DISCUSSION[1]

R. C. Leffingwell.—No university man, certainly not one who studied economics in the university, can approach this audience without—I would not say trepidation, but—respect. I accepted your invitation not only with respect, but with real enthusiasm, because I look upon the economists of today as the priests of a religion of material salvation which must be successfully preached throughout this land if we are to survive the disastrous consequences of the great war.

I shall not allow myself to be diverted, either by my own impetuous disposition or by Professor Sprague's cordial invitation, into a discussion of the Treasury's policies. I had the honor of reading a paper on "Treasury Methods of Financing the War in Reference to Inflation" before the Academy of Political Science last spring in New York, and any one who is interested in my answer to Professor Sprague is respectfully referred to its proceedings.[2] The problem of today is the problem of banking and currency, and the assigned topic of this meeting is Federal Reserve Board policy. I propose to talk as briefly as I can about that absorbingly interesting subject. But in passing let me say this: the Treasury struggled, first to finance the war so that it should be won, and second to finance it without avoidable inflation. There was never a moment when the latter thought was not in the minds of Treasury officials; there was never a moment when the American people did not know that their duty was to save and to buy Liberty bonds and pay taxes with their savings. The methods chosen by the Treasury, the Federal Reserve Board, and other instrumentalities of the government to combat inflation were chosen thoughtfully and were on the whole very successful. No equal financial burden was ever assumed in a like period of time by this or any other government in this or any other war, yet war inflation here was less than in other countries including non-belligerents.

But inflation did come. It came to us before we entered the war. It came to Japan, it came to European neutrals. Inflation came because the world was wasting more than it was producing. We may be very ingenious in our methods and very wise in our policies, but they could not solve the problem presented by the fact that the world was using up more than it was producing. It is exceedingly important that we should have the discussion of federal reserve policies we are having today. But it is more important that we should realize what federal reserve or treasury policies will not do. They will not take away the curse of war. We fought a great war. We are proud of it and glad of it. But from the economic point of view, it was a reckless debauch, and the people ought to be told that the next time they enter upon an economic debauch they must pay the price, and the price will be registered in inflation. We must not delude ourselves, or those who rely upon us, with the belief that the consequences of economic waste can be avoided by any amount of wisdom and ingenuity in finance or banking.

Having thus got the question of method back in perspective, let us consider the Federal Reserve Board's policies. The problem of credit control

[1] The remarks of Dr. A. C. Miller, who took part in the discussion will appear in more amplified form in an article to be published in the June number.

[2] *Proceedings of the Academy of Political Science* (New York), vol. IX, no. 1.

since the creation of the federal reserve system, shortly after the war broke out in Europe, has passed through four phases: (1) before we entered the war, (2) during our active participation in the war, (3) the first year after armistice, and (4) the present readjustment period.

Before we entered the war, expansion in this country was based upon the importation of gold and investment securities. The federal reserve system was as powerless as a babe unborn to prevent it. The federal reserve banks were hard put to it to earn their operating expenses. Member banks did not have to borrow and therefore bank rates could not be effective.

The outbreak of the war in Europe, prior to the organization of the federal reserve banks, found this country well nigh helpless to meet the financial and banking problems thrust upon it. New York City had trouble to meet its foreign obligations in gold. The New York Stock Exchange was closed for a protracted period and later hesitatingly resumed operations under careful restrictions. These things happened because our financial system was in its infancy, and notwithstanding the fact that America was not a party to the war. It was not long before the federal reserve system was put in operation, and when, nearly three years after the outbreak of the war in Europe, America herself entered the war and assumed financial burdens of unparalleled magnitude, the federal reserve system made it possible for us to meet them without financial disturbance and without embarrassment of the Nation's capacity to produce and transport war materials and supplies. The Federal Reserve authorities have no need to shelter behind the Treasury's broad shoulders and they are entitled to high praise and the lasting gratitude of the American people for the important part they took in financing the great war. They advised the Treasury in the dark days of the war. Treasury officials and Federal Reserve authorities did not always agree among themselves or with each other, but, in the proud record of the Treasury, as well as of the federal reserve system, members of the Federal Reserve Board and governors and chairmen of the federal reserve banks are entitled to claim a share.

After we entered the war the addition of this government's buying power to the buying power of the governments of Europe created a wholly abnormal situation. The enthusiasm of our War Department and Navy Department was unlimited. Their orders and contracts called for goods and services far in excess of the country's capacity. During the whole period of the war any attempt of the Federal Reserve Board to control credit through rates would have been futile. The Treasury would have had to meet any rate they made at home, and the federal reserve bank rate could have no effect upon the international situation, because the international movement of goods, gold, and capital was controlled by foreign governments or our own for the purposes of the war. The adoption of a "dear money" policy during the war, with a view to preventing inflation, would have failed of that purpose unless it had been carried to such an extreme as to bring about such conditions in war time as exist today, in which case we should have lost the war and would have had to inflate afterwards in order to pay the indemnity which Germany would have imposed upon us! No, you cannot use rates in such a period as that from April, 1917, to November, 1918, effiectively to control credit. You have to adopt methods such as were adopted, and with a very extraordinary degree of success. The response which the American people made to the efforts of the Treasury and Federal

Reserve Board, of the Liberty Loan and War Savings organizations, of the Capital Issues Committee, of the Food and Fuel Administrations, and of the War Industries Board, for the most part without compulsion of law, to conserve capital, credit, goods, and services, was amazing proof of the passion with which the people entered the war. They worked and they saved and they did without things, and they are entitled to be proud of it.

After the war was over in the fighting sense, it went right on in the Treasury sense. We reached the peak of expenditures in the three months, November and December, 1918, and January, 1919. We spent two billion dollars a month. That was as much as the First Liberty Loan each month. Since armistice day this Government has paid out as much as before armistice day, twenty billions before and twenty billions after. The gross debt of the Government on armistice day was eighteen billions. Nine months later it was twenty-six and a half billions. While the Government debt was mounting thus, the same condition continued which had existed during the period of active warfare. It was no more practicable to exercise control of credit by the use of dear money than it had been before. Indeed, it was less practicable, because the enthusiasm, devotion and self-sacrifice of the American people while war was on vanished over night with the signing of armistice. The bills did not get paid any easier, but a good deal harder, because the Germans had capitulated.

The magnitude of the Government's expenditures after armistice day was such that plans had to be made for funding the greater part of them. The Victory Liberty Loan was floated in April and May, 1919, successfully, and a large part of the after-armistice indebtedness was lodged with investors. It could not have been floated in any such amount upon any terms in a period of dear money. If it had not been for the Victory Loan, the floating debt would have amounted to more than $8,000,000,000 on August 31, 1919. You cannot have credit control with an unmanageable floating government debt. If the Federal Reserve Board had prematurely adopted a dear money policy, they would have rushed into the difficult position in which unfortunately the Bank of England found itself because the British floating debt had gotten out of hand.[3]

The situation I have described did not really end on August 31, 1919—not indeed until January, 1920. Notwithstanding the success of the Victory Loan, it was not paid for in full until the latter part of November, 1919, nor had the Fourth Liberty Loan, issued in the fall of the previous year, yet been paid for in full; and the Federal Reserve Board remained in a difficult position with respect to the problem of credit control on this account and on account also of the fact that nearly two billion dollars of

[3] *Economist*, London, Jan. 24, 1920, p. 113: "Plenty of money and a consequent demand for bills have been the chief features of the internal history of the money market. The plenty may be attributed to the fresh creation of ways and means advances, necessitated by the maturing of more Treasury bills than were applied for. By this process, as we have frequently pointed out, dealers in and users of credit can now at any time oblige the government to create more 'cash at the bank' by the weapon that they hold in the shape of 1,000 millions odd Treasury bills outstanding. Thus the powers that be can make money dear by paying more for it, but they can not make it really scarce until, by taxation or otherwise, they have reduced the effectiveness of this weapon."

treasury certificates of indebtedness matured within six weeks, or thereabouts, in December, 1919, and January, 1920. The last six months of 1919 were therefore trying months, and the Federal Reserve authorities, rightly I think, moved cautiously in the use of the discount rate, testing that instrument under novel conditions. Early in November, 1919, they began a series of fractional increases in rates, but notwithstanding that caution, a quasi-panic in the securities market, particularly in government bonds, developed in the latter part of November, 1919.

There were a number of other obstacles in the way of more rapid progress in establishing credit control during that period:

The Treasury was in honor bound to use the bond purchase fund established by Congress for that purpose to support the market for Liberty Bonds. Thus whatever pressure upon the money market resulted from the efforts of the Federal Reserve authorities to control credit was automatically relieved by the Treasury. It is noteworthy that efforts to control credit never gave any sign of becoming effective until in April, 1920, the Treasury's moral obligation having been satisfied, it discontinued purchases for the bond purchase fund.

The Federal Reserve authorities had, wisely I think, undertaken the task of creating a market for acceptances, but in the effort to do so had felt it necessary to take acceptances at an artificially low rate.

An arrangement had been entered into during the war by which an increase in the clearing banks' rate on interbank deposits would result from any increase in the reserve banks' ninety-day rate on commercial paper. It was generally agreed that such an increase in the rate upon interbank deposits would be harmful to the whole situation, but the Federal Reserve authorities did not find it possible to eliminate this arrangement until January, 1920.

The effort to eliminate the differentials in favor of loans on government securities, which had much to commend it from a theoretical point of view, placed the federal reserve system in a dilemma between subsidizing inflation by maintaining a rate much below the market on commercial paper, or, on the other hand, creating a disaster in the market for government securities. It was finally solved in January, 1920, subordinating theory to the practical requirements of the situation, by elevating the commercial rate considerably more than the rate on war paper.[4]

Though something may be said for the view that in the latter part of 1919 there might have been a somewhat earlier and greater advance in rates

[4] The Federal Reserve Banks' holdings of paper secured by Government war obligations reached their peak on May 16, 1919 (just before the date, May 20, 1919, when the first payment on the Victory Loan reached the Federal Reserve Banks), when the amount of such paper was $1,863,000,000. On the same date, May 16, 1919, the Federal Reserve Banks' holdings of commercial paper, including bills bought in the open market, were at about low-water mark, $359,000,000. Since May 16, 1919, there has been a pretty continuous contraction in their holdings of paper secured by Government war obligations and expansion in their holdings of commercial paper. On December 26, 1919, war paper had been reduced to $1,510,000,000, but commercial paper, including acceptances, had increased to $1,270,000,000. On December 3, 1920, war paper had been reduced to $1,161,000,000, but commercial paper had increased to $1,859,000,000.

on commercial paper and in the open market buying rates for acceptances, my own judgment is that this is a question of detail, rather than of substance, and that the effort to make money really dear before January, 1920, when the Government was first able to reduce its floating debt to manageable amounts and maturities, would have risked more than it could have hoped to gain.

During the whole of 1919 the continuance of war expenditures and policies by the other departments of our Government, such as the War and Navy Departments, the Shipping Board and the Food and Railroad Administrations, and the expenditures of foreign governments out of loans made by the Treasury in pursuance of credits or commitments previously made, continued the abnormal demand for goods and services and the inflation of prices and wages, and of the public debt. Professor Sprague spoke of one instance: The regrettable fact is that the Government of the United States continued to furnish railroad transportation at less than cost until September 1, 1920, nine months after the Federal Reserve Board adopted its dear money policy, and continues today to lend money to the railroads at less than cost and much less than the market rate.

On the other hand, the removal by the Treasury and the Federal Reserve Board of the gold embargo immediately after the Victory Loan was the most important and effective step towards deflation taken in 1919.

During the latter half of 1919, the Federal Reserve Board attempted to deal with the problem of inflation by what Dr. Miller has called "direct action." It was apparent that, because of the gold embargoes maintained by practically every country except the United States, and because of other extraordinary conditions, an increase in the reserve banks' rates could not operate upon the international situation, in accordance with the pre-war classical example of the Bank of England, for instance, either to cause the importation or curtail the exportation of gold, or to curtail the importation or increase the exportation of commodities. An increase in rates could operate solely upon the domestic situation, and with painful results. Under these circumstances the Federal Reserve Board was, I think, bound to make the effort to deal with the problem by direct action. As a matter of fact, it was not until the spring of 1920, when both direct action and dear money were in full effect, that the reserve system was able to get any control of credit.[5]

A difficulty, peculiar to this country, in the way of the successful exercise of credit control by the Federal Reserve Board, whether by direct action or by dear money, lies in the fact that there are some thirty thousand

[5] *The Economist,* which has been a consistent critic of the Bank of England's dear money policy, puts the argument for direct action briefly in its issue of January 3, 1920, page 3, as follows: "In old days when the gold standard was effective, raising money rates at a time of undue credit expansion used to increase the basis of credit by bringing us gold. In these times no such effect can be counted on, and the higher price that has to be paid for money by speculators in securities and commodities has little effect upon them in view of the great fluctuations in prices and the large profits that these fluctuations bring them. If credit is to be reserved for producers and distributors of necessaries and restricted for those who are holding up commodities, this end would seem to be best accomplished by joint action on the part of the banks."

banks and trust companies in the country of which only some ten thousand are members of the federal reserve system, and that non-member banks and non-borrowing member banks possessed an enormous capacity for expansion independent of the federal reserve system.

When in January, 1920, the Government's floating debt had at last been reduced to manageable amounts and maturities, but the hoped for liquidation did not materialize, the Federal Reserve Board proceeded with vigor to control credit through rates. There was no reluctance about the Treasury's acquiescence in this change in the discount policy of the Federal Reserve Board. On the contrary, the Treasury strongly advised the 6 per cent rate which was adopted in January, and the 7 per cent rate which was adopted in May, 1920.

In thus advancing rates the Federal Reserve Board proceeded wisely and courageously in the effort to *control* expansion. With equal wisdom and courage it has not attempted to *prevent* it; and by permitting rates to remain below the open market rates and credit to be expanded during the period of deflation of prices, it has prevented the present business depression from degenerating into an old-fashioned panic.

The experiment made in 1920 of establishing penal rates for excessive borrowings was well worth trying. It may be questioned, however, whether experience has justified it. Certainly the adoption of the system of penal rates in a given federal reserve district does not justify the maintenance of a basic rate in that district lower than the rate maintained by reserve banks of neighboring districts or of the financial centers of the country.

Turning now to the future of federal reserve policy:

I share Dr. Miller's objection to Professor Sprague's suggestion that federal reserve rates should be determined by price movements. There is no man, or group of men, to whom the American people will, or should, accord the right to determine whether they shall be prosperous or miserable, whether they shall have high prices or low prices, whether they shall have good times or bad times. The day Professor Sprague's suggestion is adopted by the Federal Reserve Board marks the end of the federal reserve system. It would be absurd for the Federal Reserve Board to ignore price movements as symptoms of the general situation, but it cannot base its discount policy upon them.

On the other hand, the reserve alone is not an adequate guide. The obvious first principle is that the discount rate should be above the market rate, whether in consequence of the elevation of the Reserve Banks' rates or the depression of market rates. When it is possible to bring about this condition it will be the first duty of the Federal Reserve authorities to see to it that the command thus obtained of credit is maintained. When the reserve banks' rates are above the open market rates they will exert an automatic pressure on the banks, which cannot be expected to meet their customers' demands habitually at a loss. It is true that under normal conditions a central bank's rate, even when it is above the market rate, is not always effective. As I have pointed out, the reserve banks' rates were ineffective before we entered the war. But that situation need not concern us now nor for a long time to come, I imagine. It cannot happen until the production and saving of real wealth have made good the war's waste, and the independent resources of the banks suffice for the normal requirements of their customers. Then the member banks' dependence upon the federal reserve system will be as it should be, seasonal or occasional, and not habitual. Until then the market rates will tend to maintain themselves above reserve bank rates automatically, unless, of course, panic rates should be established, and we may be confident that they will not be.

If the reserve gets big enough to be embarrassing, the best cure for the situation which will then arise is to pay out gold and gold certificates, and restore them to circulation. Currency and credit have been expanded by the federal reserve system both because of the economy in the use of the reserve permitted by the federal reserve act and because of the withdrawal of gold and gold certificates from circulation in this country and the substitution of federal reserve notes requiring only a 40 per cent reserve. We shall not have restored our pre-war financial strength until we have returned to circulation the gold and gold certificates withdrawn during the war and since, and thus re-created the greatly depleted "secondary reserve." To the extent that gold and gold certificates are thus restored to circulation and federal reserve notes withdrawn, the practical importance of the objection raised by Professor Sprague and Dr. Miller to the federal reserve note as a credit note, as compared with the Bank of England note as a gold note, will be reduced.

In conclusion: Vastly important as are these questions, more important by far is the fact that today the governments of the world are busily engaged in dissipating the resources of the people of the world; and the Government of the United States of America is not guiltless. Just so long as we enroll armies and build navies in preparation for future wars, as men rush to Washington for relief and for special privileges, just so long will the fabric of the economic state be in peril. There is nothing that economists can do, nothing that the American people can do to save themselves, except demand that the waste of public funds shall stop—that there shall be no more militarism, no more subsidies or doles.

The Federal Reserve authorities have stood, during the three or four years of my acquaintance with them, for sound things in finance, for sound things in banking and currency. They are entitled to the support of all good citizens, because they stand today with their shoulders squared against the winds of popular stupidity, of political ingenuity, and of selfish interest. Give them your support.