TO: The Federal Reserve Board X-4314

From: Divisions of Bank Operations and Research and Statistics.

THE MCFADDEN BILL TO REVISE THE FEDERAL RESERVE ACT

General purposes of the amendments

The amendments to the Federal Reserve Act proposed by Congressman McFadden immediately prior to the adjournment of the last Congress apparently have two purposes: (1) To reestablish a closer connection between the volume of Federal reserve notes in circulation and the currency requirements of business. With this in view the bill prohibits the use by reserve banks of gold and of acceptances purchased in the open market as collateral for Federal reserve notes, leaving discounted paper as the sole authorized collateral. (2) To reduce the lending power of the reserve banks, by permitting member banks to withdraw from the reserve banks, and to hold in their own vaults, a part of their required reserves.

Both of these objects appear to be based largely on misconceptions arising from imperfect appreciation of the experience of the system. The first of them assumes that the volume of Federal reserve notes in circulation currently depends upon the character of the paper or other collateral which may be used as cover for the notes, but experience has demonstrated that this is not the case. Notes get into general circulation only when customers of member or nonmember banks withdraw currency to meet their current needs. Member banks retain in their own vaults only such an amount of currency as they need to meet daily requirements, because it does not pay them to keep more, and it is only when these daily requirements increase, by reason of the demands of the public, that member banks find it necessary to obtain more currency from the reserve bank, using any acceptable collateral that they may have. The elasticity of the Federal reserve note does not depend on the character of collateral that member banks use to obtain currency. Federal reserve notes issued against gold come in for retirement as promptly as notes secured by commercial paper. It is through the Federal reserve banks' meeting the currency demand when it arises that the amount of currency in circulation is constantly adjusted to the requirements of business.

The provision authorizing member banks to hold part of their reserves in their own vaults, which is apparently intended to diminish the lending power of the reserve banks, through a reduction of their reserves, would have little effect, when taken in conjunction with the other proposed amendments, because member banks would have no inducement to exercise their option to any extent. That portion of their resources which the law or experience requires the member banks to hold as reserves would remain inactive and unproductive of earnings, under the proposed amendment as it is under existing laws, and a mere transfer of reserves from reserve banks to member banks would not increase the member banks' lending power or earning capacity, but would merely reduce the lending power of the reserve banks.

Gold with the reserve agents not to count as reserves

The provision in the McFadden bill that gold held with the Federal reserve agent shall not count as part of the reserves of the reserve bank is a repeal of an amendment adopted in 1917, principally for the purpose of facilitating note issues and permitting the reserve banks to count all the gold, whether held by the agent or by the reserve bank, as part of their reserves. Notes were exchanged for gold prior to the amendment butthis was accomplished in a roundabout way, and it was thought best to authorize the direct exchange.

The effect of this proposal at the present time would be that of the $1,700,000,000 of Federal reserve notes in circulation, only about $400,000,000 could continue to be a liability of the reserve banks because this is the total amount of discounted paper held by the twelve reserve banks. Against the remainder of the notes, the Federal reserve agents now hold gold and in order to comply with the proposed amendment the reserve banks would have to follow one of two courses; either to pay this gold out into circulation in exchange for an equivalent amount of Federal reserve notes; or to impound the gold with the agent to be held by him exclusively for the redemption of notes. The reserve banks would probably adopt the procedure of letting the $1,300,000,000 of gold held by the agents as cover for notes be applied to the reduction of the banks' liability on reserve notes. Thus the gold as an asset and an equivalent amount of notes as a liability would be taken out of the reserve banks' balance sheet and would appear only in the account ofthe Federal reserve agents. Under present conditions the reserve banks would after this transaction still have a reserve of about 60 per cent against their combined note and deposit liability. In some of the reserve banks, however, the result would be a deficiency of reserveseven at the present time.

The reserve banks could increase the volume of paper eligible as note cover at their disposal; i.e., paper eligible as cover under the amendments, by selling acceptances and securities and thereby causing member banks to discount paper with the reserve banks. While technically this would be a method of increasing the volume of paper eligible for note cover, it would involve a complete withdrawing of Federal reserve banks from open-market operations.

Under the McFadden proposal the note-issuing power of the reserve banks, which is now limited by reserve requirements, will be limited in addition by the amount of eligible paper availabe as collateral for note issue. As pointed out earlier, this additional limitation does not increase the elasticity of the reserve note but merely erects a cumbersome piece of machinery that might under certain conditions prevent the smooth performance of their functions by the reserve banks. A situation might even arise, under the proposed amendment, where reserve banks, by reason of low reserves and shortage of eligible paper, could not issue Federal reserve notes to member banks unless these banks borrowed $3.00 from the reserve banks, and kept $2.00 of this on deposit with the reserve banks, in order to obtain $1.00 of Federal reserve notes. Under conditions of unusual credit and currency demand, therefore, the McFadden amendment would cause unnecessary difficulties to our banking system, and since the test of the soundness of a banking system is the way it would stand up under a strain - this is a serious argument against the proposal.

In considering the possible effect of these amendments in decreasing the gold reserves of the reserve banks through further increases of gold in circulation, the fact should not be overlooked that the gold now held by the reserve banks for the most part was not withdrawn from domestic circulation but was imported from abroad. As the result of paying out gold certificates the volume of gold in circulation at the present time is nearly as large as before the system was established, and the reserve banks in recent months have also met out of their reserves a considerable demand for gold for export.

The chief effect of the proposed amendment relating to gold cover appears to be to lower the reserve ratio of the reserve banks by impounding a part of their reserves with the Federal reserve agents. At a time when reserves are ample, as at present, the impounding of the gold would not bring the reserve ratio near the legal minimum, but under conditions of exceptionally large demand for credit and currency the amendment would interfere with the smooth operation of the reserve banks and might make necessary a suspension of reserve requirements.

<u>Acceptances ineligible as collateral against notes</u>

In prohibiting the use of acceptances as cover for Federal reserve notes, the amendment places acceptances in regard to ineligibility as cover for notes on the same footing with United States securities, the other class of open-market purchases of the reserve banks. Acceptances, however, are as directly connected with the financing of current business as are promissory notes, and reflect the underlying commercial transactions in contrast to paper secured by United States obligations which is now eligible and would continue to be eligible under the amendment, to serve as cover for Federal reserve notes. It is probable that the object of this amendment is not so much to increase the elasticity of the Federal reserve note as to limit the reserve banks' open-market operations.

Authority to hold part of reserves in members' vaults

The proposal to authorize member banks to hold part of their required reserves in their own vaults would in its present form permit member banks to count as part of their reserves the vault cash which they now carry as till money. If the amendment were adopted without increasing the reserve requirements of member banks, it would make available to the member banks about $500,000,000 which they could use either as a basis for additional lending or to reduce indebtedness at the reserve banks. When in 1917 reserve requirements changed so as to make only balances at the reserve banks count as legal reserves for member banks, at the same time required reserve percentages were reduced in recognition of the fact that the cash which member banks would continue to carry in their vaults would no longer count as reserves. The present proposal to permit the vault cash of member banks to be counted as reserves without correspondingly increasing the legal reserve requirements would result in reduced borrowing at the reserve banks and in member banks seeking increased investment for their released funds.

If the proponents of the bill would upon consideration decide to include in the amendment an increase in reserve requirements equal to the amount of cash in vault, the proposal would have relatively little effect on the credit situation.

Existing provisions not emergency measures

The McFadden proposal has been generally understood to have the object of restoring the Federal Reserve Act to its original form through repeal of war time amendments. Experience indicates that the 1917 amendments, though their passage may have been expedited by the war emergency, are not in the nature of emergency provisions, but are a logical rounding out of the reserve system. In effect the McFadden proposal would have the system return to the ideas and theories of the framers of the Federal Reserve Act prior to the system's establishment, and would thus sacrifice the lessons of practical experience acquired during the decade of its operation.