "I am an unqualified believer in and enthusiastic supporter of the Federal Reserve System. Its fundamental principles are sound; its benefits to the country have been immense and will become more apparent with each succeeding year. Though from the point of view of banking technique, one single central bank would have been easier to administer and, in some respects, might have been more economical and efficient, I am convinced that the undisturbed development of our financial system is better assured and that danger of business or political control is more certain to be avoided by a system of coordinated central banks. That

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the system might possibly be simplified and made stronger and more efficient by merging some of the districts, is an opinion held by many, a view which I entertained before the organization of the districts, and to which I am still wedded.

"By merging a few districts into twin districts, greater strength, greater efficiency, and cheaper operation might be secured, without changing or weakening the intimate touch now produced by the respective local organizations."

Mr. Warburg quoted Mr. Hartley Withers's recent statement:

"America is now one of the leading powers in international finance, and on the wise and skilful use of its strength the future prosperity of the civilized world will, to a great extent, depend."

and asked: "Shall we be found wanting?" He continued:

"The answer will largely depend upon you, the bankers of the United States; upon the strength you give to your Federal Reserve System and upon your contribution to the moulding of its future."

END.