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CONFIDENTIAL (6) July 17, 1928.

MEMORANDUM TO THE OPEN MARKET INVESTMENT COMMITTEE

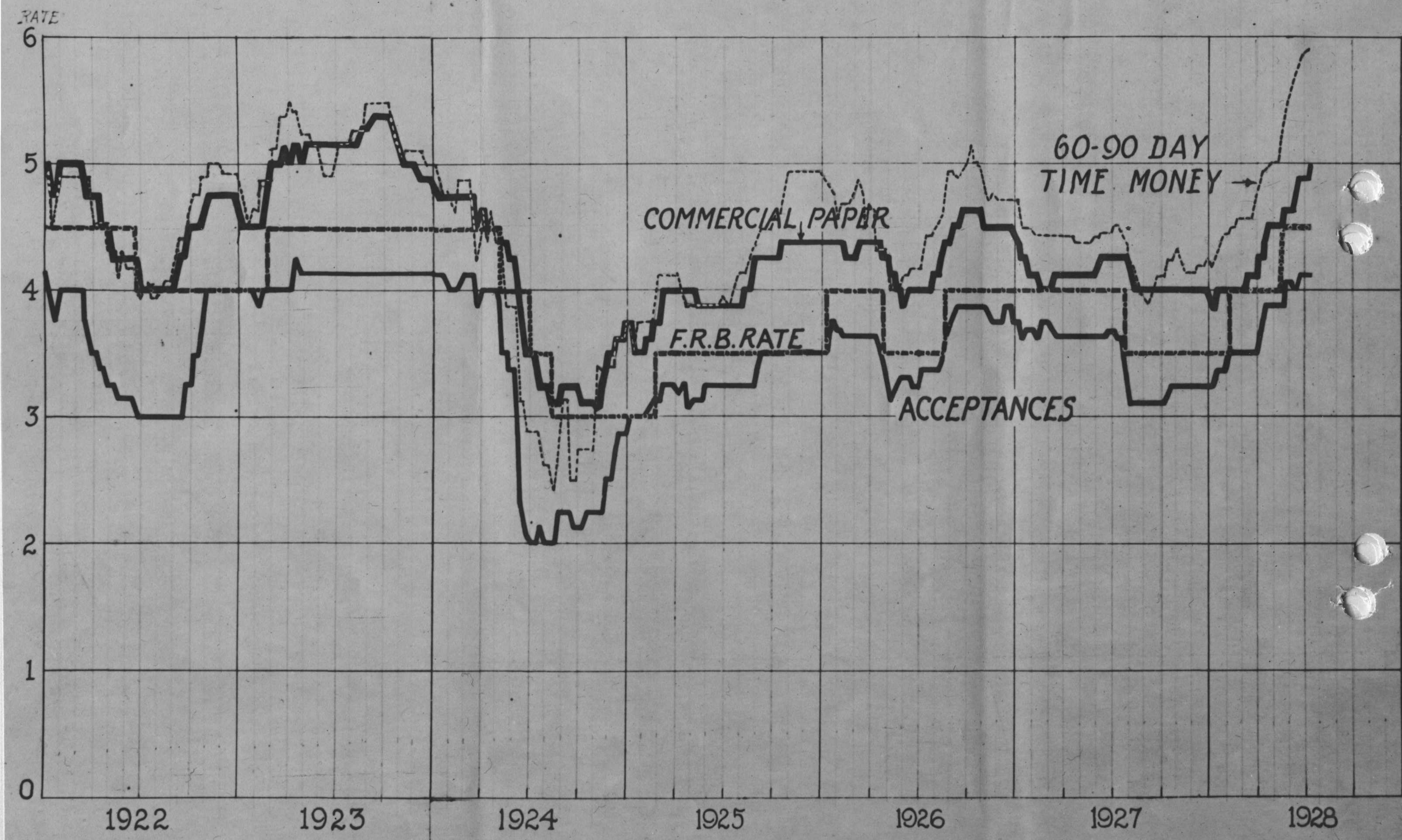
Interest Rates

Interest rates are higher today than at any time since 1921. The primary reason for high money rates is that the member banks owe the Federal Reserve Banks about one billion dollars, compared with an average borrowing of about 500 million for the preceding six years and 400 million last summer. The heavy borrowing is due primarily to gold exports of 500 million dollars since last autumn, sales of 300 million of securities by the Federal Reserve Banks, and some additions to reserve requirements of member banks because of excessive credit expansion. Partly offsetting these losses of funds, there has been a gain through the retirement of over 100 million of currency (reflecting some reduction in factory payrolls and increased use of checks).

As the autumn demand for funds comes on, larger borrowings and still higher money rates may be anticipated unless counteracting steps are taken. Ordinarily autumn trade requires nearly 100 million additional rediscounts (exclusive of additional Federal Reserve credit called into use through the seasonal expansion in holdings of bankers acceptances).

Testing the Credit Situation

The present high money rates are testing the credit situation and it seems reasonable to believe that pressure will be felt most at the weakest point, whether this is the prices of industrial securities, the volume of new issues, the amount of new building, or whatever else. It seems likely that a brief period of rates at present levels is likely to result in a check to movements which may have gone beyond a sound economic basis. The fact that such a testing is going on is evidenced by the changes in the total volume of credit, which with the exception of a temporary rise



Weekly Rates in the New York Money Market.

at the first of July has shown no increase since the early part of May. The volume of new long time security issues also shows some sign of pause, and security prices of various types are considerably lower than they were early in May.

Effect on Business

If the present high interest rates are continued for several months it seems probable that business activity may be affected six months or a year from now. The evidence for this probability may be summarized briefly.

1. Charts of business volume and interest rates since 1900 show that continued high rates have almost invariably been followed by business declines after a lag of six months to a year.

2. A reasonable explanation is found in the restriction of new enterprises by high money rates.

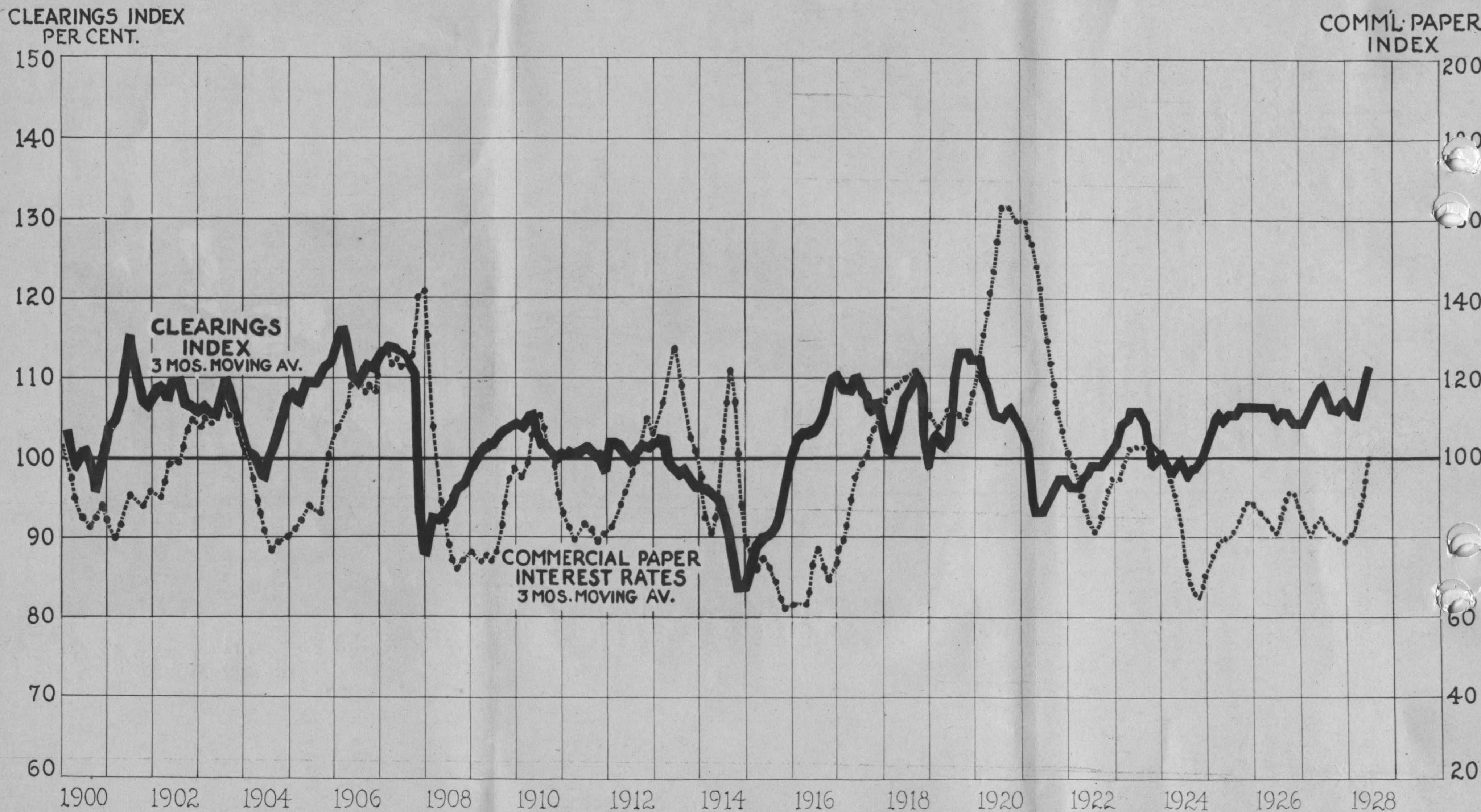
   (a) High money rates discourage speculative building construction - as indicated by declines in building six months to a year following high money rates.

   (b) High money rates tend to discourage new financing, which would lead to business activity six months to a year distant.

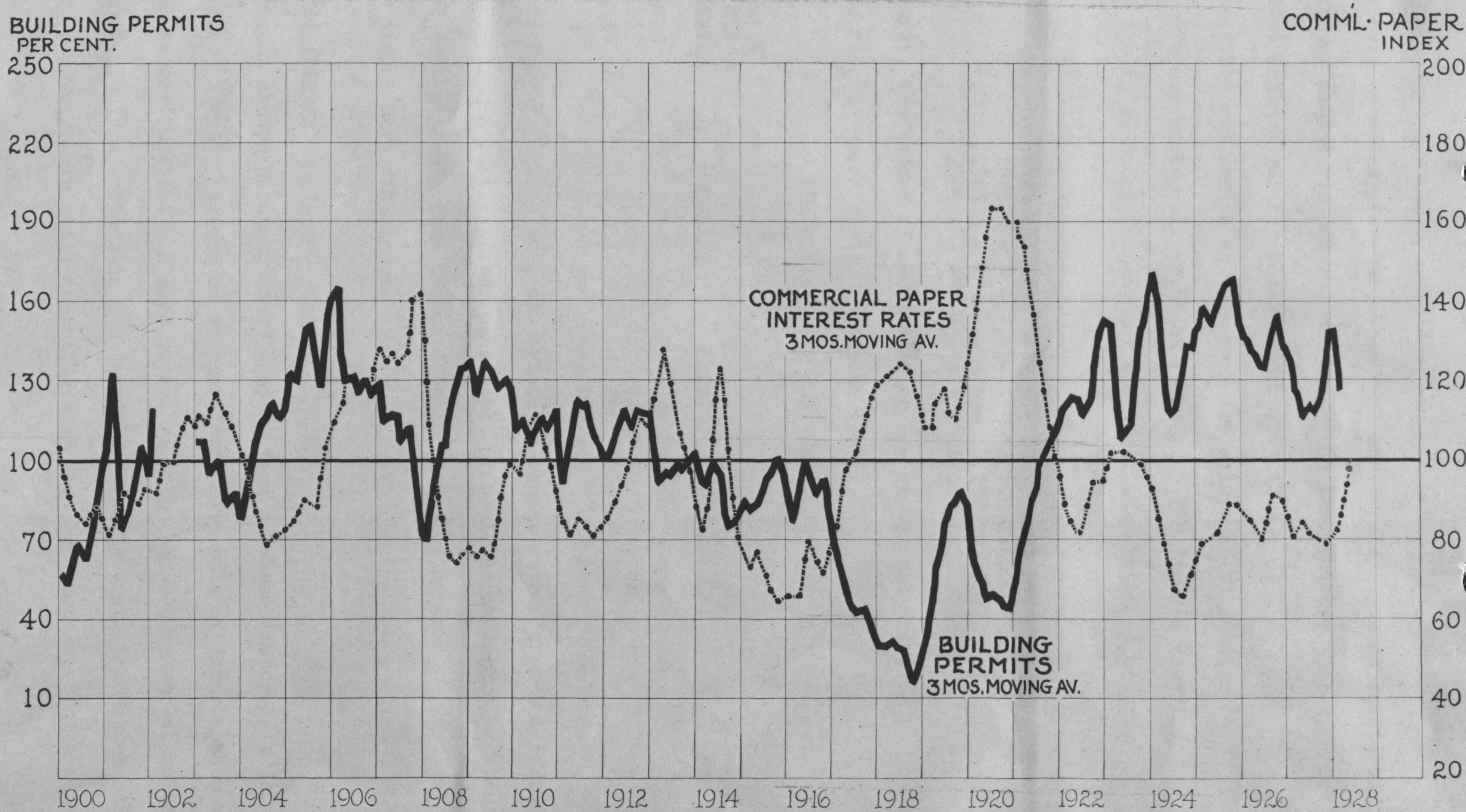
3. Present business conditions may be peculiarly susceptible to restriction of credit.

   (a) There was considerable unemployment last winter. Outdoor work, particularly building, has largely absorbed surplus labor, but factory employment has increased very little. When outdoor work slackens, further unemployment is at best a danger.

   (b) Any considerable unemployment will give installment selling its first considerable test.



Clearings Index of Business Compared with Interest Rates



Interest Rates & Volume of Building

It should be noted, however, that high money rates have not continued long enough for any noticeable adverse effects. On the contrary, the figures which would first reflect adverse consequences show that -

1. In the first six months of this year the volume of building contracts has broken all previous records. The figures reported by the F. W. Dodge Company for the first six months of recent years follow:

1925 - - - - - - - - - -	$2,748,695,000
1926 - - - - - - - - - -	3,128,158,000
1927 - - - - - - - - - -	3,187,993,000
1928 - - - - - - - - - -	3,444,868,000

2. Similarly, the volume of new financing has broken all previous records, as shown by the following table:

(In millions of dollars)

First Six Months	Domestic	Foreign	Total
1925	3,130	571	3,701
1926	3,436	616	4,052
1927	4,508	786	5,294
1928	4,528	1,135	5,664

The foregoing figures suggest perhaps an excess rather than a deficiency of new undertakings. A little slower pace would probably be wholesome. There is beginning to be some evidence that the pace is in fact slowing down. Just in recent weeks new issues have diminished.

Effects on World Finance

In recent months European money centers have not been adversely affected by high rates here, largely because of extraordinary movements of funds connected with the French reconstruction. A more normal relation between rates and movements of funds is now beginning. Sterling has declined steadily since the French stabilization. The exchanges are still generally high, but long continued high rates here would undoubtedly draw funds from abroad and lead to higher money rates abroad and lower exchange rates, and perhaps eventually gold shipments to this country. It would probably take some weeks for these developments to occur, and it may also be said that the speculation which has taken place in this country has been paralleled by similar movements abroad, encouraged by cheap money; and somewhat firmer money conditions here may not be unwholesome.

Germany is a particular case with peculiar conditions. She has had heavy speculation, rising prices and wages, together with high money rates; and as far as temporary money market conditions are concerned they may perhaps be bettered rather than injured by firm money rates here. In the long run, however, the payment of German reparations is dependent upon a steady flow of money from this country.

The foreign aspects of future policy may be summarized by saying that they appear to offer no pressure toward immediately lower rates here, but in the long run would be adversely affected by a continuation of abnormally high rates here.

Future Program

From these various considerations and other aspects of the current situation, it would appear that some further period of testing the credit situation by firm money conditions might not be undesirable. But it would also appear that too extended a period of high money rates would be detrimental to business and would react unfavorably on the world financial position.

Looking into the autumn problem for Federal Reserve policy appears to be to find a means of bringing about somewhat easier credit conditions, without at the same time encouraging a renewed expansion of credit. It seems particularly desirable that money should be somewhat more easily available for the crop moving season.

The two alternatives which naturally present themselves are a reduction in discount rates or the purchase of government securities.

There are a number of objections to considering rate reductions under anything like present conditions -

1. Even after recent increases discount rates are low relative to open market rates, and offer encouragement to borrow.
2. The present volume of rediscounts is now so large that banks find it very difficult to keep out of debt at the Reserve Banks and the tradition against borrowing, which has been the principal source of effectiveness of Federal Reserve policy, appears to be breaking down.

The chief danger in open market purchases is that, as they appear in the statement, they may be regarded as an indication of a change of Federal Reserve policy and made the occasion for excessive demands for credit.

From these considerations it seems desirable -

1. That no precipitate change in policy is called for;
2. That rate reductions should be made only after the volume of member bank indebtedness has been materially reduced;
3. That open market purchases should be made at such times and in such quantities that they will be absorbed either -
   (a) In meeting seasonal needs for additional credit; or
   (b) In reducing the amount of indebtedness at the Reserve Banks.