

**Reply**  
*of the*  
**Federal Reserve Board**

*to*

**A Letter from Senator Robert L. Owen**  
**Criticising Certain Policies of**  
**the Federal Reserve System**

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## Reply of the Federal Reserve Board

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November 29, 1920.

My dear Senator:

Your letter of the 18th instant was received several days ago and has been given consideration by the Federal Reserve Board.

You urge (1) that the rates of discount established by the Federal Reserve Banks upon the approval and determination of the Federal Reserve Board be lowered, and (2) that the loans of the Federal Reserve Banks be expanded "to the extent which may be required for purposes of legitimate production and distribution."

The Federal Reserve Board is reluctant to discuss proposed changes in discount rates, and has consistently cautioned all Federal Reserve Banks to refrain from any announcement of recommendation made by their directors until the rates have been approved and made effective by the Federal Reserve Board. Premature discussion of discount rates would have an unsettling effect and would give those best in position to form an opinion as to the probable action of the Board an advantage over those not thus situated.

While the reserves of the Federal Reserve Banks as a system are stronger than they were several weeks ago, there is still a large amount of inter-bank rediscounting being done, and several of the Federal Reserve Banks would today have reserves much below the normal minimum required by law—some less than one-half—but for the fact that under the authority of paragraph (b) of Section 11 of the Federal Reserve Act they are permitted by the Federal Reserve Board to rediscount some of their discounted paper with other Federal Reserve Banks.

You have on several occasions expressed your approval of the management and policies of the Bank of England, and the Board regrets that up to this time it has been impossible to adopt in this country the well-established policy of the Bank of England under which the Bank's discount rate is fixed at a figure slightly in excess of the current market rate. The wisdom of such a policy is apparent, for as it eliminates all profit in rediscount transactions, it gives the Bank better control over its own reserves and causes the joint stock banks to rely to a greater degree upon their own resources in extending accommodations while still affording them an outlet for any undue accumulation of loans. The exigencies of war financing in this country were such as to make necessary the adoption of a policy just the reverse of the time-honored policy of the Bank of England, and while the margin between Federal Reserve Bank rates and current market rates is not now as wide as was the case a year ago, the average legal and current rate throughout the country is still higher than the Federal Reserve Bank rate. It is the expectation of the Board, however, that conditions will ultimately adjust themselves so that Federal Reserve Bank rates may be maintained at a level slightly higher than current rates without any disturbance to commerce and business. In fact this adjustment has already begun in some districts where member banks have reduced their rates on commercial loans. While members of the Board always keep in mind the matter of discount rates and discuss the subject freely among themselves, they realize that in the determination of Federal Reserve Bank discount rates recognition must be given to going rates and in the rate revisions which the Board has approved from time to time, the view has always been taken that discount rates cannot be pegged or fixed arbitrarily for there are always certain basic conditions affecting the demand for and the supply of credit throughout this country and throughout the world which must be taken into account, and the formal establishment of a Federal Reserve Bank discount rate is merely an inter-

pretation of these conditions. The whole question of discount rates was discussed at length in my two letters to you of May 3 and 24, 1920.

As to the expansion of loans of the Federal Reserve Banks "to the extent which may be required for purposes of legitimate production and distribution," your attention is called to the fact that at the close of business Friday, November 26, 1920, the invested assets of the twelve Federal Reserve Banks, including bankers' acceptances discounted and bought, member banks' fifteen-day collateral notes secured by Government obligations, and eligible commercial paper discounted for member banks, amounted to \$3,303,747,000 as compared with \$3,024,741,000 on Friday, November 28, 1919. Federal Reserve notes outstanding on November 26, 1920, amounted to \$3,325,629,000 as against \$2,852,277,000 on November 28, 1919. These figures prove that during the past twelve months there has been no curtailment or reduction in the aggregate of the credits extended by or through the Federal Reserve Banks, but on the contrary there has been a very substantial increase which has been steady and continuous all through the year, as is shown graphically by the chart to which I called your attention when you were in my office a few days ago.

As you know, the Federal Reserve Banks are not permitted by law to have direct dealings with the public; they are allowed merely to rediscount for member banks, upon their endorsement, eligible paper as defined by the Act, representing loans or advancements made by the member banks to their customers. The discount powers of national banks are broadly defined in those sections of the Revised Statutes of the United States commonly known as "The National Bank Act," and those of the state banks and trust companies which are members of the Federal Reserve System are governed by the laws of the respective states in which these institutions are located. Thus the Federal Reserve Board has no control over the discount policies of individual member banks and cannot force them to

make loans which they do not desire to make, nor can it restrain them from making loans which in the lawful exercise of their discretion they may make.

The extent to which the discount facilities afforded by the Federal Reserve Banks are now being used shows that through the medium of member banks the Federal Reserve Banks are participating actively in extending credits. On August 22, 1907, just before the panic of that year, bills payable and rediscounts of all national banks amounted to \$59,177,000 against total loans and discounts of \$4,709,027,000, the percentage of bills payable and rediscounts to total loans being 1.26%. On September 23, 1908, the percentage was 1.11%; on September 12, 1914, total bills payable and rediscounts had increased to the then unprecedented amount of \$150,071,000, or 2.34% of the total loans, which amounted to \$6,417,910,000. This increase was due to the disturbance incident to the outbreak of the European war. On September 12, 1916, bills payable and rediscounts had fallen to \$91,893,000, or 1.16% of the total of loans of all national banks. On September 11, 1917, the first year of our participation in the war, bills payable and rediscounts amounted to \$285,104,000, or 3.09% of the total loans, \$9,234,289,000. These figures, of course, reflect war financing. The same observation will apply to figures compiled from reports of condition of national banks on August 31, 1918, and September 12, 1919, when the percentages of rediscounts to total loans were 12.8% and 13.04% respectively. There has, however, been no new financing by the Government since the flotation of the Victory Loan; the total volume of Government obligations outstanding has decreased since September 12, 1919, when rediscounts and bills payable of all national banks amounted to \$1,505,516,000, while on September 8, 1920, the national banks' liability for money borrowed in this way amounted to \$2,299,640,000, or 16.8% of their total loans of \$13,723,611,000. The figures for State banks and trust companies are not available, but there is no reason to believe that the proportion of money borrowed by these institutions

to their loans and discounts is any less than that shown by the national banks. The foregoing figures demonstrate clearly that the present discount rates at the Federal Reserve Banks are by no means prohibitive and the Board does not believe that if Federal Reserve Bank discount rates should be lowered in advance of a decline in the general level of interest rates there would be any appreciable reduction in the rates member banks would charge their customers.

You refer in your letter to the fact that "the Federal Reserve Board is approving a 6% rate on loans secured by Treasury Certificates of Indebtedness." As you know, the rate of interest borne by these obligations is determined by the Secretary of the Treasury. Recent issues of Treasury Certificates have borne interest at from 5 $\frac{3}{4}$ % to 6% per annum according to the length of time they have to run. It is the Board's understanding that it is the policy of the present Secretary of the Treasury to offer certificates at rates sufficiently high as to make them attractive to investors, large and small, thus effecting their distribution to the public instead of having them congested in the portfolios of the banks or passed along by them to the Federal Reserve Banks. The Federal Reserve Board has approved for notes secured by Treasury Certificates of Indebtedness rates corresponding with the rates of interest borne by the certificates, thus giving member banks an opportunity of carrying them without loss pending their distribution but offering the banks no inducement in the way of a spread in the rate to retain them as an investment instead of passing them on to the public. In this way the banks of the country and the Federal Reserve Banks are better able to respond to the requirements of agriculture, commerce and industry than would be the case if a larger portion of their assets were invested in Government obligations.

You state that "it seems to be the policy of the Board to raise the rates of interest for the purpose of broadly deflating credits." The rates were raised not

for the purpose of a broad curtailment or deflation of credits, but with the object of bringing about more moderation in the use of credits, which a year ago were being diverted into all kinds of speculative and non-essential channels, and for the additional purpose of conserving the resources and credit power of the member banks and of the Federal Reserve Banks in order that they might better respond to the seasonal needs which arise every autumn.

The chart to which reference has been made shows that on September 19, 1919, the total earning assets of all Federal Reserve Banks were in round amounts \$2,350,000,000, while on January 27, 1920, the total was nearly \$3,300,000,000, an increase of almost \$1,000,000,000, or nearly 50% within a period of four months. The chart shows graphically that the angle of ascending credit during this time was forty-five degrees. Certainly no banking system which permitted so rapid an expansion of credit could long sustain itself, and while no deflation was attempted, measures were taken to regulate the credit expansion. Consequently the Board approved a sharp advance in discount rates for all of the Federal Reserve Banks between January 23rd and January 30th. This advance brought about a moderate amount of liquidation, and the chart shows that by March 26th, the earning assets of the Federal Reserve Banks had declined to \$3,200,000,000. About the middle of May, however, the tendency towards further expansion again became marked and the earning assets of the Federal Reserve Banks approached the previous level of \$3,300,000,000. On the 18th of May the Board held a conference with members of the Federal Advisory Council and the Class "A" directors of the Federal Reserve Banks, at which it pointed out that in view of the essential credit requirements which the banks had ahead of them later on in the year, it was necessary to check the rate of expansion. Following the conference the banks of the country were urged to use more discriminating judgment in the matter of extending credit and to give preference in their loaning operation to essential credits, being

advised at the same time that they themselves must be the judges of the essential character of the purposes for which loans were asked of them. It is interesting to note that a somewhat similar policy of credit rationing has been urged by the French Government upon French banks, and that the British banks under the leadership of the Bank of England have for many months past been exercising a discriminating judgment in granting credit accommodations. At the beginning of the present year, upon the previous recommendation of the Royal Commission on Currency and Exchanges, and at the instance of the Chancellor of the Exchequer, a limit was fixed on the maximum amount of currency notes which might be issued during the year 1920, not to exceed the maximum amount outstanding during the year 1919.

Following the conference on May 18th the earning assets of the Federal Reserve Banks gradually declined until July 23rd, when they were around \$3,150,000,000. Since that date they have advanced steadily with occasional slight recessions until November 26th when the total amount reached \$3,303,747,000. The chart shows that while the angle of credit from September 19, 1919, to January 27, 1920, was about forty-five degrees upward, the angle from January 27, 1920, to November 26, 1920, shows an upward slant of only about two degrees.

In your letter you state that the Federal Reserve Board has been pursuing for a year a policy of high interest charges which has "brought on a condition of industrial depression resulting in checking, and in some cases absolutely stopping, legitimate production and legitimate distribution." You seem to lose sight of the fact that the production of great agricultural staples this year has been unusually large and that the price recessions of which you complain are due in part to world-wide conditions; and you also ignore the economic forces governing the movement in prices which for months past have been in evidence all over the

world. It was generally recognized many months ago, following the collapse of the silk market in Japan early last spring, that certain price readjustments were inevitable. In fact, as early as August, 1919, the continuous expansion of credit and the constantly advancing costs of living became objects of grave public concern, and the Senate addressed a communication on the subject to the Federal Reserve Board on August 5, 1919. Shortly afterward the President in an address to Congress called attention to the dangers of the situation. From that time until the adjournment of Congress last June these matters were the subject of frequent discussions in both Houses. In the United States an important factor has been the revulsion of sentiment against the unnatural levels attained by prices in the year 1919, when circumstances over which the Federal Reserve Board had no control, prevented the Federal Reserve System from exercising its important function of regulating the flow and volume of credit.

On the 17th of May last, the Senate adopted a resolution (No. 363) directing the Federal Reserve Board "to advise the Senate what steps it purposes to take or to recommend to the member banks of the Federal Reserve System to meet the existing inflation of currency and credits and consequent high prices, and what further steps it purposes to take or recommend to mobilize credits in order to move the 1920 crop."

There were large importations of wool brought into the United States just at the time when our domestic wool clip was coming into the market, which resulted in a slump in the price of wool, and in the utter demoralization of the wool market. Sugar was advanced by speculative manipulation until it reached a price which checked domestic consumption and virtually stopped exports to Europe while stimulating imports into the United States from practically all sugar producing countries in the world. Then followed

a drastic decline in the price of sugar. Imports of rubber and coffee increased in like manner until the accumulated stocks became so great that the markets collapsed. The domestic production of other great staples—cotton, corn, wheat, rice and tobacco—proved to be greater and the demand for them less than had been expected, and the prices of these commodities have declined sharply. Meanwhile there has been, ever since the Board undertook to hold the tide of expansion in check a year ago, a persistent campaign of misrepresentation of the Board's policies with frequent misstatements or studied avoidance of basic facts and figures. Not only have exaggerated ideas of the powers of the Board been disseminated, but some of the Board's critics have published statements repeatedly to the effect that its policies were ruinous, that it was determined to bring about drastic deflation, and that the inevitable result would be widespread disaster. It speaks well for the common sense of the country that the public has refused to be stampeded, although perhaps the critics may have succeeded in some cases in making conditions appear worse than they really are.

The Board believes that the unfavorable conditions which are now the subject of so much complaint were inevitable and could not in any event have been long deferred. It confidently asserts that but for the precautionary measures taken several months ago, conditions today would be far worse than they are with the prospects of stabilization and revival much more remote. The Board agrees with you, however, that in some sections there has been a very substantial curtailment of credits during the past twelve months, particularly in those credits which are related to non-productive activities. This curtailment is particularly in evidence in the City of New York, as pointed out by you in your letter when you say "incidentally, the individual deposits of New York City banks which were November 12, 1919, \$6,313,998,000, were reduced on November 10, 1920, to \$4,916,375,000, a net loss of deposits in New York City of about \$1,400,000,000

and a net reduction of loans amounting to a similar amount." There has not, however, been a similar curtailment in the country at large, for as you say in your letter, "but while the individual deposits and loans of New York City banks were coming down, the total deposits of all the banks of the country, including bank deposits, increased according to the Comptroller's letter of October 13, 1920, \$4,045,164,000, and loans increased \$5,805,736,000 (including overdrafts and discounts) for the fiscal year ending June 30, 1920, so that this disparity of reduced deposits and loans in New York City is all the more conspicuous." You say further that "the New York City banks have above all others pursued the policy of indiscriminate deflation, and have deflated their own deposits accordingly. The balance of the country's banks, therefore, increased their deposits, exclusive of New York, about \$5,000,000,000."

The Board has no information showing that the banks of New York City have pursued a "policy of indiscriminate deflation," for although there has been a substantial reduction in the volume of Street loans, secured by stock exchange collateral, the facts are that the falling off in the deposits of New York City banks has been caused principally by withdrawals by interior correspondents, and not only have banks in other sections of the country checked heavily upon their existing balances in New York City, but they have increased considerably their discount lines with their correspondent banks in that city.

You state "the price of Government bonds has been seriously depressed because the American market of stocks and bonds is located in New York City, where this policy of deflation is peculiarly in evidence." In my previous correspondence with you, I pointed out that the decline in the market value of Government bonds was no reflection upon their intrinsic worth, for it reflected merely temporary conditions in the money market. Government bonds are investment securities payable at a fixed time in the future and bearing a rate of interest lower than that borne by other high-grade

securities available for purchase by the public. With the exception of the First Liberty Loan which bears interest at the rate of only  $3\frac{1}{2}\%$ , the Government war obligations have very limited tax exemptions. The investor can choose between Government bonds bearing  $4\frac{1}{2}\%$  interest with negligible tax exemptions, securities issued by private corporations bearing much higher rates of interest, and municipal bonds bearing interest at the rate of  $5\%$  or more which have full tax exemptions. Your attention was also called to the fact that the average price of Liberty Bonds in the market declined to about 94 at a time when Federal Reserve Banks were discounting at a  $4\%$  rate notes secured by Liberty Bonds carrying a rate of  $4\frac{1}{2}\%$ .

In your letter of April 27th, you attributed the decline in the market value of Liberty Bonds entirely to the advance in discount rates at the Federal Reserve Banks, giving no consideration to the possible effect of the withdrawal from the market of the War Finance Corporation as a daily purchaser. In my letter to you of May 3rd, I ventured the prediction that "the policy of the Federal Reserve Board to curb inflation will, in the long run, result in improving the market value of Liberty Bonds and a contrary policy of furnishing credit at cheap rates at a time like this would impair the market. The value of a promise to pay a sum certain at a future date is impaired by the inflation which the Board is trying to control." In my letter to you of May 24th, I stated "the obligations of the Government of the United States offer the best opportunity for investment in the world today. They are being sold now on a most attractive investment basis, and as speculative tendencies are curbed, as the gains of the profiteers are reduced, as commodity prices decline, and as the business and industry of this country settle down to a more normal peace basis, the market value of these securities will rise very rapidly." A comparison of market quotations last May with those of the past week will show that Liberty Bonds have advanced several points.

You still appear to be inclined to the opinion which you expressed in your letters to the Board last spring, that Federal Reserve Bank discount rates should be related to the earnings of the Federal Reserve Banks. You say in your letter of November 18th that "the Federal Reserve Banks earned last year over 100% and are earning now at a rate in excess of 150% per annum on its capital, contrary to a sound public policy. This excess profit is all the more reprehensible because it goes to the Treasury, is made by a Governmental instrumentality and puts the Government in the position of profiteering, and setting a national bad example." I endeavored to point out in my letter of May 24th, that the earnings of the Federal Reserve Banks were the result of their large volume of invested assets, as much as the rate of interest obtained from these investments, which include rediscounts for member banks. The earnings of the Federal Reserve Banks depend as much upon the volume of loans and investments as upon the rate of discount. The present large volume of invested assets of all Federal Reserve Banks results in part from the demand for currency which in the form of Federal Reserve notes has been furnished by the Government through the Federal Reserve Banks. The volume of these notes now in circulation is about \$3,300,000,000. A direct interest charge of 2% on these notes against the Federal Reserve Banks, which the Board is authorized by law to impose, would bring a return to the Government of \$66,000,000, an amount approximately as great as that which all the Federal Reserve Banks are expected in January to pay to the Government as a franchise tax out of their excess earnings. Had such an interest charge been imposed this year the earnings of the Federal Reserve Banks on their capital would not have been regarded as abnormal.

The case, however, may be stated in another way, and it is well that it should be, in view of your repeated charge of "profiteering." In an ordinary banking corporation the sole contribution by the stockholders is the paid-in capital stock plus accumulated and undis-

tributed earnings; the deposits, which are the principal basis of the bank's earning power, come from the public. In such cases the earnings are measured in terms of percentages of the bank's capital, or its capital and surplus. The Federal Reserve Banks on January 1, 1921, will have an earned and accumulated surplus equal to about 200% of their paid-in capital. They also hold the reserves of their stockholding banks, which are deposits without interest contributed not by the public but by the stockholding banks, and these reserve deposits during the past year have averaged about \$1,800,000,000. If, therefore, the percentage of earnings of the Federal Reserve Banks should be expressed in terms related not to the capital stock alone but to the total contributions of their stockholders, that is, capital plus reserve balances, without taking into account the surplus which in the last analysis is the property of the Government, the net earnings of the Federal Reserve Banks for the present year will be, not 150% or more, but barely 7% on their liability to stockholders.

The Board does not deem it necessary to enter into a discussion of your analysis of the position of the Bank of England. Our financial situation is distinctly different from that of England, our laws and banking practices are not the same, and it is difficult to make a comparison of the statement of the twelve Federal Reserve Banks combined with the statement of the Bank of England. You say, "England is not on a gold basis." It is certain, however, that America is. Restrictions upon the export of gold from this country were removed by the President in June, 1919, and since that time we have maintained an absolutely free gold market, thereby enhancing greatly American prestige everywhere and establishing a credit throughout the world never before enjoyed. Our free gold market is one of the chief influences which causes such a world-wide premium on dollars, which incidentally gives us a command of the world market for gold. You point out in your letter that on a recent date, "gold was at a premium of 45% in London while

selling at par in New York. This explains why the paper pound Sterling in New York is selling on the Exchange around \$3.35 per pound." Would it not, however, be more accurate to state the case the other way around and to say that because the paper pound Sterling is at a discount and because the paper currency of other countries is at a discount, gold is selling at a premium in England and in other countries, while selling at par in New York where American paper currency has a value equal to that of gold?

The Board regrets to learn that in your opinion public confidence in the wisdom of the Federal Reserve Board and the Federal Reserve Bank management is being impaired, but hopes that even though your views and those of the Board as to the proper policy to be pursued in the present circumstances may not coincide in all respects you may later on reach the conclusion in the light of subsequent events that the Board's policies are sound. It is impossible to forecast the future accurately, but the recent past is an open book and we should always strive to profit by experience. You may remember that about eighteen months ago you believed it possible to stabilize the principal foreign exchanges and to maintain them at a parity with each other and with the American dollar, and if I remember correctly you urged the Board as a matter of public duty to undertake this stabilization. In view of the reference made in your letter to the embarrassment that export houses are experiencing, the inference may be drawn that you do not now regard the problems connected with our foreign trade as being as simple as you once did and that you realize how impossible it would have been for the Board to maintain foreign exchanges at their normal parity and what grave disasters would have fallen upon the Federal Reserve System and the country had the Board attempted to carry out your suggestion.

Respectfully yours,

(Signed) W. P. G. HARDING,

HON. ROBERT L. OWEN,  
United States Senate.

Governor.