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FEDERAL RESERVE BOARD

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December 20, 1919.  
X-1766

Subject: Method of Determining Required Reserves.

Dear Sir:-

You are advised that the Federal Reserve Board has ruled on advice of Counsel that there is no warrant in law for the Federal Reserve Banks in making any deductions from their gross deposits in determining the amount of the reserves required to be carried under the terms of Section 16 of the Federal Reserve Act.

The Board does not, of course, construe the law as requiring that a reserve be carried against transit items or other deferred availability credits which represent deposits not immediately available. It rules therefore that the required reserves are to be based only upon those deposits which are immediately available. A copy of Counsel's opinion on this subject is transmitted herewith for your information, and the Federal Reserve Banks are advised that they should apply the new method of determining the reserves on and after January 2, 1920.

Very truly yours,

Enclosure.

Governor.

Letter to Governors and Chairmen of all F.R. Banks.

X-1766 a

**Subject: Deductions from Gross Deposits of Federal Reserve Banks for the Purpose of Determining the Amount of required Reserve.**

"This office has been asked for an opinion on the question whether a Federal Reserve Bank may, for the purpose of determining the amount of its required reserve, deduct from its gross deposits the amounts 'due from foreign governments' and 'due from foreign banks'. The Statistical Division is preparing a new form of balance sheet for Federal Reserve Banks and a determination of this question is necessary before that form is finally sent to the printer.

"It appears that at the present time Federal Reserve Banks are deducting from their gross deposits the following items:

DEDUCTIONS FROM GROSS DEPOSITS:  
 Branches or Head Office,  
 Due from foreign governments,  
 Due from foreign banks

Uncollected items -  
 National bank notes  
 Bank notes of other F.R. banks  
 F.R. notes of other F.R. banks  
 Unassorted currency  
 Transit items  
 Checks and other cash items,  
 Exchanges for Clearing House  
 Domestic transfers purchased.

"The question presents itself not only as to the right of a Federal Reserve Bank to deduct the balances due from foreign governments and from foreign banks, but also as to its right to deduct any of the items described above.

"Under the terms of Section 16 of the Federal Reserve Act, it is provided that

"Every Federal Reserve Bank shall maintain reserves in gold or lawful money of not less than thirty five per centum against its deposits."

There does not appear to be in the law, any provision express or implied, which can be construed as an authority to make any deduction from its deposits for the purpose of determining the amount of the reserves required to be carried under the terms of Section 16. In the case of national banks and other member banks, it is provided in Section 19 that

"In estimating the balances required by this Act the net difference of amounts due to and from other banks shall be taken as the basis for ascertaining the deposits against which required balances with Federal Reserve Banks shall be determined."

The Federal Reserve Board in construing this particular provision of Section 19 has heretofore determined that (a) exchanges for clearing house; (b) checks on other banks in the same place; and (c) items with Federal Reserve Banks in process of collection are to be considered as balances due from other banks in estimating the required reserve balance of member banks. These deductions, however, have been authorized by the Federal Reserve Board solely because of that paragraph of Section 19 quoted above. There is no other provision in the law justifying them.

"In considering the question of the amount of reserve which must be maintained by a Federal Reserve Bank against its deposits, it is evident that Section 16 contains no such provision as that paragraph of Section 19, which relates solely to the reserves of member banks and which the Board now considers controlling in determining what are the permissible deductions by member banks. If, as the Board has ruled, a national bank cannot be permitted to deduct cash on hand or balances due from foreign banks or from foreign governments, Federal Reserve Banks certainly should not be permitted to do so. With reference to the other deductions which Federal Reserve Banks now make from their gross deposits, including national bank notes, bank notes of other Federal Reserve Banks, Federal reserve notes of other Federal Reserve Banks, unassorted currency, transit items, checks and other cash items, exchanges for clearing house and domestic transfers purchased, it is believed that there is no more authority in law than in the case of cash on hand or of balances due from foreign banks and balances due from foreign governments. Even though it may be contended with some force that as a matter of principle deductions of the uncollected items specified should be permitted nevertheless that is a mooted question and whether right or wrong cannot of itself be determinative of the proper construction of an existing statute. It might be proper to place such an argument before Congress with the purpose of procuring an amendment to the law but there is not in the Federal Reserve Act as it reads at the present time any express or implied authority to make such deductions and in the opinion of this office none should be permitted.

"On the basis of the unvalidated statement of all Federal Reserve Banks for November 28, 1919, it appears that their total gross deposits including both immediate and deferred availability credits were \$2,902,825,000. The total deductions permitted that week were \$1,013,426,000, that is 29.08% of the gross deposits. But it should be noticed that of the total deductions allowed \$875,562,000 were 'transit items', that is, approximately 80% of the total deductions. These transit items represent an equivalent amount of deposits but deposits which are not immediately available. If, therefore, instead of basing the required reserve upon the amount of the total gross deposits, (including both immediate and deferred availability credits) the required reserve were to be based upon only those deposits which are immediately available, as I think it should be, the total gross

deposits subject to reserve would be reduced by the amount of the transit items which as previously stated, form approximately 80% of the present total deductions. If this were done the reserve percentage would vary but little from the percentage obtained under the present rule and the method of calculation would be strictly in accordance with both the spirit and the letter of the law. It is evident not only that it was not intended by Congress that deductions from gross deposits should be made by Federal Reserve Banks in determining the amount of required reserve but also that it was not contemplated that items received for collection and deferred availability credit would be included in the deposits against which reserve must be carried. It is believed that objections on both of these points would be overcome if reserves are calculated in the manner suggested above.

"On the basis of the figures as of November 28th, the reserve percentage of the Federal Reserve Banks was 45.5. This percentage was based upon the total gross deposits (including both immediate and deferred availability credits) less a deduction of all those items defined in the beginning of this memorandum. Had the reserve percentage on November 28th been estimated upon the basis of only those deposits which are immediately available, allowing no deduction whatsoever, the percentage would have been 44.1, a difference of only  $1\frac{1}{2}\%$ .

"It may be contended that this difference is a great difference when reserves of the Federal Reserve Banks are as near the minimum as they are at the present time and for that reason it may be felt that this is an inopportune moment at which to institute a change in the method of calculating required reserves, but it is the belief of this office that such a change should be made and as soon as it is possible to do so without causing any considerable disturbance through even a slight lowering of the reserve percentage of the Federal Reserve Banks. In any event it is believed that the proper method of calculating the reserves in accordance with the terms of the law as it now reads is that outlined above, that is, to estimate the required reserve on the basis of those deposits which are immediately available and to permit no deductions whatsoever.

Respectfully,

(Signed) GEORGE L. HARRISON.  
General Counsel. "