1. MEMORANDUM on article proposed by Dr. Miller for insertion in the Annual Report as to the regulation of Federal Reserve note issues by the Federal Reserve Board.

2. MEMORANDUM as to the proposal of Dr. Miller for insertion in the Annual Report of the reasons for setting up separate reserve ratios for deposits and notes.

1.

After a careful re-reading of Dr. Miller's article favoring a new policy of direct control by the Federal Reserve Board of Federal Reserve note issues, I am unable to accept its conclusions and believe it would be unwise to insert it in our Annual Report.

I appreciate that the part of this article which it was agreed at our last meeting should be stricken out makes the article less objectionable, but I feel that the portion of the article which was left in is merely the reasoning intended to justify the conclusions in the article which we agreed should be stricken out,- namely, that the Federal Reserve banks are, and were created for the purpose of being primarily note issuing banks, and, further, that the Board is charged with the duty of directly limiting future note issues instead of leaving such issues to the discretion of the Federal Reserve banks.

I believe it would be better to omit the entire article from our Report.

The article in question is based upon three propositions:-

1. That the Federal Reserve Act places upon the Federal Reserve Board direct responsibility for the issue of Federal Reserve notes through the respective Federal Reserve banks.

2. That the Federal Reserve banks were created for the primary purpose of issuing Federal Reserve notes to member banks against credits established by them. (article p. 6)

3. That member banks rediscount commercial paper with the Federal Reserve banks mainly for the purpose of obtaining Federal Reserve notes with which to meet the demand of their customers. (article, p. 6)

Based upon these premises, the article in question takes the position that the Board should change its present and past policy with relation to the issue of Federal Reserve notes, should immediately place restrictions upon future issues of such notes, and, further, that the Board should take certain not clearly defined action with regard to such notes as are now in actual circulation.

With neither (2) or (3) of the above propositions, nor with the conclusion derived from them, am I in accord. While they give a fairly accurate statement of the intent of the Aldrich Central Bank Bill, under which the note issues, available for reserves, were the principal function, they do not represent the principles underlying the Federal Reserve Act.

An examination of the debates and the committee reports prior to the passage of the Federal Reserve Act, and, as well, the preamble of the Act as passed, shows that the purpose of Congress in creating the Federal Reserve banks was not only to furnish an elastic currency but, as well, and primarily, to furnish a means of rediscounting commercial paper. That the discounting function was the primary function will clearly be seen, when it is remembered that, under the Act as originally enacted, every Federal Reserve note issued was tied to, and arose out of the rediscount of commercial paper, that is, arose out of an antecedent credit granted by the

Federal Reserve bank to the member bank.

The Federal Reserve Board, on the other hand, has the ultimate power to control the antecedent credit by fixing the discount rate, and the further power to control the issue of Federal Reserve notes through the imposition of an interest charge on any issues not covered, dollar for dollar, by gold. The power also given to grant or to refuse altogether the application of any Federal Reserve bank for Federal Reserve notes, in my opinion, was intended to be used only in case the imposition of an interest charge failed to be effective.

On analysis, it will, I believe, be realized that the privilege of issuing notes, from the point of view of the Federal Reserve banks, is merely the privilege of protecting their cash reserves by issuing such notes, which notes are received by the public, when paid out by the member banks, as the equivalent of cash.

The question of the regulation of Federal Reserve note issues, therefore, has to do more with the internal administration of the Federal Reserve banks than with the public, for what the public desires is merely circulating medium, and it can always obtain the circulating medium it desires, in the form of cash, if not of notes, as long as the member banks and the Federal Reserve banks are solvent.

The real problem which confronts the Federal Reserve Board is, therefore, whether at any given time it should forbid a Federal Reserve bank to protect itself against demands for cash by member banks by issuing Federal Reserve notes; that is to say, whether the Federal Reserve Board, by limitation of note issues, should insist that such demands for cash by member banks be met by Federal Reserve banks by drawing down their cash reserves rather than by issuing Federal Reserve notes.

The whole matter, however, was wisely left by Congress to the discretion of the Federal Reserve Board and it is the necessity for the exercise of such discretion which is now before us for consideration.

In considering the desirability of a change in the policy of the Board as to the issue of Federal Reserve notes, as advocated by the article in question, we should first consider what the policy of the Board has been in the past in this matter.

We have heard it frequently stated in Board meetings that the Board never has had a policy in the past but that, ignoring its plain responsibility under the law, it has thrown down the reins and left to the unbridled discretion of the Federal Reserve banks, the privilege of deluging the country with issues of paper money, thus directly aiding the extraordinary speculative activity which was at one time rampant, and causing, as well, the serious inflation of prices from which the country is even now suffering.

With some confidence I assert that just the contrary is the fact.

There never has been a question before our Board which has been so carefully and thoroughly considered as the question of the policy of the Board as to Federal Reserve note issues. The whole question was argued and debated, covering a period of some years, at the very time when the inflation of prices was going on. The conclusion finally reached by the Board was communicated to the Senate on August 8, 1919, when it was pointed out that existing inflation was caused by the excess of deposit credits over production and distribution needs, and the conclusion was stated that the issue of Federal Reserve notes merely represented the needs of the community for small change in handling retail trade transactions, payrolls,

and for pocket money, and similar services; that the increasing issues of Federal Reserve notes were not the cause of inflated prices but were merely the result of inflated prices which were really caused by excessive deposit credits. (25 Federal Reserve Bulletin, p. 699)

The conclusion of the Board was supported by a study of the ebb and flow of Federal Reserve notes, which brought out the fact that the moment the amount of such notes in circulation became in excess of the needs of the community they were immediately presented for redemption and cancellation. This fact is borne out graphically by the figures of Federal Reserve notes in circulation at the present time. Since December 23, 1920, when the peak was reached,-3,404.9 millions, the circulation has declined to 2,017.4 millions on February 8, 1924, a decline of over 1,387 millions of dollars, or 40%,- and this decline took place without any limitation or interference with such issues on the part of the Federal Reserve Board.

The Board, as above stated, reached the conclusion that it was safe to leave to the discretion of the respective Federal Reserve banks the right to determine how far they should respond to demands for cash by member banks by paying out gold, or in the alternative by issuing Federal Reserve notes.

In my opinion,- whatever criticism may be made of the Board's use of its power to fix discount rates upon the underlying credits given by the Federal Reserve banks during the war and post-war period,- the exercise of its discretion in refusing to place a tax upon or to limit the issue of Federal Reserve notes during such periods has been amply justified by experience.

Another important point to be borne in mind is that the conclusion

of the Board, as above stated, was a unanimous conclusion and was so expressed in its answer to the Senate sent on August 8, 1919.

On September 25, 1919, Dr. Miller, in an address delivered to the American Association of the Baking Industry, at Chicago, among other things said as follows:

"The form that credit demand (and expansion) has taken in the United States has been banking credit in the shape of bank deposits. Expansion of the currency has played a very subordinate role. It is no exaggeration to say that expansion of the currency has been a consequence, rather than a cause of our high prices.

"So far as expansion of the purchasing medium of the country is responsible for our great rise in prices it has been and is purchasing medium in the form of bank deposit credit and not in the form of Federal Reserve notes."

At the time this address was delivered inflation was in full swing. While it is true that Federal Reserve note issues continued to increase for some four months after this address was delivered, the relative increase was much smaller than that which had taken place during the war period, which was prior to the date of this address.

Later, however, Dr. Miller changed his opinion. In an article in the American Economic Review for June, 1921, he quoted approvingly the letter of the Board to the Senate Committee of August 8, 1919, to the effect that "the expansion of currency is a consequence of the expansion of credit and increase of prices and is not a causal factor in price movement," but he qualified this approval by stating that it "applies to normal conditions"

The conclusion of the Board, however, expressed in said letter of August 8, 1919, was expressly stated by the Board to apply to the then existing conditions which, so far from being "normal", were chaotically abnormal at that time. Dr. Miller, however, as shown by his address on September 25, 1919, above referred to, concurred in the conclusion of the Board as contained in said letter of August 8, 1919. The same conclusion was expressed by the Board in October 1919, in its Review of the Month. (See 5 Federal Reserve Bulletin, page 913.)

I do not, of course, question the right of any member to change his opinion. I merely cite Dr. Miller's address to show that the opinion given by the Board in said letter represented his opinion as well as the unanimous and carefully thought outconclusion of the Board.

The article now before us asks us in effect to change the policy expressed in said Board letter of August 8, 1919, to the effect that inflated prices were not caused by the issue of Federal Reserve notes, and to lay down the new theory that excessive issues of Federal Reserve notes are responsible for past and present price inflation, that in the future such issues must be regulated by our Board, and further that the original conception of Federal Reserve banks, as above set forth by me, is erroneous and that such banks are and were created to be primarily note issuing banks.

When one considers that the Federal Reserve banks have today outstanding about two billions of Federal Reserve notes in circulation and hold reserve deposits of member banks of nearly the

same amount, and are sustaining credits granted by member banks to their customers, based on these reserve deposits, in excess of 18 billions of dollars it would seem somewhat difficult to draw the conclusion that the Federal Reserve banks are primarily note issuing banks.

When further it is realized that today the Federal Reserve banks, taken together, could pay off dollar for dollar in gold every Federal Reserve note in circulation and yet have left in their possession gold and cash equivalent to a ratio of 68% of their deposits, it would certainly seem surprising to call these banks primarily note issuing banks.

Every Federal Reserve note in circulation, other than those issued dollar for dollar for gold, grows out of some antecedent credit granted to the member bank by the Federal Reserve bank, and if the Federal Reserve banks and the Federal Reserve Board have properly regulated this antecedent credit through the discount rate and open market operations, I believe that experience has shown that there will be no necessity for direct limitation of the issue of Federal Reserve notes.

If, however, a majority of the Federal Reserve Board believes that the time has come to change the present policy of the Board as to Federal Reserve note issues, a policy which I have shown was adopted after most careful consideration and which has been in force since the Federal Reserve System was established, the Board should frankly state in the Annual Report that the past policy of the Board was erroneous and that a new policy is to be

adopted, leaving to the minority the right to record themselves to the contrary or to send to Congress a minority report.

2.

The publication of separate reserve ratios against deposits and Federal Reserve notes.

I cannot see any weighty objection to the publication by the Federal Reserve Board each week of the reserves actually carried by the Federal Reserve banks as a whole against deposits and against Federal Reserve notes respectively, assuming for the purpose of such publication, that the gold held by the Federal Reserve banks in the Gold Settlement Fund is allocated to the reserve against deposits.

I feel strongly, however, that the reasons given in the proposed article for such publication should not be published in the annual report. My reason for this feeling is that Dr. Miller's article, to my mind, necessarily implies that the Board has in its mind some ulterior object other than merely giving a photograph of reserve conditions as they actually exist from week to week.

I feel very confident that if the reasons contained in this article were published in the Annual Report they would at once bring to mind the article published by Dr. Miller in The American Economic Review for June 1921, in which he not only favors stating the reserves separately, but also favors allocating a certain amount of gold to the Federal Reserve Agent as a gold reserve

against notes, such amount to be determined by the Federal Reserve Board, and to remain a fixed quantity not to be reduced by the Federal Reserve banks unless the Federal Reserve Board determines that conditions justify a change. In other words, as I understand the article, the gold held by the Federal Reserve agents as reserve for the notes is to be "pegged" so as to bring about a certain pre-determined reserve ratio, at the cost of the deposit reserve, which is to be permitted to fluctuate at whatsoever ratio will remain after the reserve fixed by the Board for notes has been kept intact by gold taken from the deposit reserve; that is to say the deposit reserve is, as it were, made a surety for the gold reserve, so that the note reserve ratio will always be constant and the deposit reserve ratio will constantly fluctuate.

While I agree that the Federal Reserve banks, without any order or direction from the Federal Reserve Board, will in all liklihood continue to do as they are doing now in the way of allocating a larger portion of their gold to Federal Reserve notes than to deposits in order to keep the note ratio higher than the deposit ratio, I confess I can now see no legal method by which the Board could order the banks to do this. I cannot see how the Board, for example, could order the note reserve to be maintained at 100% when the Federal Reserve Act simply

prescribes that the minimum shall be 40%. While the Board has authority to lower the reserve requirements, it certainly has no authority to increase them. Furthermore, even admitting for the sake of the argument, that the Board has the power to fix a reserve fund of 100% against Federal Reserve notes, I fear that if in the future this 100% reserve should have to be reduced, because of demands for gold for export or for other causes, it might cause serious apprehension on the part of the public similar to that caused in 1893 by the enforced reduction of the one hundred million gold reserve held for the redemption of the so-called greenbacks.

I venture to hope, therefore, that the Board will content itself by merely publishing the separate reserve ratios as they exist from week to week and will decide to leave out of the Annual Report arguments contained in this article which, to my mind, clearly point to further requirements of at least doubtful legality.

C. S. HAMLIN
Feb. 12, 1924.