FEDERAL RESERVE BOARD

WASHINGTON

March 30, 1918. X-855

Dear Sir:

You will doubtless remember that at the conference last Saturday there was some discussion as to the proper method of distribution among the Federal reserve banks of bills and acceptances bought by the Federal Reserve Bank of New York, and attention was called to the probability that the New York Bank would like to dispose of a block of these acceptances during the present week.

A statement of the reserve position of the various banks was read and the suggestion that the amount be distributed among the six or seven banks having the highest reserve was readily acceded to, and it seemed to be the general sentiment that 4¼% would be a fair rate. The question, however, was not discussed as fully as would doubtless have been the case had Governor Strong been present. Members of the Board, having in mind recent transactions where two Federal reserve banks sold acceptances at a 4¼% rate, and feeling that after all the rate was of no material consequence in view of the excess earnings now being made by all the banks, did not press this matter of rate for discussion as fully as they might otherwise have done, and the Governors of the banks interested in the arrangement left with the feeling that the paper would be offered them at a 4¼% rate.

It has developed since, however, that this rate was not entirely satisfactory to Governor Strong and the directors of the Federal Reserve Bank of New York, and the Board understands that sales by that bank have been made on the basis of 4% up to 60 days and 4-1/8% from 60 to 90 days. The Board wishes to call your attention to the fact that for a considerable period of time, -- probably during more than two years following the establishment of the Federal reserve banks, when there was only a negligible demand for rediscounts and the earnings of the banks were small, -- the Federal Reserve Bank of New York very generously gave all other Federal reserve banks an opportunity of participating in the New York bill market by making allotments to the other banks of bills purchased by it. It is true that the Federal Reserve Bank of New York was allowed a commission of 1/8 of 1% for its services, but this did not by any means cover the loss of income that it sustained through its policy of dividing its purchases with the other Federal reserve banks. As a result, during all this time, it was able to take advantage of its local market to not more than 20% of the purchases made. The bank's policy was inspired entirely by a desire to be of service to the whole system, and the other Federal reserve banks were able to make much larger earnings than would have been the case had they been compelled to rely upon strictly local discounts.

Since the entry of the United States into the war, conditions have radically changed. The Government is constantly in the market for funds, and reserve banks generally have withdrawn from the old arrangement and now make only occasional purchasesof bills in New York; and Governor Strong advises the Board that the directors of the Federal Reserve Bank of New York feel that the disadvantage under which the bank operates in this respect is sufficiently important to justify a better understanding than now exists. He points out that the New York Bank is not able to take advantage of its own market when it is obviously to its interest to do so, but that it must carry the entire burden of the New York market when it isto the apparent advantage of the other Federal Reserve banks to withdraw, although their reserve positions may be much stronger than that of the New York bank. It hardly seems fair that by withdrawing from the market and awaiting a distribution of the bills purchased by the Federal Reserve Bank of New York under the provisions of the Act which enable the Federal Reserve Board to regulate rediscounts between the respective Federal Reserve banks, that those banks which have withdrawn should be able to get bills at better rates than would have been the case had they participated in the purchase originally. Furthermore, the New York bill and acceptance market is a very important factor and it is essential that it should be sustained. As the control of this market by the Federal Reserve Bank of New York in the early days of the system redounded to the advantage of all the other Federal reserve banks by reason of the allotment policy adopted, it seems that all Federal reserve banks should cooperate with the Federal Reserve Bank of New York in sustaining the market now, and without insisting on endorsements where they were willing heretofore to buy acceptances without endorsement.

In view of these considerations the Board feels that each of the Federal Reserve banks should look at the matter from a national rather than a local standpoint, both as to the rate of interest and as to the question of endorsement by the Federal Reserve Bank of New York. In the exercise of its statutory power to require inter-bank rediscounts, the Board would hesitate to direct one Federal Reserve bank to take paper from another without the endorsement of the selling bank, but there certainly seems to be no occasion, when paper is sold by one bank to another as the result of negotiation and not by direction of the Board, for the endorsement of the selling bank to be given, if the names on the paper bought are well known to, and satisfactory to, the purchasing bank. In the case of paper sold by the New York banks the names as a rule are well known to all the Federal Reserve banks and have been bought freely by them in the past without the endorsement of the New York bank. It is quite probable that, although the Federal Reserve Bank of New York might be desirous of building up its reserves, it would prefer to continue to carry the burden of the New York market rather than sell bills with its endorsement at a higher rate than that at which they were purchased.

It will be the Board's policy to watch the reserve situation very closely, with the view of preventing any disproportionate decline at any Federal Reserve bank, and hereafter, should the Board have occasion to invite voluntary rediscount operations, it hopes that the principles above outlined will be observed by the Federal Reserve Banks. In case any of the Federal Reserve banks should be required by the Board to rediscount paper for other Federal Reserve banks, the endorsement of the selling bank will be given, when demanded by the purchasing bank, but the transaction will be at a lower rate than would obtain if sold without endorsement.

The Board would appreciate an expression of your views on this subject.

Very truly yours,

Governor.