

First Draft  
W.P.G.H.

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S I R:

In conformity with the requirements of Section 10 of the Federal Reserve Act, the fourth annual report of the operations of the Federal Reserve Board for the calendar year ended December 31, 1917, is submitted herewith:

The outstanding feature of the year has been, of course, the entry of the United States into the war. The declaration by Congress of a state of war, on April 6th, had been preceded by a period extending over many months of unprecedented activity and expansion in practically all lines of business and industry, tempered, however, in the minds of thoughtful men, by uncertainty and apprehension as to the ultimate adjustment of international relationships. The Board had seen, for a long time, that the feverish conditions brought about by the rapid change in our position from a debtor to a creditor nation, by the great influx of gold into the country, and by the large foreign credits negotiated here, rendered it imperative that the Federal Reserve system should be strengthened and brought to the highest state of efficiency, in order that it might perform the most effective service in either one of two events which seemed likely to transpire -- the conclusion of a general peace in Europe, or the entry of the United States itself into the war. In the event of peace, a radical readjustment was to be expected, and there would have been a slowing down of those industries which were engaged in supplying war material, a consequent heavy falling off in our exports, accompanied, in

all probability, by a strong demand upon us for gold; and on the other hand, in the case of our own belligerency, it was foreseen that there would be a greatly increased demand for all articles necessary for the equipment and maintenance of our own military and naval establishments, much larger credits to the countries associated with us in the war, and an inevitable cessation of gold shipments to us by those countries.

For these reasons, the Board felt that it should in either event, during this period of uncertainty, undertake to preserve the liquid character of the assets of the Federal Reserve banks, to discourage any undue expansion of credits, and to reduce to very moderate proportions the holdings of the banks in such investments as bonds and warrants which had been made primarily for the sake of income. Early in the year, therefore, the Board began to carry out these policies and the end of March found the Federal Reserve banks in a very strong position, with assets unusually liquid. While some of the banks had purchased and were holding government bonds, the aggregate amounted to less than five per cent of their total resources. Holdings of municipal warrants, which at times had been freely purchased by some of the banks also, had been reduced to a comparatively small amount.

In order better to provide for the strengthening of our banking structure, for the conservation of our gold supply, and for the regulation of its outflow, the Board in January suggested some amendments to the Federal Reserve act which were designed to make membership in the

system more attractive to the state banks and trust companies, and to modify reserve requirements in such a way as to increase the gold holdings of the Federal Reserve banks and to make their gold more available as a basis for note issues. These amendments finally became law on June 21st and will be discussed more fully in other parts of this report. In anticipation of these changes and of future contingencies, the Board determined upon the preparation and distribution of a much larger volume of Federal Reserve notes, and during the months of January and February placed additional orders with the Bureau of Engraving and Printing, through the Comptroller of the Currency, for more than \$900,000,000 of these notes, and arranged also that the stock of notes on hand should no longer be reduced through withdrawals for current needs, but that as drawn upon by the Federal Reserve banks new orders in equal amount should be placed automatically. In order to insure immediate availability, ample supplies of notes were placed at the subtreasuries for delivery to the Federal Reserve agents as required. The precautions taken have been justified by events and an ample supply of Federal Reserve notes has been available throughout the year.

When a state of war was declared on April 6th, the reserve position of the Federal Reserve banks was exceptionally strong. Gold in the Federal Reserve banks and with Federal Reserve agents amounted to \$943,552,000; the reserve against notes was 101.2% and against deposits 76.5%, the combined reserve against deposits and notes being 84.7%.

Investments in government bonds and municipal warrants had been reduced to \$51,836,000 and purchases of acceptances were in smaller volume.

FEDERAL RESERVE BANKS AS FISCAL AGENTS OF THE  
UNITED STATES.

The entry of the country into war resulted almost immediately in the assignment to the Federal Reserve banks of new and exceedingly important duties. Section 15 of the Federal Reserve Act provides in part that the banks when required by the Secretary of the Treasury shall act as fiscal agents of the United States. This function had hitherto been a negligible one, but on May 2nd the Secretary of the Treasury made public the details of the first bond issue, known as the Liberty loan of 1917, and at the same time he announced that each Federal Reserve bank would be constituted a central agency in its own district for the organization of a bond campaign, for receiving subscriptions and payments, making deliveries and managing the necessary details. The banks were also charged by the Secretary of the Treasury with the duty of placing the successive issues of short time Treasury certificates which have been offered, and of redeeming them at maturity. These new duties have brought the banks into more intimate contact with the Treasury and have also increased enormously their operating problems. It has been necessary for them to add to their working space and to more than double their clerical staffs. They have rendered especially valuable service in the prompt flotation of the various issues of Treasury

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certificates of indebtedness which, running for short periods only in anticipation of receipts from the long term bonds, were placed with banks rather than with the investing public.

The first issue of \$50,000,000 offered under the provisions of the Act of March 3, 1917 in anticipation of income tax receipts accruing on June 30th, was offered before rates for money had advanced, and at the request of the Secretary of the Treasury, the Federal Reserve banks themselves subscribed for the entire issue, at the rate of 2% per annum. This constituted their first direct service to the government in its war financing. This issue however, was only a beginning. It was followed by an offering of \$250,000,000, at 3%, on April 25th, which was quickly distributed by the Federal Reserve banks among the member and nonmember banks of their respective districts. This process has been repeated on eleven subsequent occasions, four issues having been made in anticipation of the first Liberty loan of \$2,000,000<sup>000</sup> which was closed on June 15th, while six were anticipatory of the second Liberty Loan, subscriptions to which closed on November 28th. The last issue of <sup>approximately</sup> \$700,000,000, in anticipation of taxes due next June, has a longer time to run than the others and being intended primarily for the convenience of those who will have taxes to pay on account of incomes and excess profits, appealed more particularly to corporations and investors than other issues, which went mainly to banks. Subscriptions are now being received by the Federal Reserve banks for a new offering of the same character.

In his annual report to Congress the Secretary of the Treasury

expressed his appreciation of the services rendered by the Federal Reserve banks as fiscal agents by stating that "The Federal Reserve system has been of incalculable value during this period of war financing on the most extensive scale ever undertaken by any nation in the history of the world. It would have been impossible to carry through these unprecedented financing operations under our old banking system. The effective machinery afforded by the Federal Reserve banks has permitted the government to execute its plans without a tremor of disturbance. Great credit is due the twelve Federal Reserve banks for their broad grasp of the situation and their intelligent and comprehensive cooperation." He added that the organizations which they have perfected have contributed greatly to the phenomenal success of the Liberty loans.

The Federal Reserve banks have from the first met with a prompt and hearty response from the member and nonmember banks in their respective districts, both in the flotation of Treasury certificates and of the Liberty bonds. The Treasury has relieved pressure upon the market by permitting the Federal Reserve banks to distribute the proceeds of the sale of certificates and bonds among the national banks subscribing, but the term of these deposits has necessarily been short, and as a considerable lapse of time is required for the redistribution of these funds throughout the country through normal trade and banking channels, the greatest measure of relief has been afforded through rediscounts of member banks with the Federal Reserve banks. These transactions have involved no loss of gold, this being obviated by a substantial expansion of Federal Reserve note issues.

## DISCOUNT POLICY.

Upon the Federal Reserve Board has fallen the responsibility of directing the policies of the system so as to insure prompt accommodation to banks whose customers required assistance in making their payments for bonds, as well as to banks which bought bonds for their own account. It was important that there be no disturbance in the money market and that interest rates should be stable and as free as possible from fluctuation. The Board accordingly, before the subscriptions to the first Liberty bond issue were closed, and in anticipation of the amendments which became law on June 21st, established a preferential rate of discount for notes of member banks secured by government obligations, whether certificates or bonds, fixing a lower rate than that borne by the securities themselves, -  $3\frac{1}{2}\%$  for notes maturing up to 90 days. As a further means of relief, the Board authorized Federal Reserve banks to discount for nonmember banks, upon the endorsement of a member bank, notes secured by government securities, whether made by the nonmember banks themselves or by their customers, when the proceeds were to be used for carrying Treasury certificates or United States bonds. These measures involved modifications in discount schedules and rates, which may be enumerated as follows:

(1) The establishment of a rate of  $3\%$  per annum for the discount at Federal Reserve banks of notes of member banks running not longer than 15 days secured by Treasury certificates of indebtedness, which certificates had been issued at rates varying from 3 to  $3\frac{1}{4}\%$  per annum.

(2) The establishment of a rate of discount at Federal Reserve banks of  $3\frac{1}{2}\%$  per annum for customers' notes running up to 90 days, with

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the endorsement of member banks, when such notes had been made for the purpose of obtaining funds for the purchase of government bonds and were secured by government obligations.

(3) The authorization of Federal Reserve banks to rediscount for member banks, on behalf of nonmember banks, notes of nonmember banks or their customers, secured by government obligations, for the purpose of obtaining funds with which to purchase United States bonds or notes.

(4) The establishment of a one day rate of from 2 to 4% at the Federal Reserve banks in the principal financial centers, New York particularly, for the purpose of restoring to the market funds temporarily withdrawn through government loan operations.

(5) The authorization of Federal Reserve banks to discount notes made by nonmember banks with the endorsement of a member bank, on condition that such notes, running not longer than 90 days, should be rediscounted only up to July 15th and that they should be accompanied by an affidavit that the proceeds thereof had been used for the purchase of government bonds by the banks or their customers.

A general assurance / <sup>was given</sup> savings banks and trust companies that the Board desired in every way to cooperate with them in avoiding stringency and that the Federal Reserve banks were prepared to extend through member banks every reasonable accommodation not inconsistent with law, for the purpose of relieving any strain which might result from withdrawals of deposits for purchases of government securities.

The rediscount policy of the Board, which was intended to assist



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those desiring to subscribe for the first Liberty loan by assuming banking accommodation pending the payment in full of their subscriptions, was amply justified by results. As nearly as can be ascertained, scarcely more than \$300,000,000 of the loan was actually subscribed by banks for their own account, and of this amount a very large part was quickly transferred to private investors who had not originally subscribed for or been allotted all the bonds they desired to obtain.

The amount of rediscounts at Federal Reserve banks of notes secured by government obligations reached its maximum of \$82,950,000 on June 22nd, one week after the closing of subscriptions for the loan, but these notes were paid off so rapidly that the total of such rediscounts had on August 17th, fallen to \$11,051,000. Reports from all sections of the country indicate that only a comparatively small percentage of the first issue of Liberty bonds is now being carried upon a long term instalment basis, and that as a rule both banks and private investors were able, within a few weeks, to pay for the securities which they agreed to take.

#### EFFECT OF ADDITIONAL LOANS.

The services rendered by the Federal Reserve banks during the second Liberty loan campaign, which began on October 1st and ended on October 27th, were even more marked than in the first instance. The experience which had been gained on the former occasion, the fact that more time had been afforded for ~~official~~ <sup>public</sup> organization, a better understanding by the people of the merits of government bonds as an investment, and a general awakening to a sense of patriotic duty, all combined to bring about the

vigorous cooperation of the public generally. The arrangements previously made to accommodate the banks and their customers who desired to subscribe to government bonds, remained effective, and there were no changes in discount rates, notwithstanding the advance of one-half of one per cent in the rate of interest carried by the bonds themselves, until the close of November and the middle of December, when general advances of one-half of one per cent in rates of Federal Reserve banks were made.

The organization of the Liberty loan committee and the arrangements for publicity and for soliciting subscriptions, had been greatly improved under the leadership of the Federal Reserve bank in each district, and the result was gratifying in a corresponding degree. The fact that the second loan, as offered to the public, was fifty per cent greater than the first, while actual subscriptions received were in an even greater proportion, <sup>the</sup> naturally increased very substantially the operations of the Federal Reserve banks in discounting paper secured by government obligations. The total of such paper discounted at the Federal Reserve banks reached a maximum on Nov 30, when the aggregate amount of notes under discount secured by government obligations was \$ 499,265,000<sup>x</sup>. As was the case with the first loan however, there were constant transfers to investors, and on Dec 28 the total amount of discounts of this character had been reduced to \$ 283,421,000<sup>x</sup>.

Experience during the year with these operations and an analysis of the consequent changes in the banking situation, demonstrate how greatly the entry of the United States into the war has increased the responsibility

<sup>x</sup> composed of \$415,605,000 of member banks' collateral notes and \$93,657,000 of call-loans' notes

of the Federal Reserve system in its relations to the Treasury and to the public. Not only have new duties devolved upon the Federal Reserve system, but it has been made more directly responsible for the soundness of the banking position. The Federal Reserve Board is, of course, not concerned with the financial policy of the government except in so far as the Secretary of the Treasury may choose to call upon its members for service in an advisory capacity. The Board, however, is charged by the Federal Reserve Act with the exercise of a general supervision over Federal Reserve banks, which, in their functions as fiscal agents of the government, are responsible for banking technique of government borrowing, as well as for the execution of policies determining the extent and manner of banking participation in public loans. This responsibility is one which, during the past year, has rested heavily upon the members of the Board, and which they cannot evade or transfer.

The Board feels that the duties which it is called upon to perform are at all times impressed with the highest qualities of trusteeship, and in times of emergency like the present, are vested, if it be possible, with an added solemnity. It seems not improper to suggest that those charged with the supervision of banks should at this time advise and caution the banks of the country in the interest of the public welfare, with the view of developing and applying methods which are best adapted to withdrawing from private employment and diverting to public service the vast sums which national necessity demands and which Congress, by its enactments, has authorized the Secretary of the Treasury to borrow or to raise by taxation. In its final analysis, war financing means the furnishing to our government

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of supplies or services for its own use or for the assistance of those governments which are associated with us in the war. These services and supplies are necessary for the winning of the war, and it is just as important that the government secure them as it is that it should procure the funds or credits with which to pay for them. In some respects the American people have not as yet cooperated to a sufficient degree, not because of any lack of patriotism, but because they have not yet been adequately impressed with the imperative necessity for their complete and constant cooperation. They have not yet been thoroughly aroused to the fact that the issue -- success or failure -- our future as a nation, lies in their hands. A great campaign of education, nation-wide in scope, lies ahead of us, and in this campaign the banks of the country have an opportunity to render great service by constituting themselves the leaders of public sentiment. Each bank in its own community ought to make the people understand clearly that the amount of goods or supplies which can be produced is limited, and that in conservation and in the avoidance of waste, as well as by increased production of food stuffs, cotton, wool, lumber, iron and steel products, and all other supplies necessary in the conduct of the war, the people who remain at home have the best opportunity of serving their country. These necessary supplies should be furnished in sufficient quantities and in the shortest possible time, for time is a vital factor. It is of course essential to economize in the use of those things which are required by the government, but by restricting the use of those things which are not required by the government, material may be released which can be used in other ways or shipped to

other countries. As an illustration it may be pointed out that if every family in the United States would use fewer clothes than they would in ordinary times, cotton and woollen goods to the value of millions of dollars could be made available for export, and the proceeds could be used in making purchases of copper in Mexico, hides and wool in Argentina, and of nitrates in Chile. By consuming a smaller amount of goods additional money is saved, which can be used by the people in paying for the war loans of the government. Decreased demand for goods by individuals and purchases of government bonds out of savings rather than by excessive borrowing from banks, will tend to retard a further rise in prices and to restrict expansion of banking credits which necessarily contribute to the rise of prices. The government is the principal customer for farm products and for manufactured articles and there need be no fear of any falling off in demand for staple articles of all kinds as the result of individual economies.

Since the beginning of the war, and more especially since the entry of this country into the war, deposits in banks have increased enormously, but it should be remembered that loans and discounts and investments have increased in an even greater degree. <sup>the country's</sup> ~~our~~ gold holdings in three years have increased more than a billion dollars and are now larger than those of any other country, but at the same time <sup>the</sup> ~~our~~ percentage of gold reserves against deposits and note issues has decreased. These conditions are not unusual in times of war, and to a certain extent they cannot be prevented, but the banks of the country should make it their business to keep these tendencies under control and to prevent too rapid an expansion of credits

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as far as possible, without placing in jeopardy the supreme object of our national effort — the winning of the war. But we should realize that in the accomplishment of this purpose, the conservation of our economic and financial strength is just as important as the augmentation of our military power, and that upon this conservation our military strength depends. Nothing must be used which can be dispensed with. There must be a conservation of credit as well as goods, and credit, generally speaking, should not be used except where it is required for the common welfare, ~~such~~ as in planting crops, the manufacture of necessary articles, or in such construction work as may be essential in bringing about increased production. <sup>Limitation</sup> ~~Contraction~~ of ordinary lines of credit is necessary to make room for the credits required by the government for the purchase of supplies essential for war purposes.

It is hoped that the banks of the country will cooperate along these lines and that they will teach the doctrine of serving and saving. This is not the time for the purchase and sale of luxuries or for carrying large stocks of any kind. There should be fewer and plainer goods carried in stock, for there is no unlimited supply of goods or of credit. This is a time for all establishments, large and small, to reduce inventories, thereby freeing goods and banking credit. It should be urged upon state, city and county authorities, that this is not the time for municipalities to engage in construction work, except perhaps in cases where such work is necessary for the public health, and that instead of engaging in new undertakings, they should rather consider cancelling existing contracts in order

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to release men and material, thereby avoiding competition with the government for man power and for the savings of the people.

It is, of course, inevitable that the war activities of the government will tend to cause a further rapid growth of deposits and loans in banks, and in order to keep our credit structure strong it is necessary that the banks should exert their influence and lend their energies to a more general absorption of government loans by savings, to a contraction of private credits wherever practicable without causing hardship. We must look to the future, and prepare unceasingly for further demands which may be made upon us. The products of the fields, <sup>the forests</sup> the mines, and the manufacturing establishments of the country are not, generally speaking, in the nature of luxuries. They can, as a rule, be classed as necessities, and with the outlook ahead of us there seems to be no possibility of over-production. It seems, therefore, that the banks of the country, from the standpoint of good business as well as from patriotism, should lend their funds and credits freely to those engaged in these productive enterprises, and their power to serve the country in this way will be increased by the curtailment of unnecessary credits and by the adoption by the people generally of a policy of common sense, practical economy.

The Board would call attention also to the very great assistance which it is in the power of the Federal Reserve banks to give to their member banks by rediscounting paper growing out of agricultural, industrial, and commercial transactions. The Federal Reserve Act as amended

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last June provides that state banks admitted to membership may retain all of their statutory and charter powers. Thus state bank members are governed by their own state laws and remain under the supervision of their state banking departments. Their interest rates and the limitations upon their loans are determined entirely by state law. There are not yet members but which are eligible for membership hundreds of good banks throughout the country, and it seems proper to refer here to a statement issued by the President of the United States on October 13th last in which he called attention to the fact that "the extent to which our country can withstand the financial strains for which we must be prepared will depend very largely upon the strength and staying power of the Federal Reserve banks," and in which he urged the importance of developing our banking power to the maximum degree and of providing financial machinery adequate for the very great financial requirements imposed upon our country by reason of the war. He pointed out that all banks should cooperate in strengthening the position of the Federal Reserve system, thereby strengthening the nation's banking power, and urged upon every bank officer and director to consider the question of membership in the Federal Reserve system as a "solemn obligation."

Since the date of the President's statement the banking departments of nearly all of the states have expressed approval of membership in the Federal Reserve system on the part of the banks under their supervision, but the reserve requirements in a few states practically prohibit the cooperation of state banks and trust companies with the Federal Reserve system, making it ~~impracticable~~ <sup>impossible</sup> for them to become members as well as



impossible to exchange their Federal Reserve notes for gold. The Board would suggest to the banks in these states that efforts should be made to obtain such legislative action as may be necessary to enable them to cooperate with the system, and that in those states where the legislatures will not meet for a year or more, the banks might feel justified in asking their governors to convene the legislature in special session.

#### DISCOUNT RATES.

The discount rates of the Federal Reserve banks have an important bearing upon the problems of government financing, and upon the condition of the banks of the country as a whole. Since the first adjustment of discount rates, effective shortly after the organization of the Federal Reserve banks, changes have been comparatively ~~unimportant~~, <sup>infrequent and have been</sup> the most significant ~~having been the establishment at various times of new rates for particular classes of paper.~~ <sup>infrequent and have been</sup> At the beginning of the year 1917, money was ~~an~~ abundant ~~supply~~, and discount rates were low. The expectation of some that the entry of the United States into the war would cause ~~immediate~~ <sup>immediate</sup> ~~basic~~ ~~changes~~ ~~in~~ ~~rates~~ ~~of~~ ~~interest~~, <sup>while</sup> was not realized. <sup>immediately</sup> Market rates have, ~~of course~~, advanced substantially, ~~but~~ the process has been gradual, and there were no changes ~~made~~ in the rates of Federal Reserve banks until the flotation of the first Liberty loan was well under way. Then, in order to facilitate the disposition of the ~~the~~ bonds, the Board indicated to the Federal Reserve banks that it would be desirable to establish preferential rates in favor of notes secured by government

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obligations. With such paper, as with ordinary commercial paper, a distinction was made between short maturities and those running for a longer period. Accordingly, notes of member banks running not longer than fifteen days, and secured by government obligations, were in general, put upon a 3% basis, while 90 day obligations secured in the same way, were given a rate of  $3\frac{1}{2}\%$ , these rates being about one-half of one per cent below the rates fixed for ordinary commercial paper of the same maturities.

Because of the generous cooperation of many banks throughout the country in making advances to purchasers of government bonds at the same rate of interest as that carried by the securities, these bond purchasers have had the full advantage of the facilities afforded by Federal Reserve banks in the rediscount of their notes. A firmer tendency became apparent during the summer at some of the financial centers, and the 4% rate borne by the second Liberty loan (one-half per cent more than the first) suggested the <sup>desirability of</sup> ~~propriety of~~ a general advance of one-half of one per cent in Federal Reserve discount rates. As already stated, this advance has been made, but the differential in favor of paper secured by government obligations is still maintained. The discount schedules have been consolidated and simplified by reducing the number of separate classifications.

In connection with the revision of rates, it was deemed proper to merge with the ordinary commercial rates the special rate which was made in the summer of 1915 for paper secured by warehouse receipts for staple and readily marketable articles of a non-perishable character, known as

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commodity paper. The continuance of this rate, which had been made originally for the purpose of assisting the orderly marketing of crops in order to avoid speculation and violent fluctuations in prices, had become unnecessary because of the great advance in the price of agricultural products, and because <sup>of the policy</sup> of price <sup>control adopted</sup> ~~fixing~~ by the government. Changed conditions made it desirable that these products should move steadily to market, and it seemed best in the circumstances not to encourage <sup>unnecessary</sup> their holding ~~in storage~~ by producers or middle men. Complete tables showing these changes in discount rates, are appended to this report, as Exhibit

EFFECT OF THE AMENDMENTS OF JUNE 21ST.

The amendments to the Federal Reserve Act which became law on June 21st last, were most opportune, as they added greatly to the ability of the Federal Reserve system to assist in meeting the financial requirements of the government, and to exercise ~~the~~ controlling influence in the money markets, just at a time when much larger demands were being made upon it because of war financing. The amendments were substantially those recommended by the Board in its last annual report, and they have opened two new and distinct avenues of added strength, - by making possible greatly increased holdings of gold in the Federal Reserve banks by permitting them to issue Federal Reserve notes in exchange for gold, and by inviting the full cooperation of state banks and trust companies, through more favorable conditions of membership.

The process of issuing notes has been simplified, and the discount power of the banks has been augmented without impairing their actual holdings of gold, by reason of their larger power to issue notes. While it may be true that the character of the Federal Reserve note as contemplated in the original act has been altered to a certain extent, and that these notes may remain outstanding for longer periods of time than had been first intended, the flexible quality of the notes has not been impaired, nor does a large issue of notes of necessity mean expansion of currency. The character of the Federal Reserve note is now best determined by the amount of the gold reserve behind it. When it is issued against gold, it merely takes the place as a circulating medium of the gold for which it was exchanged. As the gold reserve is reduced, commercial paper is deposited to preserve the security, and the note takes on more of the quality which it possessed under the original act, and when the rediscounts of the Federal Reserve banks are reduced, the paper securing the note issues is returned to the makers, and the gold reserves are correspondingly increased, thereby giving outstanding Federal Reserve notes more of the character of gold certificates.

Amendments to the act have also changed the former reserve requirements for member banks by fixing them at 13%, 10%, and 7% for central reserve, reserve city, and country banks respectively, and have, at the same time, strengthened the position of the Federal Reserve banks themselves by requiring the maintenance with them of the member banks' entire reserves in collected funds, the amount <sup>of</sup> vault cash to be carried by a member bank being left to its <sup>own</sup> discretion, as determined by actual needs. This change, together with the expiration of the time limit for the com-

plete transfer of reserves as required by the original act, involved the transfer of a large amount of actual money to the Federal Reserve banks. The termination of the period when funds deposited with banks in reserve cities might be counted as reserve for country banks, would not, for reasons explained in the Board's last annual report, have made necessary any material transfer of cash, but the new reserve requirements led to the shifting of about \$250,000,000 and a corresponding increase in the cash holdings of Federal Reserve banks.

Another amendment included in the act of June 21st, permits nonmember banks to open for exchange or collection purposes, accounts with Federal Reserve banks, thereby availing themselves of the facilities of the check clearing and collection system. This change, at the outset, increased still further the cash holdings of the Federal Reserve banks, as several large nonmember institutions opened accounts of this kind with Federal Reserve banks. Most of these institutions have, however, now become members, so that the balances held by nonmember banks are comparatively negligible, amounting on December 31st to \$                    . <sup>revised</sup> The <sup>correct</sup> gain in <sup>was it really?</sup> actual cash by Federal Reserve banks, ~~as the result of the amendments,~~ <sup>following the amendments</sup> may be best demonstrated by a comparison of their condition on June 1st (three weeks before the amendments were adopted,) with their condition on August 3rd. On the earlier date, the gold and lawful money <sup>held by</sup> in Federal Reserve banks and with Federal Reserve agents, amounted to \$933,425,000, while on the latter date the total was \$1,421,382,000.

#### MEMBERSHIP OF STATE BANKS.

Second only in importance to the change in the reserve and note issue provisions of the law, must be reckoned the amendment to Section 9, under

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which state banks and trust companies may become members of the Federal Reserve system and retain, at the same time, their full charter and statutory privileges. The Board has already given such assurance in its regulations relating to membership of state banks, but there had always been a question in the minds of many as to the validity and permanence of these regulations, in the absence of definite statutory authority. The action of Congress in confirming what the Board had attempted to accomplish by regulation has given state banking institutions firm assurance that they may continue to carry on their business in substantially the same way as they have heretofore done, without fear of future changes in methods prescribed, and it has given them in addition the definite right to withdraw from the system upon six months' notice, subject to conditions which they regard as reasonable. The inducement to the state banks to become members of the system thus held out by the amendment to Section 9 of the Act was further strengthened by an opinion of the Attorney General of the United States rendered on September 10th, in which he expressed the view that this amendment, in reserving to the state banks as members their full statutory and charter powers, released them from the restrictions of Section 9 of the Clayton Act, as to interlocking directors, to which they had been previously held to be subject, in common with the national banks. Just at a time when the principal obstacles which had previously stood in the way of the enlargement of the system by state bank membership were thus overcome by statute and by <sup>authoritative</sup> ~~the~~ legal interpretation, an additional incentive was given the state banks and trust companies to apply for membership in the system by reason of the rapid development

of the government's requirements in war financing, the patriotic desire to assist in meeting and supplying these needs, and an appreciation of the added safety to themselves resulting from membership. Compelling reasons for membership in the system from a patriotic standpoint were brought to the attention of all the banks in a strong statement by the President on <sup>Sept.</sup> October 13th, to which reference has already been made. Under all these influences many of the strongest state banks and trust companies in the United States have filed their applications and have been admitted to membership. At the time of the passage of the Act on June 21st 59 state banks and trust companies were members of the system, but on December 31st membership had been increased to 750. The aggregate capital and surplus of the member state banks and trust companies was on that date \$75,705,530 and aggregate resources ~~in~~ <sup>of</sup> about 5 billion dollars (a) as compared with \$78,491,165 and about \$25 millions on June 21st. It is estimated that the membership of the Federal Reserve system represents at this time about 57% of the total banking assets of the country. Thus it is evident that substantial progress has been made toward the complete unification of our banking system. A table showing the titles, dates of admission, capital and surplus, and aggregate resources of state bank members appears in the appendix.

## CREDIT EXPANSION.

Great as is the admitted power of the Federal Reserve system, equipped with its new resources and supported by the greater part of the banking ~~resources~~ <sup>reserves</sup> of the country, there are nevertheless, limits to its

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capacity. During the past year there have been very naturally some expressions of anxiety on the part of the financial community as to expansion of credits. The Board has fully recognized the dangers of over expansion and has endeavored in every way not hurtful to war financing, to prevent such a condition. The question as to how far expansion has drifted toward the danger point, despite concentration and careful use of our banking resources, should be carefully considered in the development of a sound policy for the future. The following tabulation from combined statements of the twelve Federal Reserve banks shows the changes in the reserve position of the Federal Reserve system during the year, the figures being as of December 31, 1916, April 1, 1917, July 1, August 1, November 1, and December 31, 1917, the four dates last named reflecting the changes directly attributable to the flotation of the Liberty loans:

(Insert table)

From the foregoing it will be noted that the increase in the total invested funds grouped as earning assets, during the months intervening between the beginning and the close of the year 1917 is about \$834,940,000. Of this sum, \_\_\_\_\_ is represented by purchase or discount of commercial paper of the kinds made eligible under the terms of the Federal Reserve Act, the remaining \$273,998,000 representing the discount or purchase by the banks of both member banks' collateral notes and customers' paper secured by government obligations, for the purpose of enabling buyers of bonds to carry them during the period necessary for the liquidation of their own obligations thus incurred. As will be seen from the table, the reduction in the reserve percentages of the Federal Reserve banks against notes and deposits was

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 Federal Reserve Bank of St. Louis  
*also temporary increase in a large extent in Govt Securities, chiefly certificates*



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most marked during the periods between April 1 to July 1 and between August 1 to November 1. During the month of July there was a notable strengthening of the reserve position and this condition is also observed in a smaller degree between November 1 and December 31. Taking the year as a whole, it will be noted that, although there has been a great increase in the total assets of the system, there has been a reduction of gold and lawful money reserves from 0.4% at the beginning, to 63.6% at the end of the year, but it should not be overlooked that the figures for December 31, 1917 represent the condition existing at a time when the process of distributing the second Liberty loan was still uncompleted. The question whether the final distribution of the second Liberty loan and the resulting financial adjustments would bring about as favorable a situation as that which ~~existed~~ <sup>existed</sup> at the closing of the first loan, is still an open one, but indications are that there will be a larger amount of bonds left in the hands of the banks and that a correspondingly greater volume of rediscounts secured by government obligations may remain with the Federal Reserve banks than was the case at the close of the first Liberty loan. This condition will no doubt be gradually improved, but the reduction in the volume of discounts will depend to a great extent upon the requirements of the government and the time which will elapse before the floating of a new bond issue becomes necessary. The position of the banks with respect to credit expansion is shown by the condensed statement of the deposits, loans, discounts, and investments of the national banks as reported to the Comptroller of the Currency on November 20th 1917, as compared with corresponding figures on

changed

November 17, 1917:

	<u>Nov. 17, 1916</u>	<u>Nov. 20, 1917</u>
Deposits, net on which reserve is computed	9,976,980.000	
Loans and discounts, <i>incl. drafts</i>	8,355,101.000	
United States bonds <i>(a)</i>	724,473.000	
Other stocks, bonds, and securities	1747,794.000	

(a) Including Treasury certificates of indebtedness

It seems reasonable to assume that while, during the year 1917, there has been a ~~material~~ lessening of the fluidity and immediate availability of the country's banking resources, the change has really been moderate when there is considered the extent of the requirements which have been made upon our banking system. It is evident also, from an analysis of the figures, that the decrease in reserve strength is ~~hardly~~ *only in a small degree* attributable to commercial discounts but that it is directly the result of government financing and its unavoidable but necessary demands upon our ~~national~~ resources. It is estimated that the advance in commodity prices during the year 1917 *as* shown by the statements of the Department of Labor has been about \_\_\_\_\_%, which may be compared with an estimated advance of about \_\_\_\_\_% from August 1, 1914 to December 31, 1916. It is clear, however, that so far as the year 1917 is concerned, the rise in prices must be attributed more to the relatively decreasing supply of necessary commodities and a greatly increased demand for them because of the war, than to expansion in the volume of currency or bank credits.

*Chapman*

Rising prices are an unavoidable outgrowth of a state of affairs throughout the world whereby a very large proportion of artisans and laborers have been transferred from productive occupations into unproductive and destructive work, no longer performing their functions as producers of raw materials and of manufactured articles, but at the same time increasing their demands upon the remaining stock of the available supplies. It seems, therefore, unjust to ascribe the rise in prices entirely to credit expansion or over-activity on the part of the banks. Nor can the increased volume of the Federal Reserve note issues be regarded as inflationary, for not only are these notes not available as legal reserve in the vaults of member banks, but the withdrawal of gold and gold certificates from circulation which has resulted from the efforts of the Board has naturally created a vacuum which could only be filled by additional issues of currency. It may be asserted with confidence that any danger of undue expansion with which the country may be confronted is likely to manifest itself not in an over-issue of circulating notes, but rather in the increase in bank deposits resulting from loans — the creation of demand credits upon the books of the banks. The danger of currency inflation, the evils of which have been felt in all previous wars of long duration, has not, up to this time, been a menacing one in the United States. The fluid condition of our banking resources and the amount of free gold held by Federal Reserve banks, <sup>should</sup> are factors which should be taken into account when the question of note issues is considered.

#### PRIVATE AND CORPORATE FINANCE.

A feature of the banking and financial situation which has been

developing during the past year, and to which the attention of the Board has been frequently directed, is the position of firms and private corporations having short term obligations maturing in the near future, and who have been accustomed to procure banking accommodations upon terms which are now impossible. The action of the President in taking over control of the railroads and of their financing has apparently solved the most serious problem with which the country had been confronted, but there remains to be considered the requirements of various public utilities corporations, as well as of some of the larger concerns which have been accustomed to borrow heavily at banks for the purpose of carrying large stocks or of providing themselves with working capital. The effect of public borrowing on a very large scale has been a withdrawal from the market of a large proportion of the funds available for short term loans, or for private investment on long term. While every effort has been made to transfer government obligations speedily and effectively to private ownership, in order to withdraw them from the market, and to prevent their accumulating in the portfolios of the banks, it is nevertheless true that during the process of distribution, large amounts are necessarily carried by the banks for their account, as well as for their customers.

The influence thus exerted upon the loan and investment market is necessarily incidental to operations of this kind. The resulting situation is more or less inconvenient for all who have been accustomed to resort to banks for loans on collateral, but it is particularly distressing to the

larger borrowers. The situation has been further complicated by the comparatively large volume of obligations of foreign governments which are being carried by the banks against short term notes, resulting in a diminution of their percentage of liquid assets. These conditions are reflected in the requests which the Board has for some time past received, from many quarters that the rediscount privilege be extended to paper of a character and form which has not been regarded hitherto as eligible.

Perhaps the most urgent request of this kind has been that the Board permit Federal Reserve banks to discount notes or acceptances which have been placed upon the market under an agreement between the borrowers and their bankers, which provides for a considerable number of successive renewals. Had the Board permitted such paper to be rediscounted, Federal Reserve banks would have been burdened with paper which the makers would not expect to liquidate at maturity. The discount of paper based upon an agreement for repeated renewals is not consistent with the underlying principles of the Federal Reserve Act, and the Board has had no hesitation in stating that it does not regard paper subject to these agreements as a desirable investment for Federal Reserve banks. The Board's attitude does not imply any doubt or question of the legitimacy of the purposes for which the funds were desired, or of the inherent soundness of the paper itself, but rather that such transactions are not a kind which Federal Reserve banks may properly facilitate, as they should never overlook their obligation to preserve the liquid character of their assets.

Another proposition of a somewhat similar character which contemplated the sale of acceptances designed to finance foreign purchases of goods in

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the United States, but which had no connection with any specific transaction, was likewise brought to the attention of the Board during the month of November; and for reasons similar to those governing the case of the renewal paper, to which reference has just been made, the Board has found itself unable to look upon such acceptances as eligible for discount at Federal Reserve banks. Another case involving the eligibility of acceptances secured by readily marketable commodities carried in warehouses, was also taken under consideration, and the Board reached the conclusion that acceptances of this kind might be eligible for discount or purchase by Federal Reserve banks, provided the goods were stored in a satisfactory manner, and unquestioned legal title of the property conveyed by the warehouse receipts. While this conclusion is in harmony with the letter of the Federal Reserve Act, it seems, nevertheless, that discounts of paper of this character should be scrutinized closely and that they should not be permitted in very large volume.

The significance of these propositions is that there is pressure on the part of commercial and manufacturing enterprises to gain access to the rediscount facilities of the Federal Reserve banks, and there is evidently a disposition to obtain the privilege upon the terms of technical points of the law rather than its spirit. The policy of the Board, however, must invariably be to interpret and apply the law in accordance with its manifest intent and underlying principles, with the end in view always

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of safeguarding and maintaining the liquid character of the assets of the Federal Reserve banks/ This duty, always present, has become imperative because of the fact that the entire reserves of the member banks, so far as based upon legal requirements, are now, by the act of June 21, 1917, carried on the books of the Federal Reserve banks. Upon these banks, and upon the Federal Reserve Board, therefore, falls the responsibility for the maintenance of a liquid condition, and upon them will justly fall censure for any improper or imprudent use of these reserve funds which are held under a trusteeship of the highest character.

Therefore, in no circumstances, can the Board admit the eligibility of paper by whomever made which, in its essential character, fails to conform to sound banking principles and to the provisions of the Federal Reserve Act. In making this statement of its attitude, however, the Board does not ignore or overlook the very serious problems which now confront private enterprises of providing for their financial requirements. From statistics which have been obtained by the Board, it is evident that there will mature during the year 1918, short term obligations aggregating a large amount, and the Board has no information, up to this time, as to arrangements for their liquidation or renewal.

Reference has already been made to the position of the savings banks and other investment institutions in general. Undoubtedly some effective measure of relief is desirable and if made available will be of great benefit not only to these requiring funds for comparatively long periods, but would also improve indirectly the general banking situation. The

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resulting problem is one which may perhaps come within the scope of the Board's advisory relationship, but it is not one which can be dealt with by the Board in an administrative way. From a purely advisory standpoint, the Board would suggest the propriety of dealing with this situation through direct governmental aid in some form approved by the Secretary of the Treasury. The Board is, moreover, of the opinion that any plan involving governmental aid is preferable to one which would be dependent upon the use of the resources of the Federal Reserve banks. Such an expedient would be justified, if at all, only after all other means had failed, and as a final and desperate ~~effort~~ resort at a time of the most urgent national necessity. It is particularly recommended also, that any plan which may be adopted for the relief of those desiring long time accommodations upon security of a non-liquid character, should not be made to depend for its success upon any access direct or indirect to the resources of the Federal Reserve banks, or upon the power to issue currency for the purpose of extending credits of this character. It ought to be possible to extend effective aid to those deserving it without jeopardizing our entire financial structure.

#### CONSERVATION OF GOLD.

The entry of the country into the war was accompanied almost immediately by a cessation of the movement of gold to this country which had been continuous since the early months of the year 1915, and in fact the movement had begun to slacken as early as November 1916. Foreign governments had found it convenient to liquidate their obligations due in other countries by purchase of bills in our own markets, and while the aggregate



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trade balance has continued in favor of this country, the balance is against us in some cases. During the second quarter of the year there developed a strong tendency to withdraw gold by those neutrals whose supplies of raw materials had been drawn upon by our own government and by other governments associated with us in the war, and during the months of June, July, and August, our net loss of gold amounted to about \$100,000,000. The movement of gold having already been restricted in all of the belligerent ~~nations~~ countries, demands for it in settling international accounts, in adjusting exchange rates, and in strengthening reserves, were naturally made in our own markets. As the movement began to assume larger proportions, the President, on September 7th, issued an executive order, attached hereto as Exhibit\_\_\_, vesting in the Federal Reserve Board, with the approval of the Secretary of the Treasury, the duty of passing upon applications for shipment of coin, bullion, or currency. Acting in conjunction with a representative of the Treasury Department, the Board issued regulations covering the licensing of such shipments, and has since held daily sittings for the purpose of considering applications. It became manifest almost immediately that applications for permission to export gold fell into a few distinct classifications. Applications for permission to ship gold to European neutral countries have, except for a few days following the date of the order, been invariably declined, for obvious reasons which it does not seem necessary to enumerate. A different problem however, presented itself in the case of applications for shipments of gold to the Orient, to Mexico, and to South American countries which had been furnishing necessary raw materials. It was

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deemed important to continue these trade relationships while reducing shipments of gold to a minimum. For a short time large shipments were permitted to go to India, but as a result of negotiations between the Treasury Department and representatives of the British government, provision has been made for rupee exchange resulting from shipments of silver, to be allotted by Federal Reserve banks to importers according to their necessities. In a few cases shipments of gold are being permitted to South American countries, although it is hoped that arrangements can be concluded at an early date which will obviate the necessity of making further shipments in any considerable volume. The Mexican government issued a decree on September ~~7th~~ 27th which requires the payment of export and import duties in gold, the return in gold of the full value of gold ores and bullion exported from Mexico, and the return in gold of 25% of the value of silver ores exported. For a time it was necessary to permit some shipments of gold for payroll purposes, in mining operations controlled by citizens of the United States, and where the products were brought into this country. More recently, however, it has been the policy of the Board to decline to permit exportation of gold to Mexico except for payment of duties, and for the return to Mexico of the value of metallic brought into this country. It has been ascertained that in many instances United States currency can be used in Mexico for payroll purposes, and that in cases where it cannot be used, Mexican gold can usually be purchased. The total amount of gold shipments to various countries which have been authorized since September 7th appears as Exhibit \_\_\_\_\_. Before the executive order was issued, considerable sums

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of gold had been earmarked ~~for~~ or held in trust for Canadian banks by some of the banks in New York City. The Board has deemed it proper to permit the exportation of this earmarked gold, and has also entered into an agreement with Canadian bankers whereby a total of \$25,000,000 of gold may be released up to July 1, 1918. This action was deemed essential in order to finance the movement of Canadian crops which were needed for export to European countries associated with us in the war, and its effect upon sentiment was so favorable that no part of the amount has so far been withdrawn, New York exchange in Canada having now advanced to a considerable premium.

Foreign exchange rates have been abnormal throughout the year and in many of the countries which send us necessary material, American bills are at a heavy discount. The Board is making a close study of our trade relationships with neutral countries and has been fortunate in securing the services of Mr. Frederick I. Kent, of New York as its foreign exchange advisor.

(Statement by Kent)

(Make reference here to the new order which the President is expected to issue giving the Board authority to issue licenses in foreign exchange transactions.)

#### CLEARING AND COLLECTION.

The volume of checks handled by the Federal Reserve banks during the year has increased enormously, although there has been no material addition to the number of nonmember banks which remit at par to Federal Reserve banks. Section 13 of the Act was amended last June as recommended by

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the Board, so as to allow Federal Reserve banks to receive accounts for collection and exchange purposes from such nonmember banks and trust companies as may agree to remit to Federal Reserve banks at par for checks drawn upon themselves and which will, in addition, maintain balances with the Federal Reserve bank sufficient to offset the items in transit held for their account by the Federal Reserve bank. Comparatively few nonmember banks have, however, availed themselves of this privilege, and the Federal Reserve banks are still unable to collect checks drawn on many nonmember banks except at heavy expense. An effort was made, on behalf of some of the banks to amend the Act by providing for a standardized exchange charge not to exceed one-tenth of one per cent, to be made by member banks against Federal Reserve banks for checks sent for collection. It was not successful, and the Act as finally amended provides that a member or nonmember bank may make reasonable charges, to be determined and regulated by the Federal Reserve Board, but in no case to exceed ten cents per hundred dollars or fraction thereof, based on the total of checks and drafts presented at any one time, for collection or payment of checks and drafts and remission therefor by exchange or otherwise; but no such charges shall be made against the Federal Reserve banks. The Attorney General has been requested to give his opinion as to whether this proviso applies to nonmember banks. ~~xxx~~ An affirmative opinion will make possible the establishment of an universal par clearing system, but if, on the contrary, it should be held that it applies to member banks only, the further development of the collection system will necessarily be slow. It seems unfair that small member banks should be obliged to remit at par while their nonmember bank competitors can continue

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to make their usual charges. The Board feels that all banking institutions should be obliged to remit at par or else that they should all be permitted to make reasonable charges.

In order to complete as far as possible the clearing and collection system, and to render all possible service to the banks and to their customers, the Board authorized the Federal Reserve banks on July 1st, to receive for collection for account of member banks maturing notes and bills, and miscellaneous drafts, subject to a moderate collection charge. Consequently, member banks which were obliged to rely upon other banks for services of this kind, can now depend upon the Federal Reserve banks for such service. There has also been put into operation by all Federal Reserve banks a system of transfer drafts, which enables any member bank to have its drafts, drawn upon the Federal Reserve bank of its own district, paid immediately, without time allowance or deduction at any other Federal Reserve bank, adjustments between the respective Federal Reserve banks being made through the gold settlement fund. In this way, any member bank has, under the proper and necessary restrictions provided, the same exchange facilities it would have by carrying accounts in each of the twelve Federal reserve cities.

#### GOLD SETTLEMENT FUND

The operation of this fund has been described, in former reports of the Board, and no extended comments upon it seem necessary at this time. Under the act as amended additional safeguards have been thrown around the fund by permitting the Treasurer of the United States to carry a special account upon his books to the credit of the Federal Reserve Board as agent.

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for the respective Federal Reserve banks and Federal Reserve agents. Settlements are now made by warrant, signed by officials of the Board, and the practice of issuing gold order certificates in denominations of \$10,000, representing gold deposited with the Treasurer by Federal Reserve banks, and which were held in the custody of the Federal Reserve Board pending transfers between the banks and the Treasury, has been discontinued.

The operation of this fund, which is in effect a clearing house between the twelve Federal Reserve banks, has been particularly useful during the past year by reason of the continuous transfers for very large amounts which have grown out of the sale of government bonds and Treasury certificates and the redistribution and disbursement of the funds realized. Without such an arrangement, our own operations would have been accompanied with great expense and much inconvenience, but by its aid, transfers have been instantaneous and automatic, and have been made without the inconvenience and expense which would have been unavoidable had physical transfers or shipments of money been necessary.

#### BRANCHES OF FEDERAL RESERVE BANKS.

During the year, branches have been established at Omaha, by the Federal Reserve Bank of Kansas City, at Louisville by the Federal Reserve Bank of St. Louis, and at Portland, Oregon, Seattle and Spokane, Washington, by the Federal Reserve Bank of San Francisco, and are in satisfactory operation. The Board has, in addition, authorized the establishment of branches at Pittsburgh, and Cincinnati by the Federal Reserve Bank of Cleveland; at Detroit by the Federal Reserve Bank of Chicago; at Baltimore by the Federal Reserve Bank of Richmond, and at Denver by the Federal

Reserve bank of Kansas City. It is expected that all of these branches will begin business during the months of January or February.

Questions relating to the establishment and operation of branch banks have been simplified by the amendment to Section 3 of the Federal Reserve Act. As originally enacted, this section provided that each Federal Reserve bank "shall establish branch banks" to be "operated by a board of directors under rules and regulations approved by the Federal Reserve Board," and provided also that there be seven directors and that they should possess the same qualifications as directors of Federal Reserve banks. The Section as now amended provides that the Federal Reserve Board may permit or require any Federal Reserve bank to establish branches within its district, and that such branches, subject to such rules and regulations as the Federal Reserve Board may prescribe, shall be operated under the supervision of a board of directors to consist of not more than seven or less than three directors, of whom a majority shall of one shall be appointed by the Federal Reserve bank of the district, and the remaining directors by the Federal Reserve Board.

The <sup>policy</sup> of the Board in the establishment of these new branches, has been to recognize the unity and paramount responsibility of the Federal Reserve bank, while extending to the banks in the territory served by the branch full facilities. By avoiding duplications in bookkeeping, and by a consolidated control of accounts at the Federal Reserve bank, it is believed that branches can be operated at a comparatively small expense.

The branch of the Federal Reserve Bank of Atlanta, at New Orleans, which<sup>date</sup> at the of the Board's last annual report, was the only one in

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operation, has, during the past year, again demonstrated its usefulness and has been, or soon will be, supplemented by the ten just referred to.

#### INTERLOCKING DIRECTORATES.

In its report for the year 1916, the Board gave full details of its work in the application of the provisions of Section 8 of the Clayton Act and the Kern amendment thereto. During the year 1917, \_\_\_\_\_ applications were received for permission to serve as joint directors, and of this number \_\_\_\_\_ have been granted, and \_\_\_\_\_ have been refused.

#### FIDUCIARY POWERS.

On June 11, 1917, the Supreme Court of the United States handed down its decision in the case of Bank vs Fellows\*, appealed from the Supreme court of Michigan, which was referred to in the Board's last annual report to Congress. The lower court was reversed, and the court sustained the constitutionality of Section 11 (k) of the Federal Reserve Act which authorizes the Federal Reserve Board "to grant by special permit to national banks applying therefor when not in contravention of state or local law the right to act as trustee, executor, administrator, and registrar of stocks and bonds under such rules and regulations as the said Board may prescribe." The decision in this case is of far-reaching and vital importance to the Federal Reserve system in that it not only sustains the right of Congress to vest in national banks the powers enumerated in Section 11 (k), but fully recognizes the right of Congress to grant to such banks any and all powers that are necessary to enable them to meet the competition of corporations organized under state law.

\* First National Bank of Bay City, v Grant Fellows, Attorney General, and others.



Prior to this decision the Federal Reserve Board had granted permits to applicant banks except in those cases where the laws of the state in which the bank was located expressly or by necessary implication prohibited such banks from exercising these powers. The language of the court, in the decision handed down on June 11th, was apparently susceptible of the interpretation that these permits might be granted in any case in which the state laws permitted competing banks to exercise such powers. In view of its importance the matter was referred to the Attorney General who reached the conclusion that while Congress is fully empowered to authorize the Board to grant permits under such circumstances, the Act as it now stands does not vest this authority in the Board. There are some states, which authorize banks or trust companies created and organized under their own laws to exercise such powers but which expressly prohibit any other corporations from doing so. In order to coordinate the powers of national with state banks it is recommended that section 11 (k), should be amended so as to permit the granting of these powers to national banks in any case in which the competing corporation organized under state laws are permitted to exercise such powers.

By direction of the Board its counsel, with the consent of the Court, took part in the proceedings both in the Supreme Court of Michigan and on appeal before the Supreme Court of the United States. The Board has granted during the year 1917, 112 permits for the exercise of fiduciary powers, making a total to date of 481.

#### EARNINGS AND EXPENSES.

The rediscount demands which have been made upon the Federal Reserve banks during the past year, and the greater employment of their funds, have been reflected in very greatly increased earnings. The combined net earnings

of the twelve banks for the year, were at the rate of \_\_\_\_\_% on the aggregate capital, and the total net earnings for the entire year were \_\_\_\_\_.

Section 7 of the act provides that "after all necessary expenses of a Federal Reserve bank have been paid or provided for, the stockholders shall be entitled to receive an annual dividend of six per centum on the paid-in capital stock, which dividend shall be cumulative. After the aforesaid dividend claims have been fully met, all the net earnings shall be paid to the United States as a franchise tax, except that one-half of such net earnings shall be paid into a surplus fund until it shall amount to forty per centum of the paid-in capital stock of such bank."

The Board construes the foregoing as meaning that no contingent funds can be set up against future expenditures or as a reserve for unforeseen losses, but that the surplus fund which, under the law, can accumulate until it reaches forty per centum of the capital of the Federal Reserve bank, is intended to take care of all such contingencies. The Board has, however, advised the banks that provision for apparent or temporary depreciation in securities should be made, before any sum is transferred to surplus account or any payment is made to the United States government. It has also permitted banks to charge off furniture and fixture accounts in full, and a reasonable proportion of the cost of vaults. It has authorized the writing off of the amounts actually paid for the printing of Federal Reserve notes, whether the notes have been put in circulation by the bank or held by the Federal Reserve agent. It has also authorized those banks which own their premises to write off five per cent of the total cost per annum as a depreciation allowance. The gross and net earnings of all the banks for the calendar year 1917, and the dividends declared by them from the date of their organization to the end of 1917, are shown in the following table:

not 4/6/17  
available

(Insert table -- See page 13 annual report 1916)

It will be seen from the foregoing that the Federal Reserve Bank of San Francisco <sup>and St. Louis</sup> has paid its accumulated dividends up to December 31, 1916, and that five others - the Federal Reserve banks of Philadelphia, ~~St. Louis~~, Kansas City, Cleveland, and Dallas, have paid their accumulated dividends up to June 30, 1917, and that six banks, those of Boston, New York, Richmond, Atlanta, Chicago, and Minneapolis, have paid all accumulated dividends to the end of 1917. These banks, after charging off their expenses and making the depreciation allowances, which have been previously described, have set aside surplus funds and have paid equal amounts to the government as a franchise tax, making the total return to the government \$ 1,134,284.

The Board wishes to repeat the statements made in previous reports that the banks are not operated primarily for profit, but in meeting the demands which are expected to be made upon them during the coming year their earnings will undoubtedly continue to be large. It is expected that all accumulated dividends will be paid during the year, and that the excess to be paid to the government as a franchise tax, at the beginning of 1919, will be very much greater than the payment which has just been made.

#### ADMINISTRATIVE POLICIES.

During the period of organization and of development which extended over the first two years of the operation of the system, the Board deemed it advantageous to obtain frequent suggestions from the officials of the Federal Reserve banks, and to have them confer with each other in order that

definite understandings might be reached, and uniform methods of operation determined upon. Many of the problems which had to be worked out were entirely new, and because of widely different conditions in the various districts, frequent consultations seemed necessary to ensure a better knowledge of administrative details. Thus frequent conferences with the Federal Reserve agents and governors of the banks, were deemed advisable, in order to secure more speedily an effective organization. The banks had, however, by the end of the year 1916, become well established, and having had two years of actual experience to guide them in the future conduct of their business, these frequent conferences gave become no longer necessary.

The Federal Advisory Council, composed of twelve members, chosen by and representative of the Federal Reserve banks, has held, in conformity with the requirements of Section 4 of the Act, four meetings during the year, thus giving the Board at frequent intervals the benefit of its views as to the trend of the money market, and the proper adjustment of discount rates. Members of the Council have reported also upon the general financial, agricultural, commercial and industrial conditions in their respective districts.

There have been no meetings of the Federal Reserve agents during the year, but the Board, in anticipation of the first Liberty bond campaign, held a meeting with the governors of the Federal Reserve banks in April, and requested them to confer with it, in Washington, again in November. The activities of the year have been so great as to require the constant presence of the executive officers at their banks. The Board now exercises broader administrative functions, and makes final decisions on all questions

of policy calling for prompt action, without awaiting an opportunity for consultation and development of opinion on matters of detail, as has been customary in the beginning. The functions of the Board as the co-ordinating body for all the banks, and as the directors of the Federal Reserve system, <sup>are now</sup> well defined, and the line of distinction between the local management of the banks and their operation as a system, has become more clearly marked. The Board has, on two occasions during the year, exercised its power of requiring Federal Reserve banks to make rediscounts for other Federal Reserve banks without submitting the question to their directors for determination. This has been done for the sake of greater ~~promptness~~ promptness and efficiency in securing the adjustments desired, and not because there was any doubt about favorable action being taken upon the suggestions of the Board, as the banks have all responded promptly in cases where the Board has made its wishes known.

#### RESERVE CITIES.

The Federal Reserve Act confers authority upon the Federal Reserve Board to add to the number of cities classified as reserve and central reserve cities, or to reclassify existing reserve and central reserve cities or to terminate their designation as such. As the reserves of member banks are now carried exclusively with the Federal Reserve banks, the designation of any city as a reserve city relates ~~in~~ only to the percentage of reserve which must be carried by the member banks located therein. The Board has retained the old classification of central reserve and reserve cities, and has also designated as reserve cities, making the banks therein subject to

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increased reserve requirements, the cities of Buffalo, N. Y., ~~and~~  
*Grand Rapids, Mich. Springfield, Tenn; Cleveland, Ill; Harris, Ill*  
*Flake, O; Ogden, Utah;* (Insert balance)

The cities so designated all have a population in excess of 100,000 and are banking centers. Without this classification, the banks in those cities would have continued to carry the reserve prescribed for country banks - 7%, and the Board deemed it equitable to bring their reserves up to the requirements of other cities of their class. The three central reserve cities under the old national banking laws - New York, Chicago, and St. Louis, have been continued in that classification, and the member banks of those cities are required to carry the maximum reserve of 13%. Philadelphia and Boston, although important banking centers, and each having a greater population than the city of St. Louis, continue to be classified as reserve cities, and reserves of 10% only are required of the banks located therein. It is difficult to make an equitable and uniform adjustment of reserves under the present law, and the Board is making a careful study of the subject, with a view of recommending to Congress at a later date a change in the law which would provide for a differential in ~~reserves~~ reserves to be carried in all towns and cities alike upon certain classes of deposits, with a minimum for time deposits, a maximum ~~for~~ bank deposits, and an intermediate figure, to be determined upon, for individual or commercial deposits subject to check. This is a matter however, which will require careful study and analysis, and the Board is not prepared as yet to make a recommendation for any change in the reserve requirements.

SUGGESTIONS FOR AMENDMENTS.

The Board sees no occasion at this time for any sweeping changes in the Act. It would suggest, however, the following for the consideration of Congress:

(1) An amendment of Section 4 relating to the election of directors.

The law provides that the member banks shall be classified into three general groups or divisions, each group to contain as nearly as may be one-third of the aggregate number of member banks of the district, and to consist as nearly as possible of banks of small capitalization, and that each member bank shall elect by ballot a district reserve elector and shall certify his name to the chairman of the board of directors of the Federal Reserve bank of the district, who shall make lists of the district reserve electors thus named by banks in the three groups and shall transmit one list to each elector in the group. Each member bank is permitted to nominate to the chairman one candidate for a director of Class A and one candidate for director of Class B. Candidates so nominated are listed by the chairman and a copy of the list is furnished by him to each elector, who, within fifteen days after the receipt of the list certifies to the chairman a second or other choice of directors of Class A and Class B respectively, upon a preferential ballot. Any candidate having a majority of all votes cast in the column of the first choice is declared elected and if no candidate have a majority of all the first choice votes, then there is added the votes cast by the electors for such candidates in the second choice column. Any candidate having a majority of the electors' vote by adding together the first and second choices, is declared elected. Should no candidate have a majority

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in this way, then the third choice votes are added. This system, which is designed to secure a representative board of directors, is complicated and has resulted in many cases in the choice of directors by a very small minority of the banks. A majority of the banks has never since 1914 chosen a district elector and there seems to be no reason why the directors of the banks should not be permitted to authorize the President or Cashier of the bank to cast the vote of the bank. The Board has ruled that electors once chosen may continue to serve until their successors are elected, but since the first year the banks have not as a rule participated fully in these elections. In the election held in December 1917 by the various groups in the respective districts, in nearly every case less than one-half of the banks participated. In the New York district 84 votes were cast out of a total of 224; in the Richmond district 72 out of 172; in the Atlanta district 66 out of 140; in the Chicago district 86 out of 360; in the St. Louis district 35 out of 162; in the Minneapolis district 45 out of 283; in the Dallas district 15 out of 201; in the San Francisco district 71 out of 178; and in one instance the successful candidate was chosen by 15 votes out of a total of 201, and in another by 28 votes out of 162.

The Board would suggest that this section be changed so as to simplify elections by permitting each bank through its President or Cashier to cast one vote for director regardless of its capitalization, and by providing that one additional vote may be cast by a bank for each \$10,000 of stock held by it in the Federal Reserve bank, the total number of votes cast by any bank not to exceed ten. It is also suggested that the banks be permitted to elect three Class B directors, but only two Class A directors, and that one Class A director



be appointed by the Board in addition to the three Class C directors now appointed by it. The member banks would still elect a majority of the Board, five against four appointed by the Federal Reserve Board, which in being permitted to appoint the third Class A director, would have an opportunity of rectifying any inequalities which might result from the election by the member banks.

(2) An amendment to Section 9 to permit state banks already in operation, having an aggregate capital and surplus of not less than \$100,000 to become members of the Federal Reserve system at the discretion of the Federal Reserve Board. This section as it is now written requires that no applying bank should be admitted to membership in a Federal Reserve bank unless it possesses a paid-up and unimpaired capital sufficient to entitle it to become a national banking association in the place where it is situated under the provisions of the national bank Act.

The attention of the Board has been directed, in many cases, to state banks otherwise eligible for membership, which cannot apply because of this restriction, and which do not feel warranted in asking their stockholders to increase their capital to the requisite amount. There are several national banks located in towns or cities whose population has been greatly increased by annexations or otherwise, which are now operating with a smaller capital than would be required of new banks in these cities, under charters granted before this increase in population took place, and the Board does not believe that any injustice would be done by modifying this section in the manner suggested so as to be applicable only to existing banks.

(3) An amendment to Section 9 to authorize mutual savings banks having no capital stock, to become associate members of the Federal Reserve system under certain prescribed conditions. This was suggested by the Board in its annual report for the year 1916, and its consideration at this time seems more important than was the case a year ago, as many savings banks now have eligible paper in the form of notes secured by obligations of the United States. The principal beneficiaries would be the mutual savings banks of the Eastern and New England states which cannot become members of the Federal Reserve system under the present law because of the lack of any provision enabling them to subscribe to capital stock in a Federal Reserve bank, as they have no capitalization of their own upon which a percentage could be based. The accommodation proposed limits mutual savings banks strictly to the discount of customers' notes secured by notes or bonds of the United States maturing within thirty days, or of their own promissory notes secured in like manner running not longer than fifteen days.

(4) An amendment of Section 16 which now permits Federal Reserve notes to be issued in denominations of \$5, \$10, \$20, \$50, and \$100 only, so as to permit their issue in the larger denominations of \$500, \$1,000, \$5,000, and \$10,000. It is thought that such an amendment would tend to increase the gold holdings of the Federal Reserve banks, particularly those in the larger financial centers. The Federal Reserve banks receive gold at the present time chiefly from two sources: by registered mail or express from national or state banks, and over the counter in cases where now currency in convenient denominations is required for payrolls or for other purposes. All avenues for loss of gold are now under control except

direct withdrawals over the counter, and an analysis of counter transactions at some of the larger Federal Reserve banks discloses the fact that from \$100,000 to \$1,000,000 of gold certificates are paid out every business day mainly because many member banks prefer to keep as part of their vault money notes of large denominations which can now be furnished only in the form of gold certificates.

(5) An amendment of Section 22. This is a penal section, not altogether definite in its terms, and the Board is constantly receiving requests for a proper construction of it. It has, however, uniformly adhered to the view that a section of this character can be construed only by the courts, and has declined in all cases to express any opinion as to the liability which might be incurred by any bank which acted upon an incorrect interpretation. As amended on June 21st this section permits transactions relating to the discount of notes, drafts, or bills of exchange by a director with his own bank, upon the affirmative vote or written consent of at least a majority of the board of directors of the bank; but there are other transactions such as the purchase by directors of goods or property taken by the bank for debt, which might well be permitted under the same conditions. It is not inconceivable that there may be occasions where a bank can best save itself from loss by being permitted to have a transaction of this kind with one of its own directors.

(6) An amendment to Section 25 to provide for the Federal incorporation of banking corporations whose stock is owned by national banks which operate under the control of the Federal Reserve banks and which are engaged solely in international and foreign banking. The present law permits any national

bank to invest an amount not exceeding in the aggregate ten per centum of its paid in capital stock and surplus in the stock of one or more banks or corporations chartered or incorporated under the laws of the United States or any state thereof, and principally engaged in international or foreign banking, or banking in a dependency or insular possession of the United States. This language appears to indicate an intention by Congress to permit incorporation under the laws of the United States, and several national banks have become stockholders in banks which have been organized under state laws for the purpose of carrying on a foreign banking business in accordance with the terms of this section. The arguments in favor of Federal incorporation are:

(1) The time will probably come when the conflict of the dual control exercised by the Federal Reserve Board and by the banking department of a state may be a matter of embarrassment or unduly restrict the activities of the banking corporation.

(2) Such a banking corporation, being essentially a national enterprise, whose stock ownership by national banks was authorized by an act of Congress, is subjected to unfavorable comment by foreigners, in that it is incorporated under local rather than national laws.

(7) An amendment to Sections 5208 and 5209 of the Revised Statutes. These are penal sections relating to the overcertification of checks, to embezzlement, abstraction or wilful misapplication of moneys, funds, or credits of national banks by officers, directors, agents, or employes of national banks, and to false entries in books, reports, or statements of national banks with intent to injure or defraud on the part of any officer, director, agent or employe of a national bank. It is suggested that these sections be

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amended so as to apply to similar acts committed by officers, directors, agents, or employes of Federal Reserve banks and member banks.

#### ORGANIZATION, STAFF, AND EXPENDITURES.

There have been no changes in the organization of the Board during the past year. The growth of the system and the expansion of the work of the Board have required some additions to its clerical and examining force. There have been some minor changes due mainly to the fact that several of the Board's staff have engaged in military service, but the Board has thus far been able to fill their places satisfactorily. There are now \_\_\_\_\_ on the staff of the Board. The total cost of conducting its work during the year 1917, including ~~printing~~ printing of the Bulletin and salaries of members, was \$ \_\_\_\_\_, which was defrayed by assessments levied upon the Federal Reserve banks amounting to ~~xxxxxxx~~ \_\_\_\_\_ % of their capital. The volume of clearings through the gold settlement fund has greatly increased, the total during the year having amounted to \$ \_\_\_\_\_ as compared with \$ \_\_\_\_\_ during 1916. The cost of operating the gold settlement fund for the year 1917 was \$ \_\_\_\_\_ as compared with \$ \_\_\_\_\_ in 1916, the net cost being \_\_\_\_\_ cents per \$1,000 as against \_\_\_\_\_ cents the previous year. The net balances, representing the change of ownership between the Federal Reserve banks of gold held in the fund were \$ \_\_\_\_\_, which represents the amount of currency or coin which would, without the facilities of the gold settlement fund, have been transported between the banks. Further details relating to the operation of the Federal Reserve banks and of the system, will appear as exhibits in the appendix of this report, as will the annual reports of the Federal Reserve agents.