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ADDRESS REPLY TO
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FEDERAL RESERVE BOARD
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April 10, 1920.

X-1894

Subject: Deficiencies in Reserves.

Dear Sir:-

The attention of the Federal Reserve Board has been directed to the fact that there is some slight confusion in the method employed by different Federal Reserve Banks in determining the amounts of their gold reserves against note and deposit liabilities.

There is enclosed, herewith, for your information an opinion filed by Counsel, dealing with the general subject of deficiencies in reserves and the rights and obligations of the Federal Reserve Banks in the matter of allocating their gold assets against deposit and note liabilities.

Yours very truly,

Governor.

To Chairmen of all F.R. Banks.

March 5, 1920.

To: Federal Reserve Board

From: Mr. Harrison

Subject: Deficiencies in reserves.

Upon the request of the Federal Reserve Board I wish to confirm in writing a statement which I made orally to the Board at its meeting on February 26th, with reference to the allocation of its gold reserves against deposit and note liabilities and with reference to the tax upon the deficiency in reserves against either of those liabilities.

The question first presented is whether a Federal Reserve bank whose total reserves against the aggregate of note and deposit liabilities is below the minimum requirements may allocate its gold assets in such a manner that its reserves against notes are maintained at 40 per cent while its reserves against deposits fall below 35 per cent.

A study of the provisions of Section 16 of the Federal Reserve Act indicates that beyond a doubt a Federal reserve bank may maintain its 40 per cent reserves against Federal Reserve notes even though the reserves against deposits may, as a result, fall below the 35 per cent limit. Paragraph 3 of Section 16, which fixes the minimum reserve requirements against both note and deposit liabilities, provides "that when the Federal Reserve Agent holds gold or gold certificates as collateral for Federal Reserve notes issued to the bank, such gold or gold certificates shall be counted as part of the gold reserves which such bank is required to maintain against its Federal reserve notes in actual circulation." Under the terms of this paragraph all gold or gold certificates held by a Federal Reserve Agent as collateral for outstanding notes must

necessarily be counted as reserves against those outstanding notes and cannot lawfully be considered as part of the reserve against deposits.

So, also, Section 16 provides in next to the last paragraph that -

"Gold deposits standing to the credit of any Federal reserve bank with the Federal Reserve Board shall, at the option of said bank, be counted as part of the lawful reserve which it is required to maintain against outstanding Federal reserve notes, or as part of the reserve it is required to maintain against deposits."

Under the terms of this clause the Federal reserve bank is granted express authority at its own option to count credits in the gold Settlement Fund as a part of the reserves which it is required to maintain against Federal reserve notes.

There is no express provision in the law itself conferring upon the bank the right to allocate the free gold held by it (that is, gold not with the Federal reserve agent and not with the Gold Settlement Fund) as a part of its reserve against Federal reserve notes instead of as a part of its reserves against deposits. It is believed, however, that that option must exist since for all practical purposes the same result may be attained under those other sections of the law previously referred to. In other words, inasmuch as the bank is authorized to procure Federal reserve notes from the Federal reserve agent upon the deposit of as much as 100 per cent gold, and inasmuch as all deposits with the Federal reserve agent must necessarily count as part of the reserves to be maintained against notes outstanding, the Federal reserve bank may always maintain its reserves against notes at the expense of its deposit reserve account by transferring free gold to the Federal reserve agent as collateral for outstanding notes. It then automatically becomes a part of the reserve against

notes. The bank may also accomplish this same purpose by depositing free gold in the Gold Settlement Fund since credits in the Gold Settlement Fund may by law, at the option of the bank, be counted either as reserve against notes or as reserve against deposits. In view of these facts it would seem to be futile to deny the right of the bank to consider free gold in its vaults as reserve against notes even though to do so results in a deficiency in the reserve against deposits.

Assuming this to be true, the sole question to be considered is whether the Federal Reserve Board is required to impose a tax upon the deficiency in reserves against deposits.

Section 11 (c) provides:

"To suspend for a period not exceeding thirty days, and from time to time to renew such suspension for periods not exceeding fifteen days, any reserve requirements specified in this Act: PROVIDED, That it shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the level hereinafter specified, AND PROVIDED FURTHER, That when the gold reserve held against Federal reserve notes falls below forty per centum, the Federal Reserve Board shall establish a graduated tax of not more than one per centum per annum upon such deficiency until the reserves fall to thirty-two and one-half per centum, and when said reserve falls below thirty-two and one-half per centum, a tax at the rate increasingly of not less than one and one-half per centum per annum upon each two and one-half per centum or fraction thereof that such reserve falls below thirty-two and one-half per centum. The tax shall be paid by the reserve bank, but the reserve bank shall add an amount equal to said tax to the rates of interest and discount fixed by the Federal Reserve Board."

Two questions are presented in connection with the construction of this paragraph, (1) whether the Federal Reserve Board is obliged to establish a graduated tax upon the amounts by which the Federal reserve bank reserves against deposits fall below the required minimum, and (2) if so, whether the amount of the tax shall be added to the rates of discount fixed by the Federal Reserve Board.

The first proviso of Sub-section (c) requires that the Federal

Reserve Board shall establish a graduated tax upon the amounts by which "the reserve requirements of this Act" may be permitted to fall below the specified levels. There is little doubt that the law which uses the obligatory "shall", and not the optional "may", imposes upon the Federal Reserve Board an obligation to establish a graduated tax upon the deficiency in the reserves against Federal Reserve Bank deposits since that is one of the "reserve requirements of this Act". This tax, however, may be fixed at any amount, large or small, that the Board deems to be advisable. Technically, it may even be an infinitesimal amount. It must, however, be a graduated tax based upon the amount of the deficiency in the reserves.

There is nothing in the law specifying to whom such a tax must be paid. In the case of a member bank it is paid to the Federal Reserve Bank, but in the case of a Federal Reserve Bank there is no one to whom the tax could reasonably be paid other than to the Government. But if paid to the Government, it would amount in substance to a tax upon the Government's own equity in the Federal Reserve Bank's surplus. The decisions of the Supreme Court have frequently held that no Federal tax law should be construed to impose a tax upon the Government itself and it might by analogy be argued with some force that Congress did not intend to require the Federal Reserve Bank to pay a tax, even though in the nature of a penalty, to the Government out of a fund which, in the final analysis, belongs to the Government.

It would seem however, that although there is nothing in the law to indicate that the tax should be paid to the Government, and although, as suggested above, it is perhaps illogical to require the Federal Reserve Bank to pay a tax to the Government out of its surplus, nevertheless, if any effect is to be given to those provisions of the law imposing the tax, the Government is the only logical payee, and if imposed, it is

believed that it would have to be paid in that manner. These inconsistencies are referred to only for the purpose of emphasizing the fact that this section is not in its entirety susceptible of any complete or satisfactory construction.

The remaining question for consideration is whether the imposition of such a tax upon the deficiency in the reserves against deposits must necessitate a corresponding increase in the rate of discount fixed by the Federal Reserve Board. Upon this question there can be little doubt since the phrase requiring the increase in discount rates is not a part of the first proviso of Sub-section (c) which provides for the tax upon the deficiency in reserves against deposits, but instead is enacted as a part of the second proviso of that paragraph which relates solely to the tax upon the deficiency in reserves against Federal reserve notes. It might be contended that the last sentence of sub-paragraph (c) refers back to the first proviso as well as to the second proviso but that is a position which it would be difficult to sustain.

In the first place, sub-section (c) of Section 11 as originally passed by the House contained only one proviso which read as follows:

"Provided that it shall establish a graduated tax upon the amounts by which the reserve requirements of this Act may be permitted to fall below the level hereinafter specified, such tax to be uniform in its application to all banks, but said Board shall not suspend the reserve requirements with reference to Federal Reserve notes."

When the bill was passed by the Senate the first part of this proviso was left substantially as it reads above but the requirement that the Board "shall not suspend the reserve requirements with reference to Federal reserve notes" was struck out and the present second proviso was inserted in lieu thereof. It is this second proviso, imposing an automatic graduated tax upon the deficiency in the reserves against notes, that contains the clause requiring the reserve bank to "add an amount

equal to said tax to the rates of interest and discount fixed by the Federal Reserve Board." Inasmuch as that clause was enacted at the same time, and as a part of, the present second proviso, and inasmuch as the two together were substituted for that part of the House bill prohibiting a suspension of reserves against notes, the logical inference is that the automatic increase in discount rates results only in the case of a tax upon a deficiency in the reserves against Federal reserve notes and not in the case of a tax upon a deficiency in the reserves against deposits. But even if the legislative history of this section leaves any doubt as to its meaning, nevertheless, the context of the section as a whole precludes the possibility of any other construction.

The first proviso provides for the establishment of a graduated tax upon the deficiency in any of the reserve requirements of the Act other than those relating to Federal Reserve notes which are expressly covered in the second proviso. That being so, if the last sentence of sub-section (c), providing for the automatic increase in the discount rates equal to the amount of tax upon deficiency in reserves should be construed to apply to the first proviso, then a deficiency in the reserves of any member bank would necessitate an increase in the discount rates since member banks' reserves are one of the reserve requirements of the Act. Any increase in the discount rates, regardless of the cause, would be applicable to all member banks alike. It is certain that no such result could have been contemplated by Congress.

Aside from the provisions of the paragraph under consideration, and independently of the question of the tax upon deficiencies in reserve, the Federal Reserve Board, of course, has power to determine rates of discount for each class of paper and that power would in itself include the power to nullify any automatic increase resulting from a

deficiency in reserves against deposits, even if a contrary interpretation of the law, discussed in this memorandum, could be supported.

In conclusion, it is the opinion of this office, first, that a Federal reserve bank may allocate its free gold in such a way as to maintain its reserves against notes at a minimum of 40 per cent even though that results in a deficiency in reserves against deposits; second, that the Federal Reserve Board is required by law to establish a graduated tax upon deficiencies in reserves against deposits although that tax may be made so small as to be practically negligible; and third, that a tax upon deficiencies in reserves against deposits does not result in an automatic increase in the rates of discount fixed by the Federal Reserve Board.

Respectfully,

GEORGE L. HARRISON.

General Counsel.