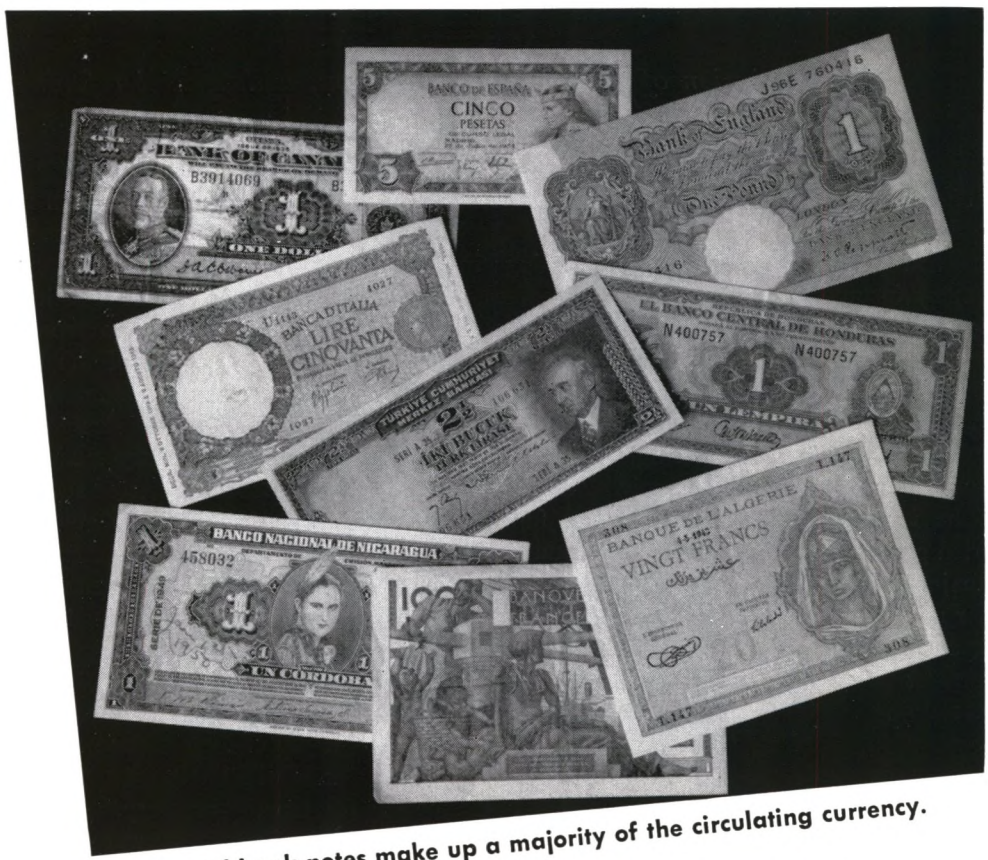
MONTHLY REVIEW



Central bank notes make up a majority of the circulating currency.

FEDERAL RESERVE BANK OF RICHMOND JULY 1962

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The Note Issue Function of . . .

CENTRAL BANKS

This discussion of the note issue function, with special reference to the Federal Reserve System, is the second in a series of articles on central banks.

The function of issuing bank notes is almost universal with central banks. In most cases the banks have had this privilege from the beginning; indeed, in many instances the primary purpose of establishing the bank was to provide a paper money issue, and often the term "bank of issue" was used synonymously with "central bank." One scholar has stated that "The primary definition of central banking is a banking system in which a single bank has either a complete or a residuary monopoly of the note issue."

The importance of the note issue function has varied greatly over time and among countries. It is a major function of virtually all central banks since their notes make up a very large part of the circulating currency. It is the dominant function in those countries where the note issue is the dynamic or determining element in the total money supply. In the more advanced countries of the Western World, however, demand deposits make up the bulk of the money supply and are the medium through which most changes in that supply are brought about. The note issue function is correspondingly less important in such countries.

DEVELOPMENT OF BANK NOTES The modern bank note had its beginning in the seventeenth century at about the same time the earliest central banks were being established. In the more densely populated and economically advanced countries, use of the notes spread rapidly because paper offered obvious advantages over the heavy and bulky coins of the day. And, of course, banks promoted the trend since assets acquired by the issue of notes were the major source of their profits.

Early bank notes often ran into competition from another form of paper money—treasury notes issued by governments. Such government issues proved to be a convenient substitute for taxation and were usually made by governments in pressing need of funds. The size of the issues bore no relationship to the economy's monetary requirements, but rather depended on the size of the issuing governments' deficits. Monetary students soon noted two important disadvantages of such money. First, the issues seldom reduced the governments' deficits. Instead, by driving up the prices of the things the governments bought they tended to perpetuate the deficits, thereby requiring further issues, which frequently led to an inflationary spiral. Second, such issues were not "elastic"; that is, they contained no features which caused them to expand when the monetary needs of the economy rose or to contract when those needs declined.

On the contrary, under a properly regulated system, bank notes were paid out only when there was a demand for them—when the economy required more money. If requirements declined, the notes were brought back to the issuing bank for redemption or for use in repaying bank loans. In either case the notes were retired from circulation for the time being.

Over the years repeated instances of inflation caused a loss of confidence in treasury-issued paper money and a realization that a well-regulated system of bank note issue provided a superior monetary arrangement. Slowly and in various ways systems of bank note issues came to replace, at least in large part, treasury paper issues.

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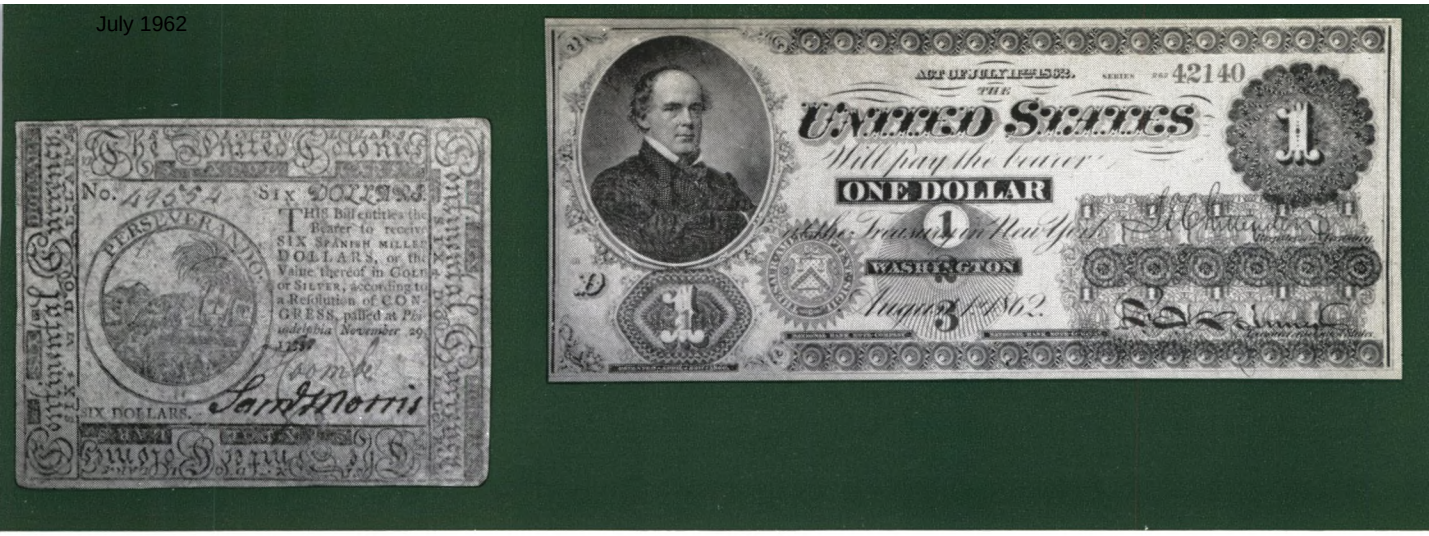

DEFECTS OF COMMERCIAL BANK NOTES The arrangements under which banks came to issue notes developed differently in different countries. In some there was no central bank for a long time and notes were issued solely by commercial banks. Where central banks had been established, they usually had no monopoly of the note issue but rather issued notes which competed with those of commercial banks.

Many difficulties and problems developed with note issues by commercial banks. Without adequate regulation, some banks abused the issue privilege, overissued notes, and failed. Even when the notes were redeemable at par by the issuing bank, they sometimes fell to a significant discount at distant points if there were no arrangements for redemption at convenient locations. This was quite important in large countries, especially those with inadequate communication and transportation facilities, because it resulted in varying values for different components of the money supply. Further, the notes frequently were not uniform as to size, shape, color, or quality of printing or engraving. These differences often encouraged counterfeiting which sometimes became a major problem. Moreover, systems of commercial bank note issues failed to provide for "emergency elasticity"; that is, arrangements for suspending for short periods of time the normal regulation governing note issues to allow larger amounts to be issued to meet public demands caused by panics or other abnormal situations. Long and painful experience has shown that such arrangements are essential, especially if there is less than complete confidence in the banking system.

Finally, as the theory and practice of central banking developed another problem emerged. The ability of a central bank to control the total money supply (including demand deposits) depends in part on the supply of coin and currency, which includes note issues. When a large part of the currency supply is made up of commercial bank notes, that supply is subject to erratic and unpredictable fluctuation depending on actions taken by the banks and whims of the public resulting from changes in confidence or other factors. Thus, the use of commercial bank notes complicated the principal task of central banks.

WHY A CENTRAL BANK MONOPOLY? The disadvantages described above can, in large measure, be overcome by giving the central bank a monopoly of the note issue. The central bank will not fail, so note holders will not lose for that reason. In addition, the notes are usually made legal tender and guaranteed by the national government. The best facilities and workmanship available are used in printing and engraving the notes so that counterfeiting is discouraged. If redemption is permitted and is significant, redemption points are established at various places so that the notes do not go to a discount because of distance. Emergency elasticity is provided because the central bank can safely be entrusted with the power to suspend normal regulations for limited periods of time. The power to control the note issue, even though incomplete, simplifies the central bank's task of controlling the whole money supply. Finally, since the note issue is the source of large profits, which come from the exercise of one of the sovereign powers of government, it is generally

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believed that it should be concentrated in one organization not operated for profit and closely supervised by the government so that the bulk of the profits can more easily be recouped by the government.

The desirability of concentrating the note issue in the central bank came to be realized slowly, mostly during the nineteenth century. But accomplishing that step was not an easy matter. The commercial banks wanted very much to retain the right to issue notes, both because of the profit it conferred and because of the prestige it carried. The process of transferring the note issue power was long and involved. One method was to deny the note issue to new commercial banks and allow the central bank to assume any issue powers possessed by banks which went out of existence.

THE UNITED STATES EXPERIENCE In the United States commercial banks issued notes until 1935. The First and Second Banks of the United States, which functioned to some extent as central banks, issued notes along with state-chartered banks. From the end of the Second United States Bank (1836) until the Civil War, state bank notes were the only paper money in the country. While some states devised safe and sound systems of note issue, many states were lax in their regulation and many banks abused the note issue privilege, causing losses to the public.

In 1863 the National Banking System was established, providing for a safe and uniform bank note issue under Federal supervision and secured by the pledge of certain United States Government bonds which had the "circulation privilege." A Federal tax on state bank notes first levied in 1865 soon drove them out of existence, leaving the note issue solely to national banks. The only other form of paper money then in circulation was the United States note ("Greenback") but the gold certificate and silver certificate were added a little later.

National bank notes represented a great improvement in that they were uniform and safe. They were greatly lacking, however, in elasticity, both ordinary and emergency. This, along with other defects in the system, was primarily responsible for the recurring money panics which scourged the country from 1870 until 1907. Those panics did much to stimulate the reform movement which culminated in the establishment of the Federal Reserve System in 1913.

Federal Reserve Banks issued notes from the beginning, and it was expected that those notes would soon displace national bank notes. Provisions were made whereby national banks could retire their notes easily without loss, but they were not required to do so and few did. In fact, in 1932, when the Reserve Banks were experiencing difficulty in meeting the great demand for currency caused by widespread bank failures, national banks were allowed to increase their note issue substantially for a short time. Only a few banks took advantage of the law and the increase in notes was modest. Shortly afterwards the regulations governing the issue of Federal Reserve notes were liberalized so that Reserve Banks could meet the currency need. In 1935 all United States bonds with the "circulation privilege" were retired and national banks ceased issuing notes. Since then the notes have been gradually retired and now Federal Reserve Banks have a monopoly of the issue of bank notes.

REGULATION AND COLLATERAL In the past the most important features of a system of bank note issue were provisions setting the maximum amount

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that could be issued, insuring the security or value of the notes, and giving elasticity to the issue. Where notes constitute the largest and most dynamic part of the money supply, those provisions are still of major importance. Also, in countries which maintain any form of the gold standard it is generally considered necessary to require some reserve against notes in the form of gold or gold certificates, or, in many countries, foreign exchange assets.

METHODS OF LIMITING VOLUME Various methods or devices, together with modifications and combinations of them, are employed to limit the maximum amount of notes which may be issued.

In many gold-standard countries it is customary to require a minimum reserve in the form of gold or gold certificates. The remaining collateral may be in the form of discounted paper, government bonds, or general assets of the bank. The gold reserve requirement sets a limit to the total amount of notes which may be issued.

Another method, long used in England, is to provide for a limited "fiduciary" issue of notes secured by government bonds and to require that all notes beyond that be fully backed by gold. That system was quite inelastic and is not used anywhere today.

Still another method is to require that the notes be secured by certain specific issues of government bonds which are limited in amount. This method was used in part to limit the volume of national bank notes in this country.

A widely used method of control is for the government to prescribe a maximum amount of notes which may be outstanding. The government, of course, is free to raise or lower that maximum from time to time as it sees fit.

Finally, reserve and collateral requirements may be abolished or indefinitely suspended, leaving the notes subject to the same regulation as the deposits or other liabilities of the bank. This means that the amount of notes outstanding is left to the discretion of the central bank or, more likely, to the automatic operation of the banking system as explained below. This situation prevails in many countries of the world today.

SECURITY AND REDEEMABILITY PROVISIONS Most bank notes are now issued by central banks, and there are few problems in insuring their security since a government cannot allow its central bank to fail or to default on its obligations. In fact, in most countries it might be said that there can be no problem of security or redemption since no meaningful redemption is allowed and the central bank note is in practice the ultimate form of money.

Usually various forms of collateral are pledged to secure the notes. If no specific assets are so pledged, note holders have a claim against the general assets of the bank, and may have a preferred status, ahead of depositors. Further, the security of central bank notes (in terms of the country's monetary unit) is further assured by the fact that they are usually made legal tender and are guaranteed by the national government. Where necessary, the maintenance of the notes at a uniform value throughout the country is assured by the establishment of a number of redemption centers.

THE FEDERAL RESERVE NOTE The Federal Reserve note was designed to add "automatic elasticity" to the uniformity and safety which had characterized the national bank note. This was to be accomplished by requiring "eligible paper" as the principal form

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