

SUBJECT: Memorandum regarding Cuban Agency prepared by the Federal Reserve Bank of New York and submitted by Deputy Governor Case at hearing before Federal Reserve Board on November 11, 1926.

The proposal for some kind of Federal Reserve Agency in Cuba appears to have arisen primarily in the search for some means of improving the physical condition of the currency in Cuba. Cuba uses wholly United States currency, which is the only legal tender currency there. The total amount of the circulation in Cuba is estimated at about \$100,000,000 as compared with total bank deposits of perhaps something less than \$200,000,000. This very high ratio of currency to deposits indicates that the people of Cuba transact their business largely by currency and their use of and confidence in banks is limited. Before the establishment of Federal Reserve agencies the currency was supplied largely through the branches in Cuba of the National City Bank of New York, the American Foreign Banking Corporation, later absorbed by the Chase National Bank of New York, the Royal Bank of Canada, the Canadian Bank of Commerce, and the Bank of Nova Scotia, which do a large part of the banking business of the island.

The shipment of currency to and from New York or Jacksonville and the maintenance in Cuba of an adequate currency reserve were expensive. Financial disturbances approaching money panics were of frequent occurrence and at such times these banks found it necessary to ship huge amounts of currency to Cuba. It was frequently difficult to get currency there quickly enough to meet emergencies and the currency reserves which the banks found it necessary to carry were probably at times as large as \$50,000,000. Shipments of currency from New York to Cuba (either directly or through Atlanta) averaged about \$30,000,000 a year for the years from 1920, 1921, and 1922.

The question of Cuban agency of a reserve bank appears to have been first raised in 1921 by Mr. George E. Roberts, vice-president of the National City Bank of New York. With reference to a proposal which had been made to establish in Cuba a central bank, modeled, perhaps, on the Federal Reserve System, Mr. Roberts suggested to Governor Strong in a letter that "the best thing that could possibly be done would be to have a branch of the Federal Reserve Bank of New York located at Havana". Governor Strong stated to Mr. Roberts his opposition to this proposal, saying that he thought Cuba should have a separate bank of issue under American supervision; that in any event he was against the establishment by our bank of issue of offices to carry on normal banking functions outside the United States. The governor advised Mr. Roberts further that means could be found for retiring mutilated and worn-out currency in circulation in Cuba and issuing fresh supplies "without the reserve bank being involved in a banking business in Havana."

In September 1921, to meet an emergency situation, the National City Bank of New York was appointed correspondent and agent of the Federal Reserve Bank of New York in Cuba. The Federal Reserve Board approved of this appointment, with the understanding that no actual transactions would be engaged in until regulations had been prescribed by the Federal Reserve Board. This appointment was made with the object of restoring confidence in Cuba and stopping runs on Cuban branches of the National City Bank. At the same time the National City Bank sent

\$5,000,000 to its Cuban branches, in order to afford the desired relief.

In February 1923 Mr. Dwight Morrow proposed that this bank circulate gold notes in Cuba with a view to supplying the Island with paper money fit for circulation. Governor Strong at this time stated that he was opposed to this bank undertaking any expense, duty or responsibility in the matter unless directed to do so by Congress.

In April 1923 the Federal Reserve Bank of Boston applied to the Federal Reserve Board for permission to establish an agency in Cuba, to which application it appeared that the Departments of State and Treasury at least made no objection. A hearing on the application was set by the Federal Reserve Board for April 30, 1923. Governor Strong at that time was absent from the city in Colorado and by telegram he renewed his objection to the proposal, on the ground that it was not authorized by law and for various practical reasons, including expense and the assumption of responsibilities for which the bank had no liability and the fact that a currency clean-up could be effected by other means. Further, that Boston should not open an office to conduct business practically all of which was for New York. The Federal Reserve Banks of New York, Philadelphia, and Atlanta, and others were invited to attend the hearing before the Federal Reserve Board on May 7, 1923, and this bank was represented by Messrs. McGarrah, and Case. Mr. Mitchell, President of National City Bank also attended. The views of this bank were expressed in a formal memorandum, prepared after consultation among all concerned. The memorandum was as follows:

"The Federal Reserve Bank of New York desires to present its views and the following consideration in regard to the application to the Federal Reserve Board by the Federal Reserve Bank of Boston for permission to establish an agency in Havana, Cuba, under Section 14-E of the Federal Reserve Act.

"Attitude of Federal Reserve Bank of New York.

"1. While for reasons set forth in the memorandum it is opposed to any Federal Reserve Bank establishing an agency in Cuba, nevertheless if the Federal Reserve Board reaches the determination that an agency of a Federal Reserve Bank should be established in Havana, the Federal Reserve Bank of New York would prefer NOT to be selected and could not therefore object to the selection of the Federal Reserve Bank of Boston or of any other Federal Reserve Bank.

"Purpose of Application.

"2. At the hearing on this subject before the Federal Reserve Board on April 30, 1923, it appeared that the application was made primarily to improve the quality of the paper money now in circulation in Cuba. It appeared also that branches of American banks in Cuba, as well as other banks operating there, might, if the agency were established, feel justified in carrying a much smaller supply of currency than at present. Our information leads us to believe that the banks would thereby save many hundreds of thousands of dollars.

"It further appeared that it might be ultra vires for the Federal Reserve Board to grant an application for the establishment of an agency for currency purposes alone, since Section 14-E does not include carrying a reserve of currency, and the issuing and redeeming of currency among the purposes for which

a Federal Reserve Bank may establish an agency in a foreign country.

"The application, therefore, takes the form of a proposal to establish an agency in Havana for the purpose of dealing in exchange, presumably for the following two reasons:

"(a) In order that it may comply with the provisions of Section 14-E under which such an agency may be established;

"(b) In order that by dealing in foreign exchange the considerable expense of maintaining the agency may be met.

"Dealings in Foreign Exchange by Federal Reserve Banks.

"3. We have always been opposed, and we believe the Federal Reserve Board has held a similar view to the idea that a Federal reserve bank should deal in exchange in the United States:

"(a) Because the number of dealers and the supply of capital engaged in foreign exchange dealings was ample;

"(b) Because it would put the Federal reserve banks in direct competition with member banks in all parts of the country who have highly developed exchange departments;

"(c) Because of the risks involved.

"With respect to dealings in foreign exchange by Federal reserve banks in foreign countries, it has been our belief that Section 14-E intended to provide not for the establishment of independent agencies in foreign countries but for the appointment of banks in foreign countries as correspondents and agents of Federal reserve banks. Through these agencies, the reserve banks, when such a course seemed desirable, could purchase bills in foreign countries for the purpose of assisting in the stabilization of international gold movements. We have, therefore, with the approval of the Board, entered into agency agreements with a number of foreign banks of issue whereby on order they will purchase for us with their guaranty prime bills in their markets, and likewise, on order, we will purchase prime bills in their markets, and likewise, on order, we will purchase for them with our guaranty prime bills in our markets. In each of these agreements all other Federal reserve banks, in accordance with Section 14-E, have been invited to participate and have done so.

"We are opposed generally to the idea that a Federal reserve bank should conduct a foreign exchange business in a foreign country merely for the profit involved. We are opposed specifically to the idea that a Federal Reserve bank should conduct a foreign exchange business in Cuba merely for the profit involved:

"(a) Because there is no important international credit movement between Cuba and the United States to be stabilized, and if we are correctly advised, (except in times of crisis) the fluctuations in exchange are limited to the cost of shipping currency to or from the United States, say 1/8 of 1 per cent,

"(b) Because such business could be done only in active competition with member and other banks with ample resources, now engaged in it.

"(c) Because of the risk involved.

"(d) Because the paper or the contracts purchased would not have the number of names equivalent to those to which in the United States we restrict our

open market purchases of bills, (i.d., two banking names).

"(e) Because it is a proceeding for which we believe there is no precedent in the experience of other important banks of issue.

"4. We are opposed to the principle of the establishment of a direct agency of a Federal reserve bank in Cuba if any other means can be found of accomplishing the desired results:

"(a) Because it renders some of our assets subject to the laws and the courts of a foreign country.

"(b) Because of the expense involved in an undertaking which is not the responsibility of the Federal Reserve System.

"(c) Because it creates a precedent for the establishment of direct agencies elsewhere.

"(d) Because it raises the question of the responsibility of a Federal reserve bank to redeem in a foreign country in gold or lawful money any or all Federal Reserve notes that may happen to circulate in that country. The law provides that any Federal Reserve note (regardless of the bank of issue) may be redeemed in gold or lawful money at any Federal Reserve Bank, and a foreign agency would in all probability be considered the Reserve Bank in law, just as much as branches in this country are. Consequently, if the present application is approved and the Federal Reserve Bank of Boston actually opens its own office or agency in Cuba might it not be expected as a matter of law 'to redeem in gold or lawful money' all of the Federal Reserve notes now circulating in Cuba, estimated to be well in excess of \$100,000,000. As a practical matter it would of course not be feasible for a small agency always to be prepared for redemption on such a large scale."

On May 16, 1923, the Federal Advisory Council asked the Board for an opportunity to be heard. Later, Mr. Warburg and others appeared before the Board and expressed views adverse to the proposal, which were substantially the same as those of the officers of this bank. Mr. Warburg, member of the Federal Advisory Council, prior to his appearance before the Board, asked the counsel of the bank for an opinion as to the legality of the proposal. An opinion was rendered (copy of which will appear later in the record) by letter of May 18, 1923, against the legality of the proposal.

Mr. Warburg suggested to the Board other means by which a currency clean up in Cuba might be effected.

By resolution passed June 27, 1923, and amended July 30, 1923, the Federal Reserve Board granted permission to the Federal Reserve Banks of Boston and Atlanta to establish agencies in Havana, it being understood that the Atlanta bank would furnish the currency required for use on the Island, while the Federal Reserve Bank of Boston would execute all exchange transactions, including cable transfers. The agencies were accordingly set up and the business has been conducted on this basis.

On September 1, 1923, the appointment of the National City Bank of New York as agent and correspondent in Cuba of the Federal Reserve Bank of New York was terminated. This was by direction of the Federal Reserve Board and was coincident with the opening for business of the Cuban agencies of the Federal Reserve Banks of Boston and Atlanta.

On Friday, April 9, 1926, there was a run on the banks in Havana. On Saturday, April 10, this bank was advised of the fact and informed that the run was chiefly on the Royal Bank of Canada; also that large amounts of currency were needed to meet the situation. Several of our member banks in this city deposited Federal reserve notes with us and directed this bank to make wire transfers of large amounts -- a total of \$31,950,000 -- with instructions to make payment in Havana in currency. It then developed that the amount of currency held by the Federal Reserve Bank of Atlanta at its agency in Havana did not exceed eight or nine million dollars, while the payments directed to be made amounted to several times that sum, so that the Federal Reserve Bank of Atlanta was unable to satisfy the cable transfers. The Cuban banks passed over the difficulty by closing at noon on Saturday, April 10. The New York correspondents of the Cuban banks urged the Federal Reserve Bank of New York to take steps to see to it that there was an adequate supply of currency there on Monday, April 12, to enable the agencies of the Federal Reserve Banks of Boston and Atlanta in Havana to make the necessary payments. This was finally arranged through the Federal Reserve Board, which ordered the Federal Reserve Bank of Atlanta to charter a special train to take the currency to Jacksonville. The money was then transported to Cuba by a Cuban gun-boat. The fact that the run occurred on Saturday and a Sunday intervened before the next business day was the only thing which prevented the development of a serious situation.

Under date of June 17, 1926, in a letter addressed to Mr. Hamlin of the Federal Reserve Board, Governor Harding outlined his objections to the dual agencies in Havana and in particular his objections to the establishment of an agency of a Federal reserve bank in Cuba for the purpose of providing the people of Cuba with currency fit for circulation and for the purpose of enabling a Federal reserve bank to keep in circulation in Cuba a large volume of its Federal reserve notes. Governor Harding, in commenting generally on the situation, also stated his view that the functions of such an agency should be limited to the purchase of bills of exchange and the purchase and sale of cable transfers, which transaction he regards as authorized under Section 14 of the Federal Reserve Act, since they would result in the stabilization of exchange rates in Cuba, and that the agency should be confined to one Federal reserve bank. He stated that unless the Board were willing to consolidate the two agencies under the direction and control of the Federal Reserve Bank of Boston, the agency of the Federal Reserve Bank of Boston in Havana should be discontinued.

On October 22, 1926, the Federal Reserve Board wrote this bank a letter announcing that a hearing would be held before the Board on November 11, with respect to the following proposals:

"(1) To consolidate the Havana agencies of the Federal reserve banks of Boston and Atlanta, and

"(2) To place under the supervision of the Federal Reserve Bank of Atlanta an agency performing all of the functions now performed by the existing agencies."

The officers of the bank have reviewed the situation in the light of existing conditions and see no reason to change the views which they have hitherto expressed on the matter, i. e., they are opposed to the maintenance of any direct agency of a Federal reserve bank in Cuba.

(The letter referred to by Mr. Case is as follows:)

"FEDERAL RESERVE BANK OF NEW YORK, May 18, 1923.

"Paul M. Warburg, Esq.,

"31 Pine Street,

"New York, N. Y.

"Dear Sir:

"You have asked for my opinion as to the respective rights of Federal reserve banks and their branches and foreign 'agencies' of Federal reserve banks to issue currency.

"Under Section 16 of the Federal Reserve Act it is provided that Federal reserve notes are to be issued at the discretion of the Federal Reserve Board for the purpose of making advances to Federal reserve banks through the Federal reserve agents of the various districts, and for no other purpose.

"Branch offices of Federal reserve banks are provided for in Section 3 of the Act. They may be established on the initiative of the Federal reserve banks or upon the mandate of the Federal Reserve Board within the Federal reserve district of the bank of which they are made a branch, or within the district of any suspended Federal reserve bank. They are subject to such rules and regulations as the Federal Reserve Board may prescribe, and the law provides that they shall be operated under the supervision of a board of directors of not more than seven or less than three, of whom a majority of one shall be appointed by the Federal reserve bank of the district and the remainder by the Federal Reserve Board. It is provided that these directors shall hold office during the pleasure of the Federal Reserve Board. It should be noted that the operations of the banks and their branches are expressly limited to their respective districts. Also it will be noted that the law provides safeguards for the operation of banks and branches, and that the establishment of branches was authorized in order to extend to the various business communities within the Federal reserve district all the facilities of the Federal reserve banks. The Federal Reserve Board has expressed the opinion that branches are merely extensions of the corporate entities of the banks. In my opinion, the note issue power extended to the banks through the Federal Reserve Board applies to branches as well.

"Section 14 provides for the appointment of agencies of Federal reserve banks in foreign countries. The origin and pre-enactment history of this section and its administration are sufficiently well known to you and clearly indicate that its only purpose was to extend in proper cases the exchange operations of the System. No express authority for the extension of the note issue privilege to foreign agencies can be found in this section or elsewhere in the Act, nor can such power be implied in the light of other limitations of the law and the history and purpose of this section.

"You ask also whether the language of Section 14 (e) properly interpreted means that the Federal reserve banks are restricted to the appointment of for-

oreign banks or banking firms as agents in foreign countries for the transaction of foreign exchange business. The language of Section 14 (e) is that Federal reserve banks may 'appoint correspondents and establish agencies in such countries'. A fair construction of this language makes extremely doubtful, to say the least, the power of the reserve banks to initiate a foreign agency as an integral part of their own organization. That an already existing institution may be designated as a correspondent or agent is clear, but that the reserve banks may establish in the sense of 'found' their own agency would seem to depend on the interpretation of the word 'establish'. This word may mean 'appoint', (see Webster's International Dictionary); and that this meaning, rather than that of 'found', was intended appears from the language of the last sentence of the section, where we find that in providing for the use of a foreign agency of one Federal Reserve bank by the other banks the law says: 'Whenever any such account has been opened or agency or correspondent has been appointed;' and again, we find the language: 'through the Federal reserve bank opening such account or appointing such agency or correspondent.' A further consideration in support of this construction of the law is that all of the purposes sought to be accomplished by Section 14 (e) may be effected by the appointment of an existing foreign bank or banking firm and consequently there can be no need for the extension by a reserve bank of its own organization. There being no such need, it is hardly to be supposed that this method was intended. If a charge should be made that an agency had been founded instead of appointed, and that what was in name an agency was in reality a branch, I think the courts would hold the transaction ultra vires and void.

"You inquire finally as to the obligation on the part of a foreign agency to redeem in gold or lawful money Federal reserve notes.

"The Federal Reserve Act provides in Section 16 that Federal reserve 'notes shall be obligations of the United States' that they 'shall be redeemed in gold on demand at the Treasury Department of the United States or in gold or lawful money at any Federal reserve bank.' From what I have said heretofore the conclusion seems inevitable that a branch of a Federal reserve bank is included in the term Federal reserve bank for this as well as all other purpose. The law, therefore, imposes a plain mandatory duty on Federal reserve banks and branches to redeem these notes in gold or lawful money. If it should appear that the agency was in reality an agency for the purpose contemplated in Section 14, and not a branch, I think the courts would hold that there is no binding legal obligations to redeem Federal reserve notes in Cuba in gold or lawful money, though it seems quite clear that under the apparent arrangement now contemplated in Cuba there would be a practical necessity to do so. If, on the other hand, a Federal reserve bank should establish in Cuba what would prove to be in fact a branch, though purporting to be an agency authorized by Section 14, and the question should arise as to the obligation of such a branch to redeem Federal reserve notes in gold or lawful money, it is my opinion that the courts would hold that the obligation of the branch to redeem in gold or lawful money is absolute, notwithstanding the ultra vires nature of such establishment.

"Very truly yours,

"(Signed) L.R.Mason, General Counsel."