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ADDRESS REPLY TO
FEDERAL RESERVE BOARD

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FEDERAL RESERVE BOARD

WASHINGTON

WILLIAM G. MCADOO
SECRETARY OF THE TREASURY
CHAIRMAN
JOHN SKELTON WILLIAMS
COMPTROLLER OF THE CURRENCY

November 24, 1916.

Dear Sir:

The Federal Reserve Board has observed that certain Federal reserve banks have recently purchased two per cent United States bonds above par and its attention has been directed to the fact that this price has been artificially stimulated by the competitive bidding of those Federal reserve banks.

While it is not the desire of the Board to restrict or to limit the purchase of two per cent bonds by the various Federal reserve banks, it is deemed advisable to point out that this policy, which is unnaturally forcing up the price of two per cent bonds, is fraught with certain dangers.

Section 18 of the Federal Reserve Act provides in part that any member bank, desiring to retire the whole or any part of its circulating notes, may file with the Treasurer of the United States an application to sell for its account, at par and accrued interest, United States bonds securing circulation to be retired. The Federal Reserve Board is given the power to require Federal reserve banks to buy \$25,000,000 of such bonds in any one year, less the amount of bonds bought by such Federal reserve banks in the open market during the same calendar year. The power of the Federal reserve banks to make open market purchases of bonds is not limited by law, so that, strictly speaking, such banks are acting within their legal rights in making such purchases even though their competitive bidding is forcing the price of two's above par.

The difficulty, however, is that this policy is creating an artificial and unnatural market for two per cent bonds. The Federal reserve banks are afforded the privilege of converting a certain amount of two per cent bonds into three per cent bonds and three per cent one-year notes. Consequently, such banks will not suffer any direct financial loss by paying for two per cent bonds practically the same amount as the normal market price for three per cent bonds. The fact, however, that Federal reserve banks may convert bonds in this manner and that two per cent bonds are because of the conversion privilege worth substantially as much as three's to Federal reserve banks, is hardly a sound reason to justify their forcing of the price of two's above their normal market value by blindly bidding against one another.

It is quite generally agreed that one of the purposes of the Act was to promote a gradual retirement of the national bank circulation, and Section 18 in affording a fixed market, at par and accrued interest, for two per cent bonds against which circulation is outstanding, contemplated that member banks would dispose in that manner of those bonds which they are required by the national bank act to keep on deposit with the Treasurer of the United States.

It is apparent, therefore, that if the open market price of two per cent bonds is unnaturally established at a figure above par, member banks will not be inclined to offer their two per cent bonds for sale through the Treasurer at par and accrued interest, even if such bonds are not free bonds and can not be released by the Treasurer for sale in any manner other than that provided by Section 18. The result will be that there will be an artificial stoppage of the retirement of national bank circulation in the manner contemplated by the Act.

The suggestion has been made that the Federal reserve banks appoint a committee to consider the purchase of two per cent bonds for the joint account of all Federal reserve banks. The Board believes that such a course would not only be conducive to a more healthy and normal market for two per cent bonds, but also that it would best promote the results intended by Congress in the matter of accomplishing the retirement of national bank circulation.

Respectfully,

Governor.