FEDERAL RESERVE BOARD

WASHINGTON

890.

November 27, 1916.

To the Federal Reserve Board,

Washington.

Gentlemen:

On May 10, 1916, I prepared for the Board a short statement dealing with Governor Hamlin's brief on the subject of note issue amendments. I took the position at that time that there were three amendments to the Federal Reserve Act relating to this matter which were very desirable:

(1) The right to issue Federal Reserve notes directly for gold;

(2) A consolidation or combination of the accounts of the Federal Reserve Agents and the Federal Reserve Banks so that we would have the responsibility of the Banks behind the custody of the notes, and not only that of the Federal Reserve Agent, so as to provide that the Reserve Banks shall show all notes outstanding in the hands of the public as a liability and all assets held against them as an asset of the Bank;

(3) An amendment to Section 14, of the Federal Reserve Act which would liberalize the law in respect to collateral behind Federal Reserve notes by making eligible as collateral bankers' acceptances, or what is known as "bought paper", as well as commercial paper rediscounted for member banks.

I then took the position that if these three amendments were secured it would be neither necessary nor desirable to ask Congress to make Federal Reserve notes legal reserve.

Since that memorandum was written the third of the above mentioned amendments has been passed by Congress and another amendment has also been passed which has a very important bearing on the situation, to-wit: the authority to member banks to keep any part of their reserve with the Federal Reserve Bank, instead of in their own vaults. I still believe that the amendments suggested by me on May 10th are very desirable and that if they were passed it would not be necessary, at least at this time, to make Federal Reserve notes available as bank reserves. However, the proposal, so ably urged by my colleague, Mr. Warburg, is entitled to the most careful consideration, first, as to the desirability of the object sought, and, second, as to whether there is any better means of attaining it.

First, as to the object sought. It appears to be Mr. Warburg's desire to impound in the Federal Reserve Banks a very large share of the country's gold supply, whereas I rather question the desirability of going too far in that direction. My feeling is that, under the changes in the law which I have suggested, we would have little difficulty in accumulating in the Federal Reserve Banks half of the gold stock of the country not in the hands of the Federal Government. If the other half were in the hands of the public and in those of member and non-member banks it would be where it could serve an important purpose as a sort of secondary reserve supply which would be called upon in case of great need. If our banking system was under a strong central management, and the form of our Government was like that of the German Empire, I can readily see where it would be natural and perhaps desirable to act on Mr. Warburg's suggestion, but, considering the form of our Government, the temperament of our people, and the dangers of over-expansion and over-speculation, I think we should not put all of our golden eggs in one basket.

We all recall that the panic of 1907 came as a climax to several years of great expansion in expenditures in all kinds of business enterprises, a period of ten or eleven years of pyramiding upwards almost without interruption. Six months before the panic came many wise men thought that things looked "squally", and yet the temptation to keep on stretching bank resources to the limit was too strong even for them to resist. For this and other reasons I can not help feeling that there is danger in putting all the elasticity in the Federal Reserve Banks and not leaving a reserve of elasticity in the banks of the country. Of course, I am aware it is somewhat inconsistent to say that a balance with the Reserve Bank shall be counted as a reserve, whereas, the notes of the Bank can not be so counted. I am also aware of the fact that as time goes on bank balances are going to play a greater part than Federal Reserve notes; that when our check clearing and collection plan is fully developed, member banks will care less about drawing out Federal Reserve notes, and more about transferring balances by drafts and checks, On the other hand, the use of Federal Reserve notes will be always greatest in the parts of the country where there is the greatest necessity for caution; in those parts of the country where other credit instruments play a smaller part and where actual currency plays a larger part.

I can see that if we do not make Federal Reserve notes reserve and if we permit, say one-half of the gold holdings of the country to remain in the hands of member and non-member banks, we may sometimes reach a point where a Federal Reserve Bank has exhausted its unpledged gold supply and can not issue any more notes. Member banks, coming to their Federal Reserve Bank to borrow will, in such a case, complain that "the well has run dry", but when that time comes the Federal Reserve Bank will say to those member banks, "If you have gold in your reserves and will deposit it with us we can help you, because we can immediately expand that gold in the ratio of 1.625 to 1, and we can hold your gold to count as reserve and still help you with currency or book credits."

I agree entirely with Mr. Warburg's argument that we should put ourselves in a position to release gold freely when the European war is over. For us, as a nation to have accumulated through a favorable trade balance an enormous fund of gold and then attempt to put the bars up and so prevent the world's supply of gold from seeking its natural level would be absurd and even monstrous.

Such action on our part might very properly lead to a demonetization of gold, but I can not conceive that gold will go out of the country except in four ways; first, by a reversal in the balance trade; second, by the spending of money in Europe by Americans; third, by remittances to Europeans by Americans and immigrants; fourth; by loans.to Europe.

There are some other general reasons against making Federal Reserve notes reserve which might also be mentioned. It is bad education for the public to let it imagine that a note of a bank is reserve because Congress says it is reserve. The fundamental reliance of our whole structure is the gold, or metallic basis behind our currency. While it is true that the Government guarantees the notes, every one of us will take the position that the notes must be secure, without leaning upon the Government and without even suggesting that the Government shall ever be called upon to make them good. The Government supervises their issue, must be satisfied that the security and the reserve behind them is ample and sufficient, but it was never seriously meant that the Government was going to tax the people to pay these notes.

Viewed from this aspect, it isn't good economics for Congress to say that "greenbacks", or any other kind of notes that are not based on the deposit of 100% of gold can be called the ultimate reserve of member banks. The fact that we have taken some wrong steps in this direction in the past does not at all justify our doing it again. The greenback is simply the promise of the Government with a gold security of approximately 35%; the national bank note besides being the obligation of the issuing bank is security of the Government, as attested by the deposit of the United States bonds and has a gold reserve of only 5%. The Federal Reserve note has 100% of commercial paper as collateral, and 40% or more of gold reserve behind it, besides which it has the guarantee of the Federal Reserve Banks, the member banks, and the Government. No one of these three kinds of currency can properly be considered ultimate reserves, and they are unquestionably good and ought to be in every sense legal tender. It appears inconceivable that they should not be absolutely good at all times and readily acceptable by the people in all sorts of transactions as a substitute for actual specie. When it comes to international transactions, gold, or its equivalent only, can be used, but in all intra-national transactions there is no reason why these various representatives of money should not perform all the functions, except those of being ultimate reserves. The fact that state banks are permitted to use national bank notes and reserve notes as reserves and a actually do so, only accentuates the necessity of keeping the ultimate reserves inviolable.

The object which Mr. Warburg seeks to attain - of securing a much larger share of the ultimate reserves of the country in the hands of the Federal Reserve Banks - might be attained in another and possibly less dangerous way if the Federal Reserve Act were so amended as to state only those reserves which member banks must carry with their Federal Reserve Bank, stating in so many words that the specie and currency which any bank shall carry in its own vault, or till, will be left to its own judgment. The ultimate reserves, in other words, will be with the Federal Reserve Bank. The advantage of this method to the member bank would be that the many kinds of currency in its possession, as well as specie, would serve its purpose equally well - gold or silver certificates, greenbacks, national bank note currency, Federal Reserve notes, or Federal Reserve Bank notes. What the reserves should be is necessarily a matter of study and calculation, but suppose, for example, we should start out with the proposal that country bank reserves held with the Federal Reserve Bank should be 8%, the member banks in reserve cities should hold 12%, and the member banks in central reserve cities should hold 15%. In this connection it is proper to mention that under the laws of a number of states the required cash reserves is left entirely in the judgment of the banker, and in European countries it is the custom to let bankers use their own discretion as to the cash reserves they shall hold. While it is not suggested that this discretion apply to the entire reserves, it is thought that it can be safely applied to the bank's own counter cash and vault requirements.

This may not be the best solution of the problem, yet it is at least worthy of consideration. If, on the other hand, Mr. Warburg's plan is adopted, he, himself, admits that it would be desirable to keep, not 40% of gold behind Federal Reserve notes, but 60% or 70%. Indeed, it is probable that it would be necessary to change the law in regard to ultimate or gold reserve behind Federal Reserve notes and to raise the limit below which a penalty, or tax, shall apply to, say 50%.

There are other ways in which, without any Congressional action, much might be accomplished to put the gold of the country in the hands of the Federal Reserve Banks and member banks, rather than by leaving it where it will be hoarded by people, or used for every-day currency; that is, by readjusting the denominations of gold and silver certificates and other forms of currency. As it has been pointed out several times, if gold certificates were not printed in denominations less than \$50, gold certificates would rarely appear as currency, and become, as they should be, almost exclusively reserve money.

From the above, it will appear that, while I am not favorable to the plan of making Federal Reserve notes reserve, I am not opposed to a limited extent, at least to the object Mr. Warburg has in view, to wit: the greater concentration of gold in Reserve Bamks.

Respectfully submitted,

F. A. DELANO.