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THE TECHNIQUE OF CREDIT REGULATION

During the past year, the Federal Reserve System has adopted measures of unusual significance and interest. Some were the familiar measures of credit regulation. Others were quite new, and involved the exercise of powers only recently granted by Congress to the Federal Reserve System and never before exercised.

These measures serve to illustrate the technique of credit regulation and I should like to review them with you as examples of technique rather than from the standpoint of policy. Let me first restate the purposes and scope of credit regulation and also the general long range policy that has been pursued by Federal Reserve authorities in the recent past.

The basic purpose of what may be described broadly as central banking powers, such as those vested in the Federal Reserve System, is aid in stabilizing and equalizing monetary conditions so that the supply of credit is neither inadequate for sound business activity nor so excessive in amount that it invites speculative abuse. For the achievement of this purpose, the Federal Reserve banks depend largely upon open market operations. That is, they may purchase investment securities in the open market at times when the supply of funds in the money market needs to be increased, or they may sell investment securities at times when an excess of funds overhangs the money market and needs to be absorbed lest it stimulate speculation.

In addition there are other means of influencing credit, particularly by raising or lowering the discount rate and by advancing funds to such individual member banks as apply for accommodation to replenish their reserves.

These means of credit technique are exercised by the banking authorities to implement policies which they believe the economic situation requires. At one time, they may feel that the situation requires a restraining policy, and to carry out that policy they may sell securities from their portfolio, or they may raise rediscount rates, or do both. At another time, they may believe that the situation requires a policy of ease, and to carry out that policy they may purchase securities in the open market - thereby supplying banks with additional reserves - and they may lower the rediscount rates. Open market operations and changes in the discount rate are the two principal means of credit technique. They are flexible instruments and they are general in their application. That is, they affect the credit picture as a whole, rather than individual banks.

As you know, the Federal Reserve authorities have felt and frequently stated that an easy money policy is essential to help promote economic recovery. Rather than speak of the considerations upon which this policy is based, I wish to invite your attention to the various technical steps whic have been taken and the several means employed in carrying out this broad general policy during the past year or so. A knowledge of the technique employed to implement a particular policy seems to me of practical importance and of interest irrespective of what that policy may be. In other words, I wish to discuss how a given policy was effected rather than why.

The measures I wish to review began with the increase in reserve requirements a year ago last August. This was not what I call a measure of credit technique. It was instead intended as a basic readjustment which placed the System once again in a position to use its traditional and flexible credit instruments and to make them effective. It was adopted because a situation had developed in which the ordinary means of credit technique - namely, open market operations and rediscount rates - had lost their efficacy. This situation arose primarily, as you know, from the flow of gold into this country from abroad, as a result of which the excess reserves of domestic banks swelled to such an extraordinary degree that the customary instruments of credit policy were wholly ineffective. If the Federal Reserve System had desired to have easy money conditions regardless of the consequences that might ensue in case unsound and inflationary conditions developed, it could have adopted a policy of doing nothing at all. But it sought instead to reestablish the position it was intended by law to occupy - a position in which it could act promptly and effectively either in the direction of easing the credit situation further, or in the direction of restraint - whichever appeared to be in the public interest.

Theoretically and historically, the technique of credit regulation has been considered most efficient when member banks have had a minimum of excess reserves and could expand the amount of credit outstanding when and as steps are taken to increase their reserves. This can be most readily effected by open market purchases, which have the effect of making funds available to the money market and of making it unnecessary for most member banks to apply to the Federal Reserve banks for advances. However, should individual banks still require funds, they may borrow from the Federal Reserve bank and when they do so its discount rates can be reduced in conformity with a policy of ease, or conversely can be raised if an opposite policy is adopted. But, of course, when the banks are superabundantly supplied with reserve funds from an outside source and therefore have little, if any, occasion to seek additional funds from the Federal Reserve banks, the discount rate, like open market operations, ceases to be applicable. Under such circumstances, even if the Federal Reserve System were to sell off its entire portfolio of government securities, the action would fail to absorb the excess reserves. Moreover, by such action the System would be flinging away the possibility of conducting further open market operations to any purpose, because subsequent purchases of securities that it might make would merely increase the excess of reserves again. The System would be exhausting its principal means of influencing credit conditions. In other words, the situation would continue to be out of control.

The Board, in explaining its action at the time, said:

"For current adjustments of the reserve position of member banks to changes in the credit situation the Reserve System should continue to rely on the traditional methods of credit control through discount policy and particularly through open-market operations. By the present action excess reserves will be reduced to within the amount that could be absorbed through open-market operations, should such action become desirable. Conversely, should conditions develop requiring expansion of reserves, they could be increased through open-market operations."

Subsequently, the Secretary of the Treasury announced that the Treasury "proposes, whenever it is deemed advisable and in the public interest to do so, to take appropriate action with respect to net additional acquisitions or releases of gold by the Treasury Department. This will be accomplished by the sale of additional public-debt obligations, the proceeds of which will be used for the purchase of gold, and by the purchase or redemption of outstanding obligations in the case of movements in the reverse direction."

The Treasury's purchases of gold pursuant to this policy had the effect of keeping the gold from getting into bank reserves and swelling them to greater volume.

On January 30 the Board announced final increases in reserve requirements and pointed out in its statement made at the time that by this action the System would be restored to "a position where such reduction or expansion of member bank reserves as may be deemed in the public interest may be effected through open-market operations, a more flexible instrument, better adapted for keeping the reserve position of member banks currently in close adjustment to credit needs."

These measures - the increase in reserve requirements by the Federal Reserve System and the sterilization of gold by the Treasury - were unusual measures taken to offset an unusual condition, namely, the enormous inflow of capital and gold from abroad. They were outside the category of normal measures of credit regulation. They were related to normal measures of credit regulation in somewhat the same way that reballasting a ship is related to its regular operation. They were measures intended to neutralize the effect of major financial disturbances originating abroad, and to keep the domestic credit situation amenable to the established technique of regulation.

As the Board emphasized at the time, these measures involved no abandonment of the policy of monetary ease which the Board has consistently pursued, by using, as it announced that it would, the customary and flexible instruments of open market and rate policy.

At this point perhaps I should briefly restate the process by which open-market operations achieve their purpose. In the first place, as you know, when a bank enlarges the amount of credit it has outstanding, either by additional loans to its customers or by additional purchases of investment securities, its reserves tend to be reduced. Consequently it cannot enlarge the amount of credit it has outstanding unless it has reserves in excess of what it is required to have. On their own initiative banks may procure additional reserve funds either by borrowing or by selling securities. Or the Federal Reserve System on its initiative may supply banks in general with additional reserve funds by open-market purchases of investment securities; for as the Federal Reserve banks pay for the securities they buy, either by check or by credit, the reserves of member banks are increased. In April, the Federal Reserve banks purchased about $100,000,000 of securities and this amount immediately flowed into member bank reserve accounts. It eased their position so that they would have no lack of funds for continuing to extend credit, whether in the form of loans or in the form of investments. Contrariwise, if the Federal Reserve System had sold securities, the process of paying for them, whether purchased by member banks or by the customers of member banks, would have reduced the reserves of member banks. Purchases by the System tend to ease the money market, sales by the System tend to tighten it.

The ease produced by the System's purchases in April, therefore, was deliberately brought about. If need had arisen that condition of ease could have been as deliberately ended by a reversal of policy and the sale of investments. The situation, in other words, was one that had been made amenable to the normal measures for influencing credit.

In August and September a further step in pursuance of the System's established policy was taken when the Federal Reserve bank rediscount rates were lowered. In approving the first of these changes the Board stated that its "approval was based upon the view that the reduction of discount rates at this time would assist in carrying out the System's policy of monetary ease and make Federal Reserve bank credit readily available to member banks for the accommodation of commerce, business and agriculture, without encouraging member banks to borrow outside of their districts or to liquidate their portfolios in order to be in a position to meet the needs of present or prospective borrowers."

The Board went on to say "The reduction in discount rates, which have had little or no practical effect during the period when excess reserves were abnormally large and widely distributed throughout the System, brings the rates into closer relation with the interest rate structure generally prevailing, and affords to member banks the benefit of rates, on advances made by the Federal Reserve bank, which are in line with those available in the money market. During the extended period when excess reserves of the banking system were between two and three billions of dollars, the occasion did not arise except in rare instances for member banks to borrow from the Federal Reserve banks, and the discount rates were accordingly inoperative as a practical matter.

"As a result of the continued progress of the recovery movement, demands of agriculture, industry and commerce for bank accommodation have steadily increased and at the present time are augmented by seasonal requirements, particularly with relation to crop movements.

"It is the Board's view, therefore, that at this time the Federal Reserve System can best discharge its public responsibility and promote the continuance of recovery by making it possible for member banks to obtain accommodation from Federal Reserve banks at rates which will encourage them to employ their funds to meet the needs of agriculture, industry and commerce."

Later in September, the Federal Open Market Committee announced that it had authorized purchase in the open market from time to time of "sufficient amounts of short-term United States Government obligations to provide funds to meet seasonal withdrawals of currency from the banks and other seasonal requirements." It said further:

"Reduction of the additional holdings in the open market portfolio is contemplated when the seasonal influences are reversed or other circumstances make their retention unnecessary.

"The purpose of this action is to maintain at member banks an aggregate volume of excess reserves adequate for the continuation of the System's policy of monetary ease for the furtherance of economic recovery."

At the same time, the Committee announced that at the request of the Board of Governors the Secretary of the Treasury had agreed to release - that is, to desterilize - approximately $300,000,000 of gold from the Treasury's inactive account. Accordingly, the Treasury was credited with that amount on the books of the Federal Reserve banks which in the course of regular Treasury disbursements found its way into the reserve accounts of member banks and increased their available funds correspondingly. This was an effective means of utilizing our monetary measures to maintain the policy of ease. The Committee's statement made at the time pointed out that:

"This action is in conformity with the usual policy of the System to facilitate the financing of orderly marketing of crops and of autumn trade. Together with the recent reductions of discount rates at the several Federal Reserve banks, it will enable the banks to meet readily any increased seasonal demands for credit and currency and contribute to the continuation of easy credit conditions."

As stated in the October Federal Reserve Bulletin, this action toward augmentation of member bank reserves was taken to anticipate the usual seasonal needs of member banks for currency and credit. The action of the System in bringing about an increase of available funds put banks in a still easier position to meet seasonal needs as well as increasing demands for bank credit. It was an exercise of credit technique under normal and typical conditions.

Before passing on to the latest measure of credit technique taken by the System, I want to mention a recent change in the regulations governing discounts by the Federal Reserve banks. This change was effected by the issuance of Regulation A in revised form effective October 1. Its significance lies in the fact that in determining the eligibility of paper for discount, the form of the obligations to be discounted is considered of less importance than it used to be. Originally the privilege of rediscount at the Federal Reserve banks had been restricted to relatively short-term paper arising from certain commercial and agricultural activities. As you know, the amount of such paper has tended in recent years to constitute a smaller and smaller proportion of the total amount of paper available to banks. To the extent that banks were dependent on such paper for discounts, the decrease in its amount meant in effect a curtailment of the power of the Federal Reserve banks to extend credit. The Banking Act of 1933 and the Banking Act of 1935 both enlarged the classification of paper upon which individual member banks might procure funds from the Federal Reserve banks for the replenishment of their reserves, and Regulation A as recently issued by the Board carries out the purpose of these changes in the law.

The new Regulation had been in preparation for a long period and the time of its issuance had no special bearing with respect to the current situation. It was rather a longer range measure. Moreover, its issuance was not of course a measure of credit regulation, like open market operations or changes in the discount rate, but a liberalization of the conditions under which the regular means of credit regulation are exercised. Let me emphasize that the term "credit regulation" is not altogether satisfactory. I have taken care to avoid using the phrase "credit control", for that is far too strong. The technique which I have been describing "influences" rather than "controls".

The latest measure of credit regulation taken by the System was the change in margin requirements announced a little over a week ago and effective last Monday. The power to fix margin requirements is, as you know, a new and special responsibility imposed upon the Board by the Securities Exchange Act which Congress adopted in 1934. Its effect is not general upon the whole field of credit. In this respect, it differs from other means of credit regulation, namely, open market operations and changes in the discount rate. It is directed exclusively at the use of credit advanced by brokers, dealers and by banks for the purpose of carrying registered securities. Theoretically, margin requirements can be raised when it appears advisable to restrain speculative use of credit and they can be lowered when it appears advisable to relax the restraints.

Because of the special nature of this particular power of credit regulation, it can be exercised independently of other measures by which the credit situation is influenced. Thus it is possible to pursue a restraining policy with respect to the use of credit for securities' speculation at the same time that an easy money policy is being pursued with respect to the use of credit for commerce, industry and agriculture. By its most recent action the Board reduced margin requirements from 55 percent to 40 percent. This eased credit conditions so far as securities' trading is concerned. It happens that this policy of ease in the special field of stock market trading coincided with the policy of ease which the Board has all along pursued in the general field of credit, but since I am discussing the technique of credit regulation I wish to emphasize the fact that conditions do not always call for a parallel policy by any means. The peculiar character of the power to fix margin requirements is that it makes it possible to influence credit conditions in a particular field independently, if necessary, of what is done in other fields.

It is evident that the exercise of Federal Reserve functions, like those of any other organization, involves sometimes merely the use of certain tools according to accepted procedure, and sometimes a change in the tools themselves or in the conditions under which they are to be used. Open market operations and changes in discount rates are the customary tools regularly employed in performance of Federal Reserve System functions. They are practicable, flexible and tested tools, which can be used to ease money conditions at one time and to tighten them at another. They can be made to accomplish their purposes without shock - without violent and painful adjustments. They can be applied gradually so that their effect is barely perceptible. If necessary, they can be applied vigorously and sweepingly.

It is true of any technique that its effectiveness is dependent upon the conditions under which it is used. The inflow of gold into this country from abroad created a condition under which the normal, flexible credit tools had lost their effectiveness. Raising or lowering the discount rate would mean nothing when banks had such a super-abundance of funds that they had no occasion to look to Federal Reserve banks for accommodation. Selling government securities when the excess reserves to be absorbed were greater than the volume of securities available for sale, would amount to throwing away tools which are necessary if there is to be any effective supervision to influence general credit policies in the broad public interest.

There has been no change meanwhile in the basic policy of monetary ease. Open market purchases of securities and lowering of the rediscount rates have been undertaken in pursuance of this same fundamental policy. And it is important to note that a situation has been restored where the normal technique of credit regulation once more applies.

The functions and responsibilities I have been discussing are not peculiar to the Federal Reserve System, of course. They are the functions and responsibilities of the central banking organization of virtually every country. And as such they differ essentially from the functions and responsibilities of privately managed banks operated for profit. A central banking organization makes loans and purchases securities not for the purpose of making a profit, but for the purpose of increasing the supply of credit available through privately managed banks. At the present time, for example, the twelve Federal Reserve banks have cash and reserves of nearly nine and a half billion and earning assets of only two and a half billion. Such a position, which is quite different from what an enterprise operated for profit would choose to maintain, is entirely normal for a central banking organization.

It appears, therefore, that during the period I have reviewed, the System has consistently pursued a policy of monetary ease amenable to regulation. The increase in reserve requirements and the sterilization of gold had amenability to regulation as their objectives. The open market purchases, the reduction of discount rates, and the desterilization of a small portion of the gold had further ease as their objectives. Each of these measures has been effective in its own way in helping to achieve the combined objective. This series of measures is informative and illuminating to those who are interested in the technique of central banking, and I appreciate your kindness in giving me this opportunity to review that technique with you.