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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

Subject:

From Mr. Goldenweiser

I attach a report of the meeting of the economic staff with members of the Board, which was held on Monday, March 9. This report was prepared by Mr. Longstreet.

CONFIDENTIAL
Notes on meeting of March 9, 1936

INSTRUMENTS OF FEDERAL RESERVE CONTROL

The framers of the Federal Reserve Act had two chief purposes in mind: to provide an elastic currency and to avoid the pyramiding of bank reserves, which, by concentrating reserves in New York City, had been an important causal factor in monetary panics of the sort that occurred in 1907. In its lending provisions the Federal Reserve Act was similar to Bank of England practice, but it adopted the Reichsbank system of requiring a minimum gold ratio. The chief instrument of control in the Act was considered to be the discount rate, while bill rate was considered important as an instrument of developing an American acceptance market.

Buying rate on acceptances

From the start the acceptance market has been fostered by the Federal Reserve System. Mr. Warburg, a member of the first Board, had received his training under the German school of banking, and he felt that a well developed acceptance market was necessary for control.

A veil of mystery has surrounded the bill market, chiefly because of the erroneous belief that farmers and other makers of bills directly benefit from a low bill rate, a broad bill market, and from Reserve bank purchase of bills. This mystery should be dispelled and the bill rate, although it has not received the consideration that has been accorded the discount rate, should be reviewed and determined just as carefully

Changes in the bill rate have always been initiated by the Reserve banks. After review by the Board, which usually set a minimum, the Reserve banks discussed the proposed change with operators in the market and the rate fixed was a result of compromise and trading. Changes in the bill rate have been discussed with operators because it has usually set the rate for the market as a whole.

The importance of the bill rate can be illustrated by experience in the autumn of 1928. At the beginning of that year a policy of restraint was adopted. The System sold about $400,000,000 worth of securities during the first five months of 1928 and the discount rate at New York and at most of the other Reserve banks was progressively raised from 3 1/2 to 5 percent by the end of July. During the same period the New York Reserve bank's buying rate for 90-day acceptances was raised from 3 1/4 to 4 1/2 percent. This level was below the discount rate and below the rate in the market, but it was felt that the bill rate did not affect the money market as a whole and that the benefit of the relatively low rate accrued to farmers. As a result of this policy the Reserve System's holdings of bills more than doubled in the last four months of 1928, increasing from about $200,000,000 to $500,000,000. These additional funds acquired by the market were available not only to farmers, but for any purpose for which the market wished to apply them. There was a spurt in activity in the security market, brokers' loans increased, stock prices rose in the midst of what was presumably a policy of restraint. The fact that funds acquired by the market through the sale of acceptances to the Reserve banks were available for any purpose was not clear to the managers of the System at that time either in New York or Washington.

Another example of the importance of the bill rate occurred in the fall of 1931. After England's departure from the gold standard in September of that year gold began to move out of the United States in large volume. In a period of six weeks we exported over $700,000,000 of gold. This loss subjected the banking system to additional strain during a deflationary period when bank failures were numerous. The System turned orthodox; the discount rate of the New York bank was increased from 1 1/2 to 3 1/2 percent and the bill rate from 1 to over 3 percent. These high rates no doubt contributed to an accentuation of the deflationary movement. Traditional central banking practice prescribed that a run on a country's gold be arrested by higher rates and this partly explains why rates were raised. Another important factor, however, was that the Glass-Steagall Act had not yet been passed and Government securities were not eligible as collateral against Federal Reserve notes. The amount of Federal Reserve notes in circulation had increased markedly during the hoarding of 1931 and as cover for these notes the commercial paper held by the Reserve banks was inadequate. Consequently a large amount of gold had to be retained.

Discount rate policy

The importance of discount rate was early recognized. Discount rate is usually less than short-term rates in the open market as well as rates banks charge their customers for loans. In this sense discount rate is not a penalty rate. It has usually been possible for banks to borrow from the Federal Reserve bank and to relend at a profit. This is not the practice, however, because of the attitude toward borrowing, which shows on the statement of the indebted banks, thus creating an unfavorable impression.

The Reserve banks used to take the lead in discount rate changes, but in 1927 the Board assumed an active part in forcing a reduction at the Chicago bank. In May of that year an easing policy was adopted largely to aid European countries in their post-war return to the gold standard. A number of foreign countries had just returned to gold and many more were preparing to do so. The Reserve banks first purchased securities on the open market. Then it was agreed that in July the Kansas City Reserve bank should take the first step in a general reduction in discount rates, as a gesture that the policy was based in large part on agricultural considerations. Governor Bailey of that bank, when asked later why he reduced the discount rate, replied, "For a good and sufficient reason — because Ben Strong told me to". The manner in which Reserve policy was determined in those days is well described in a recent book by Karl R. Bopp, entitled "Agencies of Federal Reserve Policy".

The Federal Reserve Bank of Chicago was not in favor of this policy and reduced its rate only under compulsion by the Board. Senator Glass objected to this compulsion on the grounds that the Board was exceeding its authority. In 1919, however, Senator Glass, acting in his capacity as Secretary of the Treasury, had requested the Attorney General to render an opinion as to whether or not the law gave the Board the power to require a change in discount rates, at the same time presenting arguments as to why he thought the Board did have the authority. An opinion was rendered by the Acting Attorney General to the effect that the Board did have the power to force a change in discount rates. With the Banking Act of 1935 this power became explicit in the statutes and now the Board must review and determine the discount rates of each Reserve bank every fourteen days, or oftener if deemed necessary.

Direct action

The Board also played an important part in discount rate policy in the early part of 1929, when the New York Reserve bank for a number of consecutive weeks voted increases in its discount rate from 5 to 6 percent, which were not approved by the Board. The Board recommended a policy of direct action. The relative merits of rate increases as opposed to direct action have been a matter of considerable controversy. From the very beginning the Reserve System has employed direct action, and contact with banks on numerous matters affecting the banking system consumes a large share of the time of the officers of the Reserve banks.

After adoption of the policy of direct action the New York bank on occasions called banks to task for borrowing from the Reserve and relending in the market. The powers of persuasion of the New York bank were not very effective and the New York banks refused to listen. The New York bank could bar member banks from rediscounting if they persisted in using Federal Reserve funds in speculation. But the New York bank continued to discount for such banks and after a time refused to participate further in the direct action policy. While it lasted this policy was not totally without effect. Brokers' loans in May 1929 were at about the same level as in February, with stock prices in the period also levelling off. Some of the other Reserve banks vigorously pursued the policy of direct action. Perhaps the failure of New York to do so was partly attributable to the disfavor that had resulted from its application in other districts, such as in Dallas, where there had been in 1925 a bankers' campaign to remove Governor Talley from office. The Dallas banks, however, were among those that stood the depression best.

Failure of direct action after May was due to lack of power, lack of cooperation, and lack of determination. The Board did not have the power to force the Reserve banks to cooperate in direct action nor did it have the determination to carry through its policy, for it reversed itself. In May David Lawrence wrote in his daily newspaper column that the System was about to abandon direct action, a statement that was inspired by a member of the Reserve Board. The general tenor of the statement was that the lid was off. In relaxing pressure the reasons were given that direct action had already been successful, that brokers' loans and borrowing for stock exchange purposes were down, and that the market was approaching a period of heavy financing.

Discount rates at the Federal Reserve banks were almost uniformly 5 percent in May 1929, compared with 4 percent in the early part of 1928. The mistake of the Board appears to have been the belief that rates at the Reserve banks could be kept low in face of a rapid rise in rates in the New York money market. Funds were moving to New York to be used in stock speculation.

After the May reversal of policy brokers' loans began to increase sharply. From the end of May to the middle of September the increase amounted to about $1,300,000,000. During the same period security prices increased by something like 20 percent. Had the policy of direct action been carried through it is doubtful if this rise could have occurred, although the 1928 and 1929 developments may have had their origins in the easing policy of 1924. In 1924 owing largely to an import of gold from abroad, reserve balances of member banks had increased from about $1,900,000,000 to a level of $2,200,000,000. All of these added reserves,

which were fully utilized by member banks in expanding their loans and investments, laid a foundation for subsequent developments. The whole period from 1924 to 1929, however, is one of great controversy, and it is better to feel that none of the views regarding this period are conclusive.

Open-market operations

The powers of the Reserve banks to buy and sell securities in the open market, granted in the original Federal Reserve Act, were not considered of very great importance at the time. For some years there was only a vague understanding of their purpose, which was currently explained by such phrases as, "to keep in touch with the market" and "to make the discount rate effective". In 1913 there were practically no Government securities available for purchase by the Reserve banks. Most of the Government securities outstanding were held by national banks as backing for national bank notes. At the outset the System's purchases were confined to warrants and were made in order to keep up earnings. This point of view was perhaps all right in those days because the operations of the Federal Reserve System were of small magnitude and not important in their effect upon general money market conditions.

Later with the development of the acceptance market and the heavy Treasury financing that appeared during the war, open-market operations of the System assumed a new importance. During the period of war financing and the post-war boom in 1919 and 1920 discounts and consequently earnings at the Reserve banks were large. With the collapse of 1921, however, discounts at the Reserve banks fell from a level of $2,800,000,000 to about $400,000,000. Earnings at the Federal Reserve banks as a consequence declined sharply and the banks began to purchase securities on the open

market in competition with one another. In order to avoid this competition and to regularize System purchase of securities without upsetting Treasury finance, Parker Gilbert, then Under-Secretary of the Treasury, and Governor Strong organized a committee of five governors of the Reserve banks to supervise the System's open-market activities.

But earnings continued to play a large part in the purchase of securities until Mr. Miller later proposed that the principles stated in the law for determination of the discount rate be followed with respect to open-market operations. This principle was adopted by the Board and published in its annual report for 1923 as follows:

> "That the time, manner, character, and volume of open-market investments purchased by the Federal Reserve banks be governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation."

This formula is vague, but perhaps therein lies its strength. An exact formula is not likely to be understood by the public, which may expect too much to be accomplished by the central bank. It is generally understood within the System that the objective is to promote business stability.

The membership of the open-market committee was raised from five to all twelve governors in 1930. This committee received statutory acceptance in the Banking Act of 1933, as provided in section 12(a). That Act also incorporated in the law the Board's principle that open-market operations were to be governed with a view to accommodating commerce and business and with regard to their bearing on the general credit situation. A Federal Reserve bank could still refuse to participate in open-market operations recommended under the law. The law implied that recommendations were to originate in the committee, but in practice the formulation of policy was largely in Washington or New York.

New instruments of control since 1933

The Banking Act of 1933 conferred upon the Board four new instruments of control, all essentially based upon the principle of direct action.

It was provided that when undue use was being made of bank credit for the speculative carrying of or trading in securities, real estate, or commodities, or for any other purpose inconsistent with sound credit conditions it should be reported to the Federal Reserve Board by the Reserve bank and the Board could suspend the member banks from the credit facilities of the Federal Reserve System. It was also provided that after a proper hearing the Federal Reserve Board could order the removal of the director or officer of a member bank who continued to violate the law or continued unsafe or unsound banking practices.

Section 11(n) of the Act was amended to empower the Federal Reserve Board to fix the individual capital stock and surplus in each Reserve district that may be represented by loans secured by stock or bond collateral made by member banks in such districts. The Board has not yet taken any action under this section.

Section 13 was amended to empower the Board to recall a loan made by the Reserve banks on collateral security if the indebted member bank, despite a warning of the Reserve bank or Board, increased its outstanding collateral loans, or loans to securities dealers for the purpose of purchasing or carrying stocks or investment securities, except obligations of the United States. This provision was put in the Act largely at the instigation of Senator Glass who dislikes lending on notes. If a Reserve bank recalled collateral loans made under this section, the member bank could substitute other paper and nullify its effect.

Of these added powers under the Act of 1933 the most important are those empowering the Board to deprive banks of the System's facilities and to remove member bank officers. No machinery has been set up for making these powers effective, but the principle under which they may be exercised is important, for it recognizes that the Reserve System is under the obligation to supervise banking developments in a general way.

In the Securities and Exchange Act of 1934 the Board was given the power to regulate the amount of margin required by brokers and banks and dealers in securities against security loans. These powers are the basis for Regulation T and the yet unissued Regulation U.

In the Banking Act of 1935 the Board was given the power to alter reserve requirements of member banks. The power to increase reserve requirements first appeared in the Thomas amendment passed in May 1933, but it could be exercised only with the approval of the President and during an emergency. In 1935 the approval of the President and the emergency clause were omitted and the Board may now raise reserve requirements and in addition reduce them to not below the present level in order to prevent injurious credit expansion or contraction. The amount by which reserve requirements may be increased, however, is limited to double the present requirements. Furthermore, requirements must be changed for all central and reserve city banks combined, for all country banks combined, or for all member banks as a whole. Reserve requirements of some banks might be altered, however, without altering the requirements for other banks in the same classification by changing the classification of the member banks concerned. Since the original Federal Reserve Act the Board has had the power to alter classification of member banks.