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THE FEDERAL RESERVE SYSTEM: LOOKING AHEAD

(Managing the gold supply to meet a foreign drain)

Address

of

A. C. M I L L E R

Member of the Federal Reserve Board.

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TABLE OF CONTENTS.

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"The European war has pushed forward the day on which America has taken its place as a leader in the international money market, and its banking system had, in the very nick of time, been reorganized in such a way that it is ready to face the problems of international finance....... The new system came into being at a time of stress, and so far has faced with admirable composure and success a series of problems for which no experience could have prepared it. America is now one of the leading powers in international finance, and on the wise and skillful use of its strength the future prosperity of the civilized world will, to a great extent, depend." These words, quoted from a recent book on international finance by Hartley Withers, England's most brilliant financial writer, reflect the growing appreciation of the profound alteration which has taken place in the position of our country in the sphere of international finance resulting from the disorganization and dislocation in established relationships and ways of doing things growing out of the great war. Mr. Withers has not exaggerated the change in our situation and the new responsibilities with which our country is being confronted in the region of world finance.

The world has changed much during the two years since the Federal Reserve System was put into operation, and there is every evidence that it is going to keep on changing at a rapid pace and for a long time to come. We are right now in the midst of a most acutely transitional position - more marked than any that has ever hitherto overtaken our foreign commerce. Our commerce is changing and will keep on changing, not only in its magnitude but in its character; we shall be trading in new things and with new countries and our industries are changing to keep pace with our commerce. And since the country's obligations and opportunities in the field of international finance depend upon its position in international commerce, it is clear that our banking machinery must change and gain in strength to accommodate our expanding and changing commerce. In the last two years, we have lived through a generation. Changes in our banking methods and the scope of banking operations which were foreshadowed in the Federal Reserve Act, and for which provision was then made for the first time in the history of American banking legislation, are coming with a speed which was not anticipated and which could not have been anticipated. Before the outbreak of the European war, our country had very little to do in the field of international finance except as a borrower and so it had no occasion to develop the machinery of international banking. It sought such international banking facilities as it required from other countries, and took them on such terms as were given. American banking had been developed strictly on domestic lines as an incident to the internal development of the country's industry and trade. The country was so large and rich, and offered so attractive a field for the investment of capital at home, that it left little or no margin of surplus banking capital for foreign operations, but instead attracted immense investments of foreign capital to it. As long as this condition continued we were content to let other countries take care of the business of international banking so far as our needs were concerned, for much the same reason that we were content to let other countries supply our needs for ocean carrying service.

More than one occasion, however, had shown that the time was approaching when our country must look to its own facilities and resources for a larger measure of accommodation in international banking. The dependence upon foreign countries was being felt to be precarious. The Federal Reserve Act, therefore, undertook to create agencies which would give to the banking machinery of the country a greater measure of control over those factors in international finance which were of consequence to the stability and ease of American trade. For this purpose, it authorized National banks to establish foreign branches; for the first time it authorized National banks to accept against transactions arising out of the foreign trade of this country; in brief, created "dollar exchange". And what is perhaps destined to be of equal importance with either of these, it authorized the Federal Reserve Banks with their considerable resources to enter the field of foreign banking by the establishment of foreign agencies and correspondents in any part of the world, and to engage in operations in foreign exchange, purchase and sale of bullion, etc. How much the unprecedented prosperity that our foreign trade and industry have enjoyed during the past two years is due to the banking facilities created by the Federal Reserve Act, it would be difficult to exaggerate. The acceptance business, hitherto a strange and unknown field in American banking, has been entered with marked success; "dollar exchange", hitherto an unknown quantity or symbol in the world of international commerce, is now recommending itself to the favor of trading nations as the most stable unit of international payment. To maintain our exchange on a stable basis through lean times as well as through fat times, is clearly so important a prerequisite to our expanding commerce and industry as to make the agencies of its maintenance and control a matter of primary concern to every banker and business man in the nation. The never-to-be-forgotten events of the early autumn of 1914, when there was a complete demoralization of the foreign exchanges and a more or less complete suspension of trade, need only to be recalled to induce an appreciation of what stable exchange means to a country. The heroic and costly efforts which England and other foreign countries have been making to protect their trade with the United States by stabilizing their exchange as far as they could through shipments of gold, shipments and sales of securities, and borrowing, emphasize the same truth, and suggest that we should carefully examine our banking machinery with a view to determining whether it is in all respects equal to the task of doing the work in international finance which is clearly destined to fall to us in the critical period of reconstruction which will be entered upon by the great trading nations after the conclusion of the war.

For we shall have to do our part, not only industrially and commercially but also financially, in helping the nations and peoples of Europe to industrial and financial rehabilitation when this most costly and destructive of wars is finally finished. Banking responsibility always attaches to countries which are financially strong and able. The American banker is clearly destined to have not only a place of larger importance in the affairs of his own country, but to play a role of first importance in the affairs of other countries. Now is the time to get ready for this work, so far as we are not yet fully prepared; to take reckoning of the demands which will be made upon us; to take stock of our resources and capabilities, and to supplement these where they seem inadequate.

There are many different angles to the problems of international finance which may be expected to affect us after the war. There is one in particular, however, which has riveted the attention of banking circles of late and been regarded by many as of such vital concern as to make it a problem of great urgency. It is the problem of devising effective ways of dealing with our gold supply. It is this problem to which I venture to direct your attention to-day, for, without sharing the extravagant anticipations, often expressed, of the difficulty that we shall encounter in dealing with this problem, I nevertheless feel that the problem is a real problem and worthy of careful thought. But I do not hesitate, at the outset, to express the opinion that it can be dealt with easily and completely if we know how to use our existing banking machinery effectively. I may go further, and add that I think there is danger, if we exaggerate unduly the magnitude and difficulties of the problem, of distorting and disfiguring our banking system to its own prejudice and to the prejudice of the country's real interests.

In dealing with any problem into which so many novel, uncertain, and incalculable factors enter, it is next to impossible to distinguish between the possibilities and the probabilities, and this error, I believe, has been made by some who have been considering the problem of how this country will meet the export demands for gold after the close of the war. But this is not the only or the principal matter regarding which I differ with them. Granting what nobody is in a position to forecast - that there will be extremely heavy demands for gold made upon us - I feel that there is a choice of methods or means of meeting such demands to which the banking and business public should not be indifferent.

It is a matter of common knowledge that, up to date, the United States has received from Europe, since August 1, 1914, on settlement of the international trade account $631,097,000 of gold. If the present gold movement into the country sustains its pace to the end of the calendar year (as seems likely if those who estimate a trade balance in our favor of not much less than 2½ billions of dollars are right) this amount will be increased greatly. Indeed, so long as there is gold to be laid hold of, it is likely that the gold exports to us will grow (unless we take steps to check them!) because of the diminution and gradual disappearance of the supply of European-held securities marketable in this country. The result will be, indeed is already close at hand, that the United States, simply in its capacity as a trading country and without any design or ambition on its part, will have come more nearly having a control of the supply of the most fundamental and important instrumentality of modern commerce and finance than has ever been witnessed.

But the gold which the European nations have been sending us because they must now have our goods, it seems clear they will endeavor, after the war, to get back from us, because, without it, it is extremely unlikely that they could reestablish their position as trading nations.

Problems of finance will be to the forefront in Europe because financial reconstruction must accompany, if not indeed precede commercial and industrial reconstruction. We are likely to see the experience of the United States, in the unsettled and uncertain decade following the Civil War, repeated on a gigantic scale in Europe. The vast debts piled up by the European belligerents (now estimated at close to 50 billions of dollars) the huge issues of paper currency in one form or another, make the problems of the restoration of credit, the refunding of debts, and the resumption of specie payments among the most urgent and the most difficult with which they will be confronted - problems for which no solution will be found which does not involve more or less participation and help on the side of the United States. It was well nigh ten years after the close of the Civil War before we were able to put through the successful refunding of our national debt, and it was fourteen years before we had wiped out the discount on our paper currency by the resumption of specie payments. How long the process of financial restoration in Europe will take, can not be foretold; but we may assume that, with our costly American experience as a warning example, to say nothing of the knowledge derived from some of their own past experiences, every effort will be made to shorten and hasten the process of recovery by shaping their policies and bending their energies toward the achievement. Specifically and concretely this means that they must put an adequate foundation of gold under their inflated credit systems and their overstrained banking structures; and their chief reliance in undertaking to secure the necessary gold must be the neutral countries whose gold hoards have augmented so rapidly as a result of the vicissitudes of war. The Scandinavian countries, Holland and ourselves, among neutrals, and Japan among the belligerents, have been the chief recipients of the outflowing gold. All of these countries are likely, therefore, to have an oppor - tunity to part with much of their recently acquired gold, but we are likely, yes, almost certain, to be the principal market in which the yellow metal will be sought, because of our vast holdings and acquisitions. We may also expect that the more rapid the process of financial recovery undertaken by the countries of Europe, the more intense will be the demands made upon us for gold. I repeat, therefore, that the problem of the wise and effective management of our gold supply is a very real problem.

I am not overlooking the suggestion, which has not infrequently been made within the past year by careful observers and students of the financial demoralization which is going on in Europe, that the commerce of the future will be organized upon some basis of barter and credit which will dispense with the necessity of having the liberal supply of gold necessitated under the old ways of international trading and banking. The suggestion certainly merits attention. It may be admitted that everything will be done which ingenuity, sharpened by the drastic experiences of war, can suggest, to economize the use of gold in the credit systems of the European nations. There is undeniable evidence of energetic efforts being made by the great banks of France and Germany to inaugurate a reign of economy in the handling of their gold by the transplantation of credit devices and expedients borrowed from the banking practice of England and the United States, such as the substitution of the checking account for the uneconomical and clumsy bank note. There is much evidence of a closer banking cooperation between the leading groups of belligerents. New and improved machinery of international settlement is being devised. This, doubtless, is one of the objects of the Economic Conference of the Entente Powers, and it is possible that some substantial and considerable changes in the gold economy of Europe will result; but it would, in my opinion be highly unsafe for us, as the leading gold holding nation of the world, to predicate our banking policies upon the supposition that gold is destined not to return to its former position of supremacy as the medium of international payment and account after the close of the war.

The history of commerce shows that banking traditions die slow and hard; and so, in my judgment, it will be with the tradition that there is but one medium of international payment which is universally valid in the modern world, namely, gold. I do not doubt that we shall get speedy and decisive testimony to this effect as soon as, or even before, the war is over. Take for example the case of Germany. Her position is in no wise different from that of her neighbors - friends or enemies - except in degree; that is, the strain upon her credit and upon her banking structure by reason of the war has been more severe, as evidenced by the magnitude of her debts and the volume of her credit circulation. Her previous position as a trading nation was the second in Europe. That trade has been completely and decisively cut off by the war. Germany's problem, therefore, presents only in somewhat exagerated form the situation of the other belligerent countries. All of them are straining public credit to the limit and involving the management of their great central banking institutions under the pressure of public necessity, in hazardous ventures in the field of finance. All, with the exception of England, have long since suspended specie payment - even though by one form of financial concealment or another they are attempting to mask the real situation and England herself, long renowned as the world's one and secure free gold market, is rapidly approaching the point where there will be no escape for her from a suspension of specie payment, if the war continues much longer. Such a step as the abandoment of specie payment and the dethronement of the pound sterling from its position of high prestige will be taken, we may believe, most reluctantly and as a last resort in a struggle of peculiar desperation and of national existence. And why? Because this greatest and oldest of the trading nations recognizes full well how essential gold is to the maintenance of her position in international trade and in international banking.

And so it will be with Germany and the others. No one will be quicker to appreciate than her clear-sighted economists and financial advisers, that she can not hope to recover her foreign trade without a sound system of banking and finance behind it. To invite others to trade with it, a nation must be in a position to inspire confidence in the stability and integrity of its financial system. The German mark, now seriously depreciated (estimated as much as 26%) must be brought back to a parity with gold. There is but one certain method for this purpose - to increase the gold supply of the country. We may expect, therefore, that no effort will be spared by Germany, England, or the other countries in a simialr position, to attain this object at the end of the war; - namely, to build up their gold supplies so as to bring them more nearly and more swiftly into equilibrium with their credit currency. Without indulging for a moment in any exaggerated fears of a so-called "gold war", we may nevertheless expect that the world will experience in an intensified form a condition analagous to that which was experienced in the decade 1870-1880, when the adoption of the gold standard by Germany and other countries, and the resumption of specie payments by the United States, Italy, and other nations, caused such a repid succession of demands for gold as to have led to its characterization, at the time, as a "scramble for gold".

The question, then, which is at once a concern to Europe and to us, is, first, where is the gold to come from, and second, what is the process by which it is going to be obtained.

The answer to the first question hardly admits of any doubt, in view of the impending loss of the position, long held and filled by England as the world's one free gold market, and in further view of the unequivocal and decisive shifting, if not for all time at any rate for a sufficiently long time, of the center of financial gravity to the United States. As a nation we now possess the largest stock of gold ever held by any single country, and we are at present the only considerable free gold market in the world. Every present indication is that our position in both of these ways will be cumulatively strengthened as the war goes on. It is clear beyond question, therefore, that the nations of Europe, in rehabilitating their finances, will look to the United States for gold. This question thus disposed of, the further questions for us to consider are, how is our banking organization situated to meet such foreign demands for gold as may arise, and by what process or processes may demands for our gold be expected to make themselves felt?

As regards the methods by which Europe will seek to recover some part of her gold supply, there are three which deserve notice; (1) the establishment of credits here to be taken out in gold; (2) the establishment and maintenance of discount rates sufficiently high to attract some part of our supply of floating capital, and (3) the establishment of a favorable balance of trade, which would require gold remittances by us. The successful flotation in the American market during the past two years of foreign government issues may have begotten the expectation that considerable loans can be placed here on the return of peace; and such may be the case for a short time and for loans of a special character and of limited amount. But it is not probable that any such method of taking gold from us could obtain large dimensions or last very long. It is probable, however, that for a while at least, some of our floating funds might be diverted to the European market by higher discount rates. If such a shifting should attain undesirable dimensions, however, it could easily be controlled by raising our own rates. European countries desiring gold from us will, therefore, have to rely mainly upon the natural processes of trade. Just as England and other countries have parted with enormous quantities of securities and gold to us because of their unfavorable balance of trade, so it will be by reversing the process and establishing a balance of trade in their favor that they will be most likely to succeed in "repatriating" their lost gold.

A country in times of peace can not, of course, be forced to part with its gold except by commercial pressure or inducement; in other words, except as it is its interest and advantage to do so. That will be when its gold has a higher value in a foreign market than it has in the home market. Prices and discount rates are the chief agencies through which gold distributes itself in proportion to normal commercial requirements among the gold-using countries. Gold will leave this country because, and to the extent, that gold prices are higher here than elsewhere, or discount rates lower. We may expect that after the war prices for staple commodities in the leading world's markets will find their new level gradually, and that gold will distribute itself so as to maintain prices in the different countries in conformity with the new price level. It is possible, and is probably a contingency not to be overlooked, that a replenishment of gold stocks may be so essential to some of the European countries that they will attempt by artificial means, (that is, through the stimulation of exports and by high discount rates) to establish the balance of trade in their favor. No doubt some such view or fear as this is in the minds of those who believe, or profess to believe, that so-called "raids" will be made upon our gold supply by means of "dumping".

ought, of course, be in a position to protect ourselves against any such artificial methods of trade should occasion arise, and for this purpose, as well as other purposes, have wisely created a tariff commission. But I venture to suggest that such anticipations are not to be taken too seriously.

No one can foretell what changes in the competitive capacities and relative positions of the leading trading nations as debtor and creditor will result in the economic and financial readjustments that will follow from the war. It is easy to draw a picture of Europe industrially exhausted, prostrate, and helpless after the war, and requiring many years for recovery. It is equally easy to conceive a Europe emerging from the trenches made strong, resolute, and formidable by the hard discipline of war. There will no doubt be elements both of strength and of weakness in the economic capabilities and recuperative powers of Europe's industrial leaders. Which way the balance will tip in the case of particular countries, no one can foresee. What is, therefore, important for us is that, while carefully watching developments and signs, not to make the error on the one hand of exaggerating the difficulties with which we shall be confronted, nor, on the other hand, of minimizing the possibilities which attach to the situation.

My own view and expectation is that the United States may be expected for a long time, perhaps permanently, to hold the position of a creditor nation, to which she has attained during the war: first, because of the practical extinction of our financial obligations to

Europe, the interest on which had long been a very important element in the international account; secondly, because of the considerable financial obligations that Europe has incurred to us; and thirdly, because industrially and commercially our position as the leading source of supply of many of the most important requisites of commerce will be strengthened by reason of the depletion of stocks of raw materials, etc., in Europe, and because the "forced draught" which war orders have given to the establishment and expansion of many of our leading manufacturing industries has given an impulse to our outward commerce which is likely for years to lead to a mass and value of exports which will pay or more than pay for all the goods and services we shall need from Europe. Indeed, it is conceivable that a situation may exist for some considerable time after the war in which the problem will be rather how to get rid of some of our redundant gold advantageously, than how to hold on to it.

We now have more gold than we need. The hard necessities of war have obliged Europe to send us gold in excess of our normal and proper requirements. Prices for commodities generally have been driven up by leaps and bounds. There are many things that we need from Europe much more than we do gold, and in return for which we should be glad and ready to part with our surplus stock of gold. Good financial policy on our part will, therefore, be directed not toward undertaking to make provision against a return of gold to Europe, but toward making provision for its return by a gradual, orderly, and well-controlled process. This problem, I repeat, which has inspired a feeling of great anxiety and even of alarm in some, really presents no difficulties which we can not easily master, even if we assume that the problem may be one of very much larger dimensions than there is now good reason for expecting.

What dimensions the gold movement to Europe may be expected to attain to, we can only conjecture. Whether, in the course of time, we shall return to Europe all the gold that we have received from her may be doubted; certainly not for some considerable time. We shall not, therefore, be erring on the side of under-statement of the possibilities of the situation, if we assume that the maximum amount of gold which we may be called upon in time to send back to Europe, will be approximately equal to what we have received.

Thus far, we have received since August 1, 1914, $631,097,000 more gold than we have exported. If we assume, further, that the rapidity with which the return will be made will be approximately identical with the rate of rapidity at which we have received it, we should be far within the limits of safe calculation if we fixed upon some $500,000,000 or $600,000,000 at the present time, as the gold export damand which the banking system of the country might be called upon to meet within a period of two years. If the war runs another year, we may have to take more millions of European gold and might have to raise correspondingly the approximate amount of gold which might have to be returned to Europe. I say "might" rather than "would", because of my firm expectation that we shall not have to return so large an amount, and also because I realize the importance of being prepared to deal with possibilities, in the face of so unprecedented a situation, however remote the possibilities may seem, and finally because of my strong conviction that there is nothing whatever in the possibilities which need embarrass us. Assuming, then, that we may have to return in the course of some two years, some $500,-000,000 or $600,000,000 of gold, how is our banking machinery prepared to cope with the problem of its orderly management?

This problem is one which concerns every part of our American banking system. But it may be admitted that it is in a peculiar sense a problem of concern to the Federal Reserve System. The Federal Reserve Banks were specifically created, among other important objects, to manage the banking reserves of their members and to regulate the movements of gold.

What, then, is the gold position of the country and of the several component parts of its banking system, and especially, what is the gold position of the Federal Reserve Banks?

The total gold holdings of the United States at this time, are estimated at $2,600,000,000. Of this amount, approximately $280,000,000 is in the Treasury of the United States, the balance being distributed amongst the banks of the country, including the Federal Reserve Banks, and the hands of the general public. Over $500,000 is held by the member banks of the Federal Reserve System, over $300,000,000 is estimated to be held by State banks and trust companies, and the rest, it may be conjecturally estimated, is in the hands of the general public. The total amount of gold held in and by the Federal Reserve System is $616,000,000. (October 13, 1916). This is made up of $406,000,000 held by the Federal Reserve Banks, and $210,000,000 held by the Federal Reserve Agents, this last being some of the redundant gold of the country which has been impounded in exchange for Federal reserve notes, and which is in the keeping of the Federal Reserve Agents, to be held until the occasion for its use arises. It should not be inferred, however, that all of the $616,000,000 held in the Federal Reserve System is free gold available to meet a foreign drain. Certain deductions must be made in arriving at a statement of the Federal Reserve System's free gold assets. The most important deductions are the reserves of 35% required by the law to be held against the reserve deposits of member banks, and of 40% against outstanding Federal reserve notes. These deductions now aggregate $195,000,000. After allowing for these reserves, and, in addition, for a 40% reserve against Federal reserve notes now secured by gold in the hands of the Federal Reserve Agents which could be replaced by the deposit of eligible commercial collateral to secure such notes, the amount of the Federal Reserve System's available gold may be set down as $345,000,000.

(In November of this year, a further installment of member bank reserves will be deposited with the Reserve Banks, to an estimated amount of about $60,000,000. If this should all be deposited in gold, the free gold holdings of the Federal Reserve Banks, after allowing for the required 35% reserve against the new deposits, would be increased by $38,500,000, bringing the total free gold of the system to over $380,000,000.)

Gold Lending Power of Federal Reserve Banks.

(Without calling in money invested in open market purchases of commercial)
(paper and municipal warrants)

Condition of all Federal Reserve Banks at close of business Oct. 13, 1916. Items (In thousands of Dollars)		As published	After (1) redeeming Federal reserve notes on hand, and (2) deducting from deposits the amount "Due from other Federal Reserve Banks	Amount of gold available after setting aside all required reserves.			
Assets:							
Gold and lawful money		405,725	424,483	Gold held by Banks		424,483	
Bills discounted:							
For Member Banks		22,099	22,099	Less required reserve of			
B't in open market		77,387	77,387				
U.S.Bonds & Notes		53,086	53,086	.35x538,669=			
Municipal Warrants		31,542	31,542		188,534		
Federal Reserve Notes		15,280	------	.40x15,794 =			
Due from other					6,317	194,851	
Federal Reserve Banks		30,089	------	Available			229,632
Other assets		3,045	3,045				
		638,253	611,642	Gold held by F.R.Agents		191,330	
Liabilities:				Less reserve which would be required were commercial paper substituted as backing for the Federal reserve notes now covered by this gold			
Capital paid in		55,682	55,682				
Deposits:							
Gov't.	24,715						
Bank	544,043	568,758	538,669				
F. R. Notes		12,316	15,794				
F. R. Bank notes in circulation		1,033	1,033				
Other liabilities		464	464				
		638,253	611,642	.40x191,330=		76,532	
				Available			114,798
FEDERAL RESERVE AGTS:				Total Free Gold			344,430
Fed. Res. Notes:							
In circulation		207,124	207,124				
Held by F.R.Bks.		18,758	-------				
Issued to the banks		225,882	207,124				
Gold held to retire F. R. Notes		210,088	191,330				
Commercial paper held as collateral for Federal reserve notes		15,794	15,794				
		225,882	207,124				

$345,000,000 of free gold is certainly an imposing aggregate. It is the largest amount of gold that has ever been massed under effective and unified banking control in this country. To many it will seem altogether sufficient to answer any probable needs. Indeed if we were to be guided in our judgment of the probable provision that should be made, purely by our past experience, and neglect the profound changes which have come to pass in the world of finance during the past two years, we might well believe that this amount would not only be ample but more than ample, easily to provide for any probable demands. But I have already stated my reasons for believing that it will be prudent, in making our calculations, to take note of the possibilities as well as the probabilities, particularly as the latter are so incalculable, and to accept $500,000,000 or $600,000,000 as the figure to bear in mind in estimating the amount of the possible gold demands that might be made upon us. Taking this figure as the goal of our calculations, it is clear that the present resources of the Federal Reserve System, big as they are, are not to be regarded in any but an optimistic calculation as certainly equal to meeting any possible drains of gold that might develop at the close of the war, and be equal, at the same time, to supplying any needs of our domestic banking situation which may develop. The practical problem confronting the managers of the Federal Reserve System is, therefore, how best to proceed in undertaking to mobilize from the extensive gold supply of the country outside of the Federal Reserve System, an amount of gold which will bring the free holdings of the System up to, say $500,000,000 or $600,000,000; that is to say, how to bring under the control or management of the Federal Reserve Banks an additional potential of $400,000,000 of gold, of which $260,000,000 would be over and above the required reserves.

This looks like a big order, but this is a day and a country of big things, and we are equal to the order. The problem should offer no great difficulty if we are alive to its importance, for the $400,000,000 additional gold required by the Federal Reserve System is but one-sixth of the country's total supply. The problem has had the careful attention of the managers of the Federal Reserve System, and in its general aspects had the attention of the Congress which enacted the Federal Reserve Act; for while such a sensational contingency as that with which we are now confronted could not have been foreseen when the Federal Reserve Act was framed it was foreseen that situations which would call for an effective marshalling of our gold resources would arise, and many of the fundamental features of the Reserve System were shaped with reference to this requirement; for the problem of handling the country's gold supply is, in a very special sense, a problem in reserve banking.

In England, France, and Germany, the marshalling and handling of the gold supply has long been regarded as the problem and responsibility of the great central banks, and the methods approved in their experience and practice will be our best guides in finding the solution for our problem, if we know how to make a discriminating application of their experience to our conditions. And because the general banking habits of our country parallel those of England much more closely than they do those of continental Europe, it would seem that in developing our banking machinery for the purpose of managing the gold export problem, the analogy of the Bank of England rather than that of either the Reichsbank of Germany or the Bank of France would be the one most likely to suggest or indicate the methods to be followed by us; all the more, as England's banking methods were developed in connection with the position long successfully maintained by her as the world's one free gold market - a position and responsibility which there are good reasons for believing may henceforth be ours.

The main difference between the banking methods of England and of continental Europe concerns their habits with respect to the use of the bank note and the bank check. The central banks of France and Germany are primarily note-issuing banks, deposit credits holding a very unimportant, almost a negligible, place among their liabilities. The bank note is their most characteristic form of credit, the means by which they build up their gold holdings, issuing their notes in exchange for gold and then holding the gold among their working assets. Without the note they cound not function.

In England, the situation is very different. There, the bank note has a very subordinate place, and as a form of currency is rapidly growing obsolete. It was long since effectively superseded in the preference of the English banking community by the deposit and checking account. The Bank of England issues no credit currency. Its notes are practically bullion certificates, and yet the Bank of England sustains a more intimate, vital, responsible and strategic relation - as a reserve holding bank -- to the whole banking and credit structure of England than that of any other of the great central banks. The great joint stock banks of England have long recognized their dependence upon the Bank of England, and maintain the larger part of their banking reserves with the Bank of England in the form of deposit credits. How successfully this system has worked, is one of the proudest chapters in the history of British banking, and it was this system which the framers of the Reserve System had in mind when they provided for the establishment of a similar relationship between the banks of our country and the Federal Reserve Banks; with this difference, that the deposit of a certain percentage of the banking reserves of the member banks with the Federal Reserve Banks, was made a legal requirement instead of being left to the voluntary action of the banks.

The Reserve Act originally provided, after the shifting of reserves incident to the establishment of the Federal Reserve System is completed in November 1917, for the maintenance of reserves by the banks of central reserve cities, reserve cities, and so-called country banks, respectively, in the following percentages, with their Federal Reserve Banks:- 7/18ths, 6/15ths, and 5/12ths of their demand deposits. A certain percentage of the balance of their reserves, after November 1917, they were, by the terms of the original Act, to be required to carry in their own vaults, as follows; 6/18ths for central reserve city banks, 5/15ths for reserve city banks, and 4/12ths for country banks. The remainder could be carried at their option either in vault or at Federal Reserve Banks. If the requirements I have stated my reasons for believing the Federal Reserve System might be called upon to meet are reasonable, it would appear that the disposition of the reserves of member banks originally made in the Act may not put the System in a sufficiently strong position in view of the new circumstances in which the country is finding itself as a result of the war. The logical and natural course to follow in meeting the situation would seem to be a further development of our scheme of Reserve Banking along the lines originally laid down in the Federal Reserve Act; that is, by providing for a lerger concentration of the cash holdings of the national banks in the Federal Reserve System.

Provision to accomplish this purpose was, therefore, wisely made by Congress in the recent amendments made by it to the Reserve Act, in an amendment which relieves member banks henceforth of the necessity of holding any fixed percentage of their legally required reserves in vault, and by leaving them free to carry such portion as they see fit with their Federal Reserve Banks, thus opening a natural way of adding to the cash holdings of the Reserve Banks. A similar result could, of course, have been reached by introducing into the Federal Reserve Act a freer system of note issue by the Reserve Banks patterned after the model of the German or French systems, but such a solution would, in my judgment, be attended with such grave dangers and be so ill adapted to American banking conditions and practices and the fundamental principles of our system of regional reserve banking that it could not but be viewed with serious misgiving by those who appreciate that the note issue system of the Federal Reserve Act makes every reasonable provision for the issue of an elastic bank note currency without inviting its abuse. I therefore regard the recent amendment to the Reserve Act allowing the member banks to increase their reserve deposits with their Reserve Banks, without limitation or restriction except such as their own judgment of their interests and necessities may impose, as one of the most important steps that could have been taken in the further development of the Federal Reserve System. It provides a simple, direct and natural way of strengthening the Reserve Banks as that becomes necessary, and forestalls any occasion for resort to alternative methods of doubtful expediency.

The situation in which we now happily find ourselves as a consequence of the opportunity thus given for the development of a closer relationship between the Federal Reserve Banks and their member banks, is that the American banking system, of which the Reserve Banks are the very heart and center (as managers of the country's banking reserve) can be made as strong for handling the problems and conditions which may confront us, as you member bankers are willing to make it.

I repeat with all emphasis that the object of this new provision of the law allowing, but not requiring, the deposit of member banks' vault reserve money in their Federal Reserve Banks, is to strengthen the gold position of the Reserve Banks. I do not doubt that it can be so used as to afford an effective solution of any gold problem which may confront us. Without any inconvenience or risk to themselves, without unduly trenching upon their cash holdings in vault or till, the member banks of the Federal Reserve System can easily spare the amount of cash which will be necessary to bring up the free gold holdings of the Federal Reserve Banks at the present time to $500,000,000 or $600,000,000.

The National banks to-day have cash holdings of over $750,-000,000. State banks and trust companies outside of the Federal Reserve System are estimated to hold upwards of $330,000,000 in gold. How much longer State banks will delay in entering the Federal Reserve System can not be foretold, but they are not likely to find their position on the outside of the Federal Reserve System a very comfortable or reassuring one, when the financial readjustments at the close of the war are under way. Accessions to the State bank membership of the System are then likely to become the order of the day. The larger the membership and the resources of the banks composing the Federal Reserve system, the easier, of course, will it be to provide the $400,-000,000, more or less, which the Federal Reserve Banks will require in order to bring their free gold holdings to $600,000,000. But even supposing that the whole burden would have to be borne by the present membership of the System, the required addition to the Reserve Banks' gold could be provided and yet leave the banks with over $350,000,000 of till money. The member banks in the three central reserve cities alone hold $340,000,000 of cash which would enable them to part with $246,000,000 to their Federal Reserve Banks and yet hold in till an amount ($97,000,-000) equal to 3½% of their deposits. When it is added that the central reserve cities and many of the reserve cities of the country are either Federal Reserve Cities or else near Federal Reserve Cities and are therefore in close contact with their Federal Reserve Banks, it is evident that they would have no difficulty in keeping themselves supplied with till money should their requirements run beyond the estimated 3 to 5 per cent. English experience has shown that in countries where the checking account is the customary method of payment, banks can in all ordinary circumstances run along safely with till money averaging about 2% of their demand liabilities. If the shifting of cash would be promoted by a change in the form of your condition statement which would show your cash in vault and in the Federal Reserve Bank as one item I see no good reason why this should not be done and could not be done.

The further solution of the problem is, therefore, in your hands. We have a splendid piece of machinery in the Reserve System, and you have it in your hands to make it an engine of gigantic power for handling, as an orderly and well-controlled process, any gold export movement that may set in, by bringing your spare cash to your Federal Reserve Banks, as the law contemplates you should and will do.

It is, of course, conceivable, though extremely improbable, that a gold export movement after the war might develop which would call for a larger provision than what I have thus far taken as the basis of our calculations. To many it will seem so improbable as hardly to merit attention, but I have stated why we should be prepared to deal with possibilities. It should not, therefore, be overlooked that there are methods of tapping the community's extensive holdings of gold which are outside of the banks, and in any event let us not lose sight of the fact that gold lost by the banks to meet a foreign drain would, in the natural course, be replaced from the community's holdings quite speedily. Only the first impact of a foreign demand for gold would be felt by the banks. The ultimate incidence of such a demand would be the now superabundant gold stores of the community. Gold holdings in the hands of the general community are estimated, at the present time, to amount to the huge aggregate of $900,000,000, and dissatisfaction is not infrequently expressed with the fact that our circulation should be so substantially made up of gold in the pockets of the people instead of being replaced by some form of credit currency. But the experience of the greatest trading and banking nations shows that a solid substratum of gold in the general circulation of a country is one of the surest foundations of a secure banking and financial system. It is wrong to assume that gold thus distributed in the channels of circulation can not be effectively mobilized when occasion arises, and be drawn into the banking reserves. The European nations in recent months have given us some impressive examples of such mobilization. I believe that the floating gold supply of the United States is a matter quite largely within the control of the banks of the country, and that the banks will exercise that control in their own interest and in the interest of the country, as it becomes necessary

The moment that gold grows in demand for the purpose of meeting foreign shipments and replenishing reserves, banks which are now indifferent or careless as to whether they pay out over their counters in response to currency demands, gold certificates, National bank notes or Federal reserve notes, will begin to discriminate. They will segregate their gold certificates, and as the withdrawal of these from general circulation reduces the volume of the community's necessary currency, the banks will find it to their interest to meet counter demands for cash by taking out Federal reserve notes. In other words, gold and gold certificates will be reserved for such uses as can not be met by the Federal reserve note; - to wit, meeting a foreign demand for gold, or increased bank reserves - and the Federal Reserve currency will be substituted to the extent that the circulating medium of the country requires it. Because at the present moment we are the only considerable country that is on a gold basis and have acquired on settlement of the international trade balance a volume of gold that has made gold so redundant in this country that gold certificates are for the moment a cheap medium of circulation, we should not hastily assume that changed conditions will not reverse the process and lead by natural and inevitable means to a substitution of the Federal Reserve note in large measure for the gold certificate. The whole question of the attitude to be adopted in the matter of the control of our gold supply turns upon whether we shall continue to have faith in the natural and normal processes of money and trade, or whether we are going to allow ourselves to be frightened into assuming that things have so changed that those processes are going to fail, and that henceforth we shall have to resort to artificial shifts and manipulations.

You bankers know how rapidly currency circulates in this country - more rapidly, in fact, than it does in any other country of the world. It is a familar fact that the American bank check is a highly flexible medium of credit, but the velocity of movement of ordinary bank or Government currency is not so highly appreciated. The fact is that these turn over with marvellous frequency compared with such countries as France, or even Germany, where the movement of the bank note is sluggish; in part because large quantities are carried idle in the pockets of the people or are locked away in the strong-boxes of shop-keepers. The turn over of the average piece of paper currency in the United States (outside of banks and the United States Treasury) has been estimated as high as twenty-two times in a year. You bankers also know as a matter of daily experience that the channels through which the paper money of the United States circulates, lead into and out of the banks, so that in the course of a year, practically the whole volume of the country's paper currency passes through the hands of the banks many times. It is therefore no unwarranted assumption to conclude that the banks have it in their power easily to withdraw the gold certificate from circulation and to substitute the Federal reserve note, when conditions indicate such a course to be desirable or necessary. In brief, in a country whose habits with respect to the circulation of the bank note are what they are in the

United States, the mobilization of a very considerable part of the gold currency of the country in a comparatively short period of time is a matter easily within the banks' power. This is a fact of such fundamental importance that it must not be neglected in estimating just what could be done in developing and making effective a policy to mobilize the gold supply of the country.

Nor should we overlook the extraordinary ability of the country to protect itself against any violent loss of gold by using for this purpose some part of the extensive holdings of European securities which we have recently acquired. To date, we have purchased European securities to the extent of $1,227,000,000. These are all of short maturity, the amounts maturing in the years 1917 and 1918, which presumably will see the close of the war, amounting to no less than $360,000,000.

MATURITIES OF EUROPEAN OBLIGATIONS HELD
IN THE UNITED STATES.

1916	$30,000,000
1917	103,000,000
1918	260,000,000
1919	150,000,000
1920	500,000,000
1921	50,000,000
1923	5,000,000
Uncertain	129,000,000
	$1,227,000,000

The events of the past two years have shown that American securities of undoubted solidity possess the quality of international currency, and are likely to figure to an important extent in the settlement of international accounts between this country and Europe. The great extension of the international loan market which has been one accompaniment of the war is certain to result in a greatly enlarged use of acceptable securities as a means of international payment and as a substitute for gold in making international settlements. There is every reason for believing that the recent experience of European countries in converting their American securities into gold have given to these securities an enviable position as secondary bank reserves, and that this will insure the reappearance of some demand for American securities after the war, thus broadening their market and facilitating their continuing use as a medium of international payment.

But, finally, let us not overlook the powerful instrument of control which the Reserve Banks possess in a movable discount rate for protecting their own and the country's gold supply, should it be threatened with too large or too sudden a foreign drain. This is the method employed by the great reserve and central banks in England and Europe. It is in particular the method, the use of which has been most effectively developed and extensively applied in England, whose money market has been more exposed than that of any other country to foreign demands for gold, because of her extensive and intimate commercial relations with the world, and because of her position as the world's principal gold market. Whenever the Bank of England has found that gold is being drawn out of the London market too rapidly, it has raised the bank rate so as to make the process of withdrawal more expensive, and thus to temper it to what the banking situation could stand. This method has been so frequently employed that a rise of the bank rate is commonly regarded as the most accurate barometer of the English reserve situation. And it is also the means by which the Bank of England exercises a strategic control over English banking at times when such control is all-important.

In the twenty-five years between 1875 and 1900, the English bank rate was altered 167 times, which means an average duration of the same rate, of only 54 days. Indeed, not only were <u>changes</u> of rate frequent, but their <u>range</u> was also considerable - such as four or five percent of variation in the course of a year. This same instrument of control, our Reserve Banks possess, and the success of our new banking system will in large measure depend upon the wisdom and skill its managers and the Federal Reserve Board develop in handling it.

It must be admitted that frequent changes of discount rates are in and of themselves not desirable. Stability of rate is a great advantage to industry and the internal banking situation, but too much stability of Reserve Bank rates must not be expected in a country whose money market has attained the international importance which ours has, at least for the present, and which it will continue to hold so long as its position in international trade is that of a creditor, and so long as it has a vast stock of gold to be dispensed. At any rate, whatever internal disadvantages may attach to a changeable discount rate, there it is, a powerful weapon for exercising a control over the reserve and gold situation by the Federal Reserve Banks at critical times, and should not be omitted from our calculation when examining our protective capacity against an undue drain of gold. It would be an especially effective and necessary weapon against any attempt of European markets to bid away gold from us more rapidly than would be consistent with our interests, by raising their discount rates.

More than that, it would be an effective method by which the Reserve Banks could throw upon the many powerful banks of the country which have large holdings of cash and foreign commitments, their proper part of the burden of supplying gold for foreign shipment, should they be unduly disposed to divert demands made upon them to the Federal Reserve Banks. Indeed, demands for foreign gold remittances would make themselves felt in the first instance as a demand by customers of these banks. To meet such demands, they would have the alternative of taking the gold out of their own accumulations or of drawing it out of Federal Reserve Banks by rediscounting or open market sales. But it is not to be expected that the Reserve Bank managers would sit idly or carelessly by and allow their gold reserves to be needlessly depleted, when they could stop such depletion by the simple device of raising their rates, unless, or until, a situation had arisen which was beyond the ability of the ordinary banks to handle with their own resources and without difficulty.

This survey shows that there are many elements that enter into the problem of handling our gold supply and many factors that enter into the organization of the machinery for most effectively mobilizing it. It may be convenient before dismissing the subject to assemble them in a summary statement. They are:

1. Europe may be expected in time to recover a large part of the gold she has sent us. There being no present method of estimating the probabilities, attention must be paid to the possibilities.

2. Europe having sent us thus far over $630,000,000, prudent calculations will address themselves toward considering how an amount of $500,000,000 or $600,000,000 of gold might best be mobilized for the purpose of meeting a foreign drain should it attain such a magnitude.

3. The Federal Reserve Banking System, including therein the member banks, possesses over $1,366,000,000 in cash, of which over $1,100,000,000 is gold (which is something short of one-half of the total gold supply of the country), the remainder being exchangeable for gold at the Treasury of the United States.

4. The total gold within the immediate control of the Federal Reserve Banks amounts to $616,000,000, of which $345,000,000 may be regarded as free gold; that is, the amount of gold lending power without any impairment of reserves.

5. To raise the gold lending power of the Reserve Banks to the point which would be necessary to enable them to meet (what is, however,

in view of present probabilities unlikely) possible demands of $500,000,000 or $600,000,000, approximately $400,000,000 would have to be added to the Reserve Banks deposits in order to give them, after setting aside the necessary reserve of 35%, additional free gold to the amount of $260,000,000.

6. This amount can be spared from vault cash now carried by member banks without unduly reducing their holdings of till money, and therefore presents the basis for the solution of the problem.

7. Gold lost by the banks to meet foreign demands would be replaced by mobilizing a part of the present floating supply of the community into their hands. This process would be facilitated by the ease with which Federal reserve notes could be issued to fill the void created by the withdrawal of gold or other forms of currency.

8. The Reserve Banks possess an important leverage of control in their movable discount rate, which could be adjusted to counter any undue attempt of foreign markets to attract our gold by high rates.

9. An important element of strength in the protective capacity of the country against an undue drain of gold is the heavy holding of foreign government obligations which run off in the next few years.

10. Finally, while realizing the importance of being alive to the possibilities in the face of a situation for which there is no parallel, let us not make the mistake of "overtraining" or of committing ourselves in advance to any definite ~~single~~ expectation of what is going to occur and in consequence lose that balance of judgment which will not hesitate to shape and reshape its conclusions

in accordance with the facts as they develop or change. An essential element in our preparation will be the ability to deal with the unexpected as well as with the anticipated.

The conclusion warranted by this survey is that the Reserve Banks can easily, with the cooperation of their member banks be put in a position where they can master any situation which may arise. Some of you may say that it is a heavy bill that I am proposing the Federal Reserve System shall draw on you, but this is the day of the bankers' acceptance in our new American banking system, and I feel confident, from the hearty cooperation that our member banks and the country by and large are giving to the Federal Reserve System, that you will not protest the draft but accept it. The bankers of the United States had to meet several severe tests in the trying months following the outbreak of the great war. Those tests they met intelligently and resolutely. I do not doubt that this one also will be met intelligently and resolutely, and that each one of our members will take careful reckoning of what he can do and do it. The Federal Reserve System is but two years old, a brief period in the life of a great and new banking experiment, but the system has already made a record for itself and an enviable place in our new financial and credit system, and is no longer an experiment in the sense that there is any uncertainty as to its high value and entire practicability. It is experimental only in the sense that there may be a question as to how rapidly it will develop its full potentialities as the shaping and guiding influence in American banking affairs.

A great banking system is as much a matter of growth and development as it is of legislation. The English banking system, which has long been the admiration of the world, has grown up pretty much without legislative guidance or interference. The Federal Reserve Act, wonderfully conceived as it was, is, therefore, to be regarded only as a beginning. It presents an opportunity. How fully the opportunity will be improved to develop a great system must depend upon the combined wisdom and vision of those of us immediately charged with the administration of the law, and the thousands of you bankers who are the partners through whom and with whom we must work. A banking system is not a set of principles and rules formulated and imposed by law, but a set of habits, practices, customs and traditions forged out of experience. Many of these that are excellent we already possess, but others we still must make. I have pointed out one of the most important of these. Our country has become a dominant factor in the world of commerce and the world of finance. Our banking system must be made equal to our matchless opportunities and our large responsibilities. Whether we like or desire the great changes which have come to pass in our position in the world of affairs makes little difference; we are there by fate and circumstance and we must cultivate the habits of thought and action which will enable us to do our part and do it well. Parochial habits and provincial customs must yield to the larger way of viewing things and the larger way of doing things. This is the day of banking cooperation and the Federal Reserve System is your rallying point in helping yourselves and helping the country. It is the best rallying point that banking wisdom and legislative ingenuity have ever given the bankers of any country, and is worthy of your every confidence and support.