BROKERS' LOANS

HEARINGS

BEFORE THE

COMMITTEE ON BANKING AND CURRENCY UNITED STATES SENATE

SEVENTIETH CONGRESS

FIRST SESSION

ON

S. Res. 113

A RESOLUTION FAVORING A RESTRICTION OF LOANS BY FEDERAL RESERVE BANKS FOR SPECULATIVE PURPOSES

FEBRUARY 9, 29, AND MARCH 7, 1928

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BROKERS' LOANS

THURSDAY, FEBRUARY 9, 1928

United States Senate,
Committee on Banking and Currency,
Washington, D. C.

The committee met, pursuant to call, at 10.30 o'clock a. m. in room 303, Senate Office Building, Senator Peter Norbeck presiding.

Present: Senators Norbeck (chairman), Edge, Frazier, Pine, Brookhart, and Mayfield.

The committee thereupon proceeded to the consideration of S. Res. 113, which is here printed in full, as follows:

[S. Res. 113, Seventieth Congress, first session]

Whereas the total loans secured by stocks and bonds of the fifty-one member banks in the New York Federal reserve district on January 11, 1928, reached the unprecedented total of $3,819,573,000; and

Whereas the largest part of this sum is used for speculation on the New York Stock Exchange as stated by the Federal Reserve Board in its annual report for 1926 as follows:

"The largest growth, both absolutely and relatively, was in security loans, which increased by about 66 per centum during the period. That to this growth in loans on securities represents to a considerable extent an increased volume of credit used in financing transactions in securities at the New York Stock Exchange is indicated by the rapid growth during the period of loans to brokers and dealers in securities in the New York market."
and

Whereas during the past year such speculative loans made through the Federal reserve system have increased more than a billion dollars, and during the past seven years more than $3,000,000,000; and

Whereas the reports of the New York Federal Reserve Bank reveal that $1,502,580,000 of these loans on stocks and bonds is for the account of out-of-town banks, representing credit transferred from other parts of the country to be used in New York for speculative purposes: and

Whereas the inevitable result of the utilization of the funds of the Federal reserve system for speculative purposes is to restrict the amount of credit available for legitimate commercial purposes, as is indicated by the fact that the amount of commercial paper outstanding as reported to the Federal Reserve Bank of New York actually decreased from a total of $925,379,000 in October, 1924, to $610,945,000 in October, 1927; and

Whereas the intent of the Congress in the creation of the Federal reserve system was to prevent its use for the encouragement of support of purely speculative operations, as is evidenced by the following paragraph of section 13 of the Federal reserve act:

"Upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice and protest by such bank as to its own indorsement exclusively, any Federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this act. Nothing in this act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount, and the notes, drafts, and bills of exchange of factors issued as such making advances exclusively to producers of staple agricultural products in their raw state shall be eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States": Now, therefore, be it

Resolved, That it is the sense of the Senate that the Federal Reserve Board should immediately take steps to restrict the further expansion of loans by member banks for speculative purposes and as rapidly as is compatible with the financial stability of the Nation require the contraction of such loans to the lowest possible amount; and be it further

Resolved, That the Federal Reserve Board be directed to report to the Congress what legislation, if any, is required to prevent the future use of the funds and credit of the Federal reserve system for speculative purposes.

The CHAIRMAN. The committee will come to order. The first matter to take up is the La Follette resolution, S. Res. 113, and Senator La Follette will make a statement.

STATEMENT OF HON. ROBERT M. LA FOLLETTE, JR., A UNITED STATES SENATOR FROM THE STATE OF WISCONSIN

Senator LA FOLLETTE. Mr. Chairman, first of all I would like to express my appreciation to the chairman of the committee and the other members for giving me this opportunity to make a brief statement. It is not my intention to take much of the committee's time this morning.

My purpose in introducing the resolution was to endeavor to bring to the attention of the committee and the Senate the situation with regard to the increased amount of loans on stocks and bonds by the member banks. At the time President Harding was inaugurated loans on that account amounted to about $778,000,000, according to my information. At the time President Coolidge was inaugurated, in 1925, they had increased to $2,119,000,000. And to-day, that is, of February 1, they amounted to $3,819,000,000. I have not the figures which were made public this morning before me.

Dr. H. Parker Willis, whom we all know took a great interest in the Federal reserve act at the time it was under consideration by Congress, who for a time served as secretary of the Federal Reserve Board, stated as long ago as last May—and I would like to quote from his statement—that:

> To-day we have much more than five and one-half billions of dollars devoted by the banks to carrying stocks and bonds, of which well toward three and a half billions is applied in this way in New York City and places affiliated with it; the greater portion of that vast sum being used in margin trading. I estimate that this amount is, roughly speaking, three times the amount so used just after the war, and probably about three and a half times the amount so used prior to the adoption of the reserve act. It is true that we have to-day a rather better control over speculation than formerly when we wish to use it, and also that our reserve system has brought about beneficial changes which have set free money that has gone into speculative uses without drawing so heavily, as it otherwise must, on other lines. But when allowance has been made by the most charitable of observers it remains a fact that our reserve system has exerted no real remedial influence upon the great American evil of stock-exchange gambling, and of the use of the liquid funds of banks in that occupation.

I also desire to quote, for the information of the committee, in part from an editorial which apepared in The Commercial and Financial Chronicle, of New York, I think, admittedly, one of the most conservative financial publications in this country, the editorial being printed, I think, on August 6, 1927. In that editorial it was set forth:

With stock-exchange speculation rampant, as just shown, and with borrowing on stock-exchange account of huge volume and steadily growing, the true course would be to raise rates, thereby rendering borrowing on the part of the member banks more costly and thus discouraging it. But the reserve banks are anxious to increase the volume of their earning assets, which latterly have been falling off somewhat, notwithstanding the absorption of so much money in stock-exchange speculation. * * *

But is such a policy sound and sensible, and is it in consonance with the theory upon which central banks are supposed to function? If not, why should the managers of our reserve institutions give adherence to it? Are there not serious portents in the course which is being pursued and should not these receive careful attention and thoughtful consideration? Are we not sowing the wind with danger of reaping the whirlwind?

I should like to say, Mr. Chairman, that it is my personal opinion, and upon such competent advice of financial authorities I am led to believe that it is also their opinion, that the use of the funds and credits of the Federal reserve system to support stock-market speculation is a violation of the clear intent and certainly of the purpose of the Federal reserve act. I call attention to the final and concluding phrase of section 13 of the act:

but such definition [referring to paper subject to discount by Federal reserve banks] shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds or other investment securities, except bonds and notes of the Government of the United States.

I also, in support of the contention as to what was the intent of the framers and the supporters of the Federal reserve act at the time it was enacted, should like to quote briefly from Senator Carter Glass, who was then a Member of the House, and subsequently as we know, Secretary of the Treasury, and now a Member of the Senate. He stated on the floor of the House on September 10, 1913:

The whole fight of the great bankers is to drive us from our firm resolve to break down the artificial connection between the banking business of this country, and the stock speculative operations at the money centers. The Monetary Commission, with more discretoin than courage, absolutely evaded the problem; but the Banking and Currency Committee, of the House, has gone to the very root of this gigantic evil, and in this bill proposed to cut the cancer out. Under existing law we have permitted banks to pyramid credit upon credit and to call these credits reserves. It is a misnomer; they are not reserves. And when financial troubles come and the country banks call for their money with which to pay their creditors they find it all invested in stock-gambling operations. There is suspension of payment, and the whole system breaks down under the strain, causing widespread confusion and almost inconceivable damage.

The avowed purpose of this bill—

said Senator Glass, then a Member of the House—

is to cure this evil; to withdraw the reserve funds of the country from the congested money centers and to make them readily available for business uses in the various sections of the country to which they belong.

On the floor of the Senate Senator Robert L. Owen, who, I think it is fair to say, led the fight for the enactment of the Federal reserve act in the Senate, stated in the course of the debate:

To put an end to the pyramiding of the bank reserves of the country and the use of such reserves for gambling purposes on the stock exchange—

he declared was one of the principal purposes of this Federal reserve act.

Mr. Chairman, it seems to me that the situation which has been in existence since more than a year ago is one which merits the attention of Congress and of this committee. It was with the hope that the attention of this committee and of the Congress would be directed to this situation, that this committee would take up this question, hold hearings upon it, obtain all of the information which is available from the members of the Federal Reserve Board and from competent financial authorities in this country, that I introduced this resolution.

I am frank to say that I am not certain in my own mind as to just what the remedy for this situation is. It is a complex, perplexing problem, I am frank to admit. But that it is a problem which should challenge the attention of the Congress and the country I believe the facts substantiate beyond peradventure of contradiction. And so, Mr. Chairman, I very modestly suggest that it is the duty of this committee to devote its attention to this situation and to endeavor to work out a sound and a substantial legislative remedy for it which will result in returning the Federal reserve system to the legitimate functions which its authors contemplated when the act was passed.

And once more I should like to express my appreciation for the opportunity of being heard by the committee.

Senator Edge. Mr. Chairman, I am a little uncertain as to just what the meeting was called for. I know the purpose that it was called for, but was it to be a public meeting; that is, to have representatives of the Federal Reserve Board as well as the sponsor, etc., give information; is that it?

The Chairman. I wrote the Federal Reserve Board telling about the meeting and suggesting that it was an open meeting and we would be glad to have them here if they were interested. The only other promise I made is that we will not take any hasty action. Senator Glass was unable to be here this morning, and his secretary phoned and asked that he be given a chance to be heard before anything is done.

Senator Edge. I see we have not a quorum.

The Chairman. We have not a quorum for the purpose of taking a vote; we have a quorum for the purpose of holding a meeting.

Senator La Follette. Mr. Chairman, may I say in answer to Senator Edge's suggestion, that I am not urging any precipitate action.

Senator Edge. It is a pretty important subject.

Senator La Follette. It is an exceedingly important subject. And, as I stated before, you came in, Senator, I admit its complexities. But what I am urging upon this committee is that it is a pressing and an important problem and one which merits the attention of this committee, and all that I am asking is that the committee shall discharge what I believe to be its responsibility in the matter.

Senator Edge. Mr. Chairman, may I make this suggestion? I have not read this resolution until I came in the committee room. I had seen some reference to it in the press. It would seem to me the first action that we should take leading to the investigation that the Senator has requested—entirely within his rights, and it is our duty, I agree with that—is that we should address officially a letter to the Federal Reserve Board and ask them to comment on the terms of the resolution in any way they see fit so that we can have that as a part of our study. After all is said and done, they are in charge of the system. And I would like to have that information. That is the usual procedure that is taken in all of our committees, I think, when an amendment or a law is proposed or a resolution is proposed affecting this or that department; we refer it to the department and get their reaction and comments, and unless there is some objection I would like them to file with us a written brief covering the intent of the resolution.

Senator BROOKHART. Mr. Chairman, some members of the Federal Reserve Board are present with us this morning. They might be ready to say something about it at this time.

Senator EDGE. Well, that is quite all right. I would be glad to hear them.

The CHAIRMAN. I wish to say in reply to the Senator from New Jersey that a letter was sent to the Treasury Department a few days ago in regard to this resolution, and we have not as yet received a reply.

Senator EDGE. Asking their comment?

The CHAIRMAN. Yes. But if the Senator desires that we address an official communication to the Federal Reserve Board, that can be done. Maybe that is where it should have gone.

Senator BROOKHART. Mr. Chairman, I have already introduced a bill which is before the committee for the specific purpose and design of correcting the evils which this resolution seeks to investigate, and if this resolution is to be submitted to the Federal Reserve Board I should like to have my bill submitted as well.

Senator MAYFIELD. That your bill be submitted along with the resolution?

Senator BROOKHART. Yes; that my bill be submitted to the Federal Reserve Board along with the resolution.

Senator MAYFIELD. May I ask the Senator what his bill proposes, briefly stated?

Senator BROOKHART. Briefly stated, my bill proposes first to prohibit speculative loans by member banks of the Federal reserve system in the same language that they are prohibited from being rediscounted by the Federal reserve banks now on the theory that if they were outlawed by the bank at the top they ought to be outlawed all the way through. There are two items of reserve bank business, the rediscount and the redeposit business, and this law only takes a little portion of the redeposit business into the Federal reserve, that is the reserves themselves, and by permitting no rate of interest to be paid on those redeposits it drives all of the other redeposits into New York, exactly what the speculators want, and I do not know, but that is probably two or three times as much as the reserves themselves. And the law itself is therefore responsible for this big accumulation, and I have prohibited one bank from paying another bank any rate of interest for redeposit. That will send this to the reserve bank where it belongs instead of to the New York bank. Then I have gone further and provided that they shall pay a 2 per cent interest rate for the use of those funds.

The CHAIRMAN. Permit me to say to the Senator from Iowa that his bill was sent to the Treasury a few days ago for their comment.

Senator BROOKHART. The Federal Reserve Board should have that.

Senator EDGE. Well, it would probably be referred to the Federal Reserve Board.

Senator BROOKHART. Then the other provisions of this bill that Senator Mayfield asked for fix the rates that they pay for these redeposits of 2 per cent. I am not a believer in the theory that we can control speculation by raising and lowering rates in some board. I think it has got to be done by law; and I think the Congress is the only board that ought to be trusted with such power. If they took these deposits at 2 per cent, a 3 per cent rediscount rate would be plenty high enough; perhaps 2½ per cent might be after we try it out. So I fix that rediscount rate by law at 3 per cent, and then if the rediscount rate is 3 per cent, the bank ought to operate at 5 per cent for loans to its members. We have from Iowa probably $400,000,000 of surplus money in New York at this moment, and a part of it is drawing on this redeposit 1¾ per cent, at least that is the last check I made, and the balance of it is invested in these listed bonds and things on the stock exchange at about 4¼ per cent. They are not getting as much as 5 per cent or anything like it in that New York investment on that vast sum of our surplus credit, and, while that is true, our loans to farmers are frowned upon as slow, and the banks are afraid to lend the savings of our own people to our own people, although before the establishment of this Federal reserve system our farmer loans were the safest and soundest in all the world.

Senator MAYFIELD. Well, instead of urging all of those various changes in the law, why do you not simply prohibit gambling in stocks and bonds on the New York Stock Exchange? In that way you could make a short cut to the proposition. Just stop it.

Senator BROOKHART. Well, I do not have any objection to doing that. But Senator Couzens, in discussing the thing, said we needed a market—a legitimate market for stocks and bonds.

Senator MAYFIELD. Preserve the legitimate market, but cut out the gambling.

Senator BROOKHART. I have been wondering if we could not provide for listing these in the Federal reserve system itself and making a legitimate market there, and do away with gambling. That is not in my bill. That suggestion has occurred to me since the introduction of the bill.

Senator EDGE. Does the Senator from Texas seriously consider passing a bill prohibiting that?

Senator MAYFIELD. There are millions of dollars of stocks and bonds sold every day by people who do not own them and have no idea of owning them. Purely gambling on the market.

Senator BROOKHART. There is no trouble at all in stopping the gambling.

Senator EDGE. It may be an old-fashioned viewpoint, but I never figured out that you could pass a law to keep a man from throwing away his own money. That is the fundamental view of it.

Senator BROOKHART. We have a law against poker gambling, and we can have a law against stock gambling. It is just as easy. The Senator from Texas is right so far as that is concerned. The trouble is to get the inclination of the Congress to pass it. That is where the trouble is.

Senator MAYFIELD. I do not object to a man throwing away his money, Senator, but what I object to is the Government lending about $3,000,000,000 to help him to do it.

Senator EDGE. In the meantime the Government is making interest I suppose.

Senator BROOKHART. I just checked up on some 13 corporations operating in Wall Street during the past year and found that these 13 that I checked had an average loss of 11 per cent in net earnings last year, but they had an average increase of 27 per cent in their stock values on the stock exchange. So the blue sky business is going at a very great rate on that stock exchange.

Senator EDGE. Mr. Chairman, are we going on with the consideration of this resolution?

The CHAIRMAN. The committee will govern on that.

Senator PINE. I think it would be advisable to confine the hearings to the resolution because if we branch out we will go too far afield.

The CHAIRMAN. If that is the wish of the committee, why we will bring this part of our morning business to a close.

Senator BROOKHART. The resolution, Mr. Chairman, calls for remedies, and these propositions I have offered in the bill are simply remedies for this identical situation. That is what I was driving at.

The CHAIRMAN. Senator La Follette has expressed the hope that Doctor Willis can be here at a later date and be heard.

Senator MAYFIELD. Mr. Chairman, I am a member of the Interstate Commerce Committee of the Senate which is going to take a vote this morning on an important measure that we have been hearing for several days and it is necessary that I go to that meeting. I want to say just before leaving that in my opinion this is one of the most important propositions before the Congress to-day, and I hope this committee will conduct a very searching investigation into this whole situation. In 1926 we have a terrible situation in Texas that affected the cotton farmers, and our cotton farmers were compelled to dump their cotton on the market and sell it for 8 and 9 and 10 cents a pound, and if the Federal Reserve Bank of the eleventh district had come to the aid of the member banks and let them have had sufficient money with which to carry this cotton for a while our farmers would have gotten, no doubt, a greater price for their cotton. And we do not understand how it is that this tremendous amount of money can be loaned to persons who are speculating purely in stocks and bonds and relief not be given to the agricultural situation of the country. Our people are tremendously interested in this question, and as a member of this committee I want to insist that we have full and complete hearings on this proposition and report to the Congress a measure that will give relief to the agricultural conditions of the United States.

Senator BROOKHART. I think, Mr. Chairman, that the law as it is now answers the main part of the Senator's question. The Federal Reserve Board is not to blame for this situation. It is not the administration of it at all. It is the law itself, when that law provides first that the reserves shall be redeposited in the Federal reserve but allows no compensation that compels that much of the redeposits of the country to go into the Federal reserve. The law permits the other surplus credit of the bank to be deposited in the Federal reserve, but again it does not permit any compensation to be paid, and that situation gives a virtual monopoly to these New York banks and they can offer whatever rate they please and get these redeposits of the country over and above the reserves that must be deposited in the Federal reserve. And the Federal Reserve Board is not to blame for that, nor the administration, but the law itself is purely to blame.

Senator FRAZIER. But the fact remains that instead of the Federal Reserve Board furnishing money to the agricultural districts that need it, such as the instance that the Senator from Texas stated, they are furnishing it to the Wall Street interests to gamble in stocks and bonds.

Senator BROOKHART. The Federal Reserve Board will not rediscount a speculative loan. That is prohibited by the law.

Senator MAYFIELD. What are the loans in New York if they are not speculative? They say to the banks in the South that want to lend money to the farmers: "No; we can not let you have that money for any length of time because that would be speculating on the prices of cotton." And yet billions of dollars are loaned in New York for the mere purpose of speculating in stocks and bonds.

Senator BROOKHART. The law itself is largely to blame for the situation.

Senator MAYFIELD. And that money is furnished by the Federal reserve bank.

Senator BROOKHART. It may be that there have been some abuses of it in the administration, but I think they are not going on now at any rate.

Senator EDGE. If it is necessary to have formal action on the resolution I make the formal motion that the committee proceed to give full consideration to the resolution, having such hearings as they deem necessary.

The CHAIRMAN. And that to-day's proceedings be included.

Senator EDGE. And that to-day's proceedings be included as a part of the record.

Senator PINE. I second that motion.

(The motion was put to a vote and carried.)

The CHAIRMAN. If there is nothing further we will adjourn. I do not suppose there is anything we can take up this morning?

Senator PINE. Do the members of the board who are here want to be heard?

The CHAIRMAN. They have not expressed any wish in the matter so far.

Senator BROOKHART. I would like very much to hear them if they are ready.

Mr. ROY A. YOUNG (governor of the Federal Reserve Board, Washington, D. C.). I received Senator Norbeck's communication last evening about 5 o'clock. I was in a conference all day and did not get out until late, and that did not give me very much opportunity to make preparation to come before this committee this morning. In addition to that I am new on the work of the Federal Reserve Board, much of it is new to me, and it is a tremendous amount of work for me to attempt to get up to date. I have been wrestling mostly with agricultural and livestock credits for the last 10 years, and this is all new to me, as to the problems that we find in the other Federal reserve districts. Now, if I understand correctly, the action that the banking committee has taken, it is that they are going to have future hearings and they will give the Federal Reserve Board ample opportunity to prepare answers to any inquiries they may make?

The CHAIRMAN. Certainly.

Mr. YOUNG. And that would be the best procedure for us to follow.

Senator BROOKHART. Mr. Chairman, I would like to suggest one or two propositions of fact which I would like to have the governor answer. One of them is the amount of deposits in the Federal reserve by member banks in comparison with the amount required by law to be deposited as reserves. How much more there is than the legal requirement. Then also, if you have that data, show how much redeposits of the banks generally of the country are in other banks than the Federal reserve. In other words, I want to see how much of this redeposit reserve bank business is being done by the Federal reserve bank and how much is being done by New York banks particularly, and banks generally throughout the country—the big banks particularly.

The CHAIRMAN. You will give the governor time to get that data?

Senator BROOKHART. Oh, yes, indeed.

Senator EDGE. I would suggest also, Governor, that you file your opinion of the terms of the resolution, its practicability, or what the difficulties are. Of course, you will naturally appear to answer questions, but I think it would be helpful to the committee to have a brief stating the views of the Federal Reserve Board as to the resolution.

The CHAIRMAN. We must have that, yes, before we conclude our hearings. The committee will now stand adjourned.

(Whereupon, at 11.10 o'clock a. m. Thursday, February 9, 1928, the committee adjourned subject to the call of the chairman.)

BROKERS' LOANS

WEDNESDAY, FEBRUARY 29, 1928

United States Senate,
Committee on Banking and Currency,
Washington, D. C.

The committee met, pursuant to the call of the chairman, in room 301, Senate Office Building, at 2.50 o'clock p. m., Senator Peter Norbeck presiding.

Present: Senators Norbeck (chairman), Frazier, Pine, Steiwer, Fletcher, Barkley, and Glass.

STATEMENT OF DR. HENRY PARKER WILLIS

The Chairman. The committee will come to order. Doctor Willis, will you give the stenographer your full name and address?

Doctor Willis. Henry Parker Willis; address, Columbia University, New York City.

Mr. Chairman, I have come here at the invitation of Senator La Follette, who suggested that I should give you my thoughts about this resolution, Senate Resolution 113, which, as I understand, is now pending before your committee.

In reply, I told him that I thought I had no information about it that is not accessible to you or to anyone who follows the current prints and the Government publications, so that all that I could do was merely to express my opinion about it as an individual; but that I am very glad to do, if such is your wish.

The Chairman. I think, Doctor Willis, it might be helpful to the committee if you would briefly set out the facts as you understand them.

Doctor Willis. Yes. Senate Resolution 113 briefly restates the condition of affairs in the reserve system at the present time with respect to what are known as brokers' loans, and then proceeds as follows:

> That it is the sense of the Senate that the Federal Reserve Board should immediately take steps to restrict the further expansion of loans by member banks for speculative purposes and as rapidly as is compatible with the financial stability of the Nation require the contraction of such loans to the lowest possible amount.

Then it further recommends:

> That the Federal Reserve Board be directed to report to the Congress what legislation, if any, is required to prevent the future use of the funds and credit of the Federal reserve system for speculative purposes.

As to that, Senator, it seems to me first of all that the situation to which the resolution calls attention is one of extraordinary importance, and I may add, very serious menace, to the present financial stability of the country. In that opinion I think I am safe in saying that the thoughtful members of the community, whether in the banking or brokerage world, are pretty well in agreement.

As to the remedy that is proposed by the resolution, I do not altogether find myself in harmony. The proposal is that the board should undertake to restrict the further expansion of loans by member banks, and as to that, I question their power—that is, I question their right to do it except through indirect means—while the statement that they are to be restricted so far as made for speculative purposes—or rather, that those that are made for speculative purposes should be restricted—seems to me too vague, for we have all kinds of speculation in this country at the present moment, both in stocks and in other kinds of value; so that the injunction to restrict the further expansion for speculative purposes would not convey to the board, I should say, any definite idea of the wishes of the Senate.

Then the statement that the loans are to be restricted to the lowest possible amount seems to me also to need further clarification. It would be difficult to say what the lowest possible amount is unless one were to formulate in his own mind very clearly a notion of propriety in the making of brokers' loans, and to state distinctly some measure or test by which that lowest possible amount should be gauged. That seems to me to be a very difficult thing to do.

I should be disposed further, Mr. Chairman, to say that the giving of an order of this kind to the board would be an unwise step to take. Either we have a Federal Reserve Board which is capable and which is willing to order a contraction of this kind or we have not; and if not, it seems to me that the Senate—or, for that matter, any legislative body—is hardly in a position to determine when an important banking step of this kind should be taken and to give the order to have it carried into effect. If you should do that now, it seems to me that the board might very well get into the habit of looking to you for instruction as to when it should do necessary things, and would increase in timidity about doing them on future occasions, until it had had a definite indication of the wishes of the legislative body.

Senator GLASS. Has the board any authority under the law to do exactly that thing now?

Doctor WILLIS. As I said a few moments ago, Senator Glass, I do not think from my knowledge of the system that it has a right to dictate to member banks what they shall do; but I will indicate in a moment what I think it might do, if the committee will permit.

Senator GLASS. I think there is something that should be done.

Doctor WILLIS. Yes; I think so, too.

Senator GLASS. I am talking about the law as it is now.

Senator FLETCHER. You spoke about there being something that the committee might do.

Doctor WILLIS. If I may, I would like to defer that for the present, Senator.

Senator FLETCHER. Yes.

Doctor WILLIS. I will complete my statement by saying that the resolution in its final paragraph requests the board "to report to the Congress what legislation, if any, is required to prevent the future use of the funds and credit of the Federal reserve system for speculative purposes." That seems to me to be a very desirable thing to ask the board to do—to indicate precisely what changes, if any, should be made in the present law.

A mere request to the board to indicate that, however, is perhaps hardly sufficient, inasmuch as the board would seem to feel that the present volume of brokers' loans is not excessive. If it thinks that, it presumably would reply that no legislation is needed; so that while I see no harm in asking the board to make this report in order to put it on record, it seems to me that investigation from another source is necessary in order to bring out all of the facts in the case.

That completes my statement, Mr. Chairman, of my views about this resolution. I may summarize it by saying that I think the resolution has performed an important public service in calling attention to a very dangerous situation, and that I think the Senate would do well to take cognizance of it and to determine upon some steps in the matter, but that I do not agree with the particular steps suggested here, except in so far as I have indicated.

The CHAIRMAN. You feel that a dangerous condition is liable to develop if the present policies are permitted——

Doctor WILLIS. To continue; I do.

Senator LA FOLLETTE. Will you enlarge a little bit, Doctor, if I might be permitted to suggest——

The CHAIRMAN. I do not think there is any harm in letting the Senator ask some questions.

Senator GLASS. No.

The CHAIRMAN. You understand, you do not need to answer them if you do not want to.

Doctor WILLIS. Yes.

Senator LA FOLLETTE. Will you enlarge a little on your view of the situation which has grown up in recent months and give the committee the benefit of your careful observation, which I know you have been making of this situation as it has grown up?

Doctor WILLIS. I shall be happy to do that as far as I can without specific statistical preparation. Not knowing beforehand exactly what ground would be covered in your questions, I shall have to answer on the basis of general knowledge, and if anything should be brought up that calls for statistical details I can, perhaps, furnish that information afterwards.

It seems to me the situation now existing in New York is in some ways quite parallel to that which existed just after the war in commodities and land. We then had the banks of the country financing land speculation and the hoarding of commodities, with the result that our price index advanced at a rapid rate, eventually reaching about 270, or, according to the revised figures of the Bureau of Labor Statistics, about 250.

It was at that time that the reserve system awakened to the great hazard which was developing and set itself to bring about a sounder position in the banking system of the country. That has often been referred to as "deflation." By whatever name we may call it, it was an effort to get back to a point at which our gold reserve was adequate to the support of our outstanding volume of obligations and at which the portfolios of the banks were of at least a moderately liquid sort. As the result of the experience then had our banking community has been extraordinarily careful during the past six or seven years not to overfinance farm-land speculation and not to overfinance commodity speculation. In fact, it has, perhaps, gone rather too far in its refusal to finance land and development of land, for at the present time it is reported in the Western States that even very good borrowers have difficulty in getting the accommodation to which they should normally be entitled.

However, during the past five or six years there has been no such hesitation about the financing of speculation in stocks and securities, and the result is that we have built up a huge structure of loans secured by stock-exchange collateral or, in the smaller cities, nonstock exchange collateral, which the banks have provided funds to carry along. Trading has spread itself very widely all over the country, so that now great numbers of people who have no knowledge of the market are in the market.

The result is that while the volume of brokers' loans may not be too great in the technical sense, and on high authority it has been stated recently that it was not too great.

Senator GLASS. What do you mean by "high"?

Doctor WILLIS. Statements of that sort, I think, have come from the White House and from the Reserve Board and from the Treasury Department.

Senator GLASS. But it does not necessarily follow that a statement which comes from the White House comes from high authority. No matter who may be the occupant of the White House, if he does not understand this particular problem. I would modify that and say "high sources."

Doctor WILLIS. Very well. While one might be disposed to say that the volume of brokers' loans is not too high in the abstract sense of the term, inasmuch as the banks hold an enormous supply of gold and resources in general, and so can carry them; and while it is probably true that many of the banks are well protected, since they have for a long time been building up exceptionally strong margins, it is a fact that the development is excessive in that it has been created on an abnormally high level of stock prices and under dangerous technical market conditions. A very great number of persons who do not know much about the stock market are interested; and thus a sharp change in prices is likely to wipe out a great many of them——

Senator GLASS. Do what?

Doctor WILLIS. Wipe them out.

Senator GLASS. The speculators?

Doctor WILLIS. Yes. While reputable brokers and bankers do not loan on "thin" margins, it is true that there is a great deal of money loaned on rather thin margins in one way or another at the present time, a hazardous situation has been developed in that way through the toleration of our banks and our reserve system, just as a similar condition was allowed to develop during the years 1919 and 1920, in another branch of speculation.

The danger, then, is analogous in the two cases. The results that may be expected, other things being equal, are somewhat similar.

The CHAIRMAN. In other words, a substantial drop in the market might cause great losses to the banks?

Doctor WILLIS. Might cause great losses to the people who are speculating, and eventually directly or indirectly, to the banks.

But what is more important than that, it might bring about a serious readjustment of values and price levels, and an increase of failures, which would be injurious all around to all classes in the community. The speculator has no doubt weighed the cost of his operations, and is prepared to lose. Whether he has wisely undertaken that kind of responsibility is another question; but we need not sympathize much with him. The person who is in danger in this case is the general stockholder or depositor in the banks, and the business community as a whole, which, of course, suffers indirectly through any breakdown of the distributive machinery.

Along with that general condition there has developed another, which is perhaps considerably more serious, but which seldom receives any attention at the present time. That has come about in this way. Owing to the very cheap money which has existed in our markets for some years past, not a few business concerns have found it more profitable to finance themselves through the stock market than at the banks. They have often found the local bank rather stingy in some parts of the country, rather inclined to charge high rates of interest, and not altogether broad visioned with respect to the development of the country. The result is that there have been great numbers of refinancings, and of resorts to the stock market through the issue of bonds and preferred stock and second preferred stock and every other kind of security; so that as a result, we have an abnormal condition in which the business house instead of applying to its bank, as it formerly used to do, often goes to the stock market for the accommodation that it wants in carrying on its business.

The CHAIRMAN. To make that clear—instead of going to the bank for loans, it markets its loans in the stock market?

Doctor WILLIS. Exactly so; and then the bank which has funds in hand and wants to do something with them, loans those funds to persons who wish to carry these stocks and bonds; so that you have a condition in which the bank is not willing to loan to the individual borrower, and yet it loans to the speculator who is going to carry the obligations of similar individual concerns. Now, that is not a matter of conjecture. For example, the Federal Reserve Board in its annual report last year shows a very marked decline in the amount of eligible paper that is being carried by the banks of the country in their portfolios. It attributes that to the growth of loans upon securities; but I should go further back than that and attribute it partly to this change in the method of financing. It gives the statistics on page 9 of its last annual report of a year ago, and it says this [reading:]

> Looking at the developments in the condition of member banks as a whole in recent years, the outstanding changes have thus been in the direction of a larger proportion of long-term investments and of loans on securities and of a corresponding increase in the proportion of time deposits, as compared with deposits payable on demand.
>
> From the point of view of the Federal reserve system, an important outcome of these developments in the character of the business of member banks has been a decrease in the proportion of the banks' assets that are eligible for rediscount with the Federal reserve banks. Of the total loans and investments of all member banks on June 30, 1926, 16 per cent was eligible for rediscount at the reserve banks, and this proportion was 18 per cent for national banks and about 12 per cent for nonnational member banks.

Then it gives totals, which show a substantial decline, which I believe has gone on at a much greater rate during the past year.

As a result, many country bankers profess that they are being forced into the stock market, or into the investment market, either as buyers of securities or as lenders on such collateral. These loans are being carried because the banks can not get enough business at home, the real fact in the case being that this change of method has automatically deprived them of loans that they need at home, and has diverted their resources into an entirely different form and kind of loan.

In general, those two things, Senator, are the basic elements in the condition which has been developed.

Senator GLASS. Doctor, the Federal reserve statute expressly prohibits the rediscount of paper for speculative purposes at Federal reserve banks?

Doctor WILLIS. Yes.

Senator GLASS. What, exactly, is the nature of the manipulation under which the resources of the Federal reserve system are applied to speculative loans?

Doctor WILLIS. The mechanism of that, Senator, is what I suppose Senate Resolution 113, introduced by Senator La Follette, would bring out if it were answered.

I would say that the situation is this: As the resolution points out, the original Federal reserve act was drawn for two purposes, the first that of absolutely preventing the use of bank reserves in speculative lines; the other that of making sure that the loans of the reserve banks were always liquid and based on actual transactions in business. The two things are quite different in a way, but they are the obverse and the reverse sides of the same situation.

With that in mind, as you well know, the act originally provided for what we call rediscounting and did not provide for direct or collateral loans.

Very early in the experience of the system, however, this was altered in two ways. In the first place, the practice of the Federal reserve banks was allowed to become such that they accepted collateral in protection of otherwise eligible paper, so that if a man brought in a note which was superficially or technically elegible, and might have been turned down on account of its intrinsic weakness, the reserve bank would discount that note provided it was backed up by collateral. That was a change which was seemingly quite necessary and, indeed, praiseworthy from the standpoint of practical banking, but which, of course, opened the door to all kinds of abuses.

The second change which was made was a change allowing direct borrowing by member banks, so that a bank could go direct to a reserve bank and borrow on its own note, provided that it submitted eligible paper as collateral protecting that direct note.

Then, by the practice of certain Federal reserve banks, these borrowers—these borrowing banks—were permitted to make loans for as short a time as one day.

Senator GLASS. I thought the limit was 15 days.

Doctor WILLIS. That is true, technically, but in practice it gets down to a day-to-day loan, because the borrowing banks are allowed to take up their paper whenever they please, so that in effect the loans are on a one-day basis. Conversely, the reserve bank, by the use of "repurchase agreements," is in position to call loans on a day's notice.

Senator GLASS. I mean, 15 days was the limit. That would not comprehend a one-day loan.

Doctor WILLIS. The facts are as I have stated, so that the member bank is allowed to get a very short loan, which it can cancel practically at will, and thus is enabled to obtain day-to-day money, or practically that, for use in its speculative operations.

Along with that, as the result of the war, came a change whereby inevitably large quantities of Government bonds were put out, as well as Government certificates of indebtedness. Such bonds or certificates of indebtedness had been specifically provided for in the act; but, needless to say, the framers of the reserve act had no foresight which enabled them to anticipate the coming on of the war, with the great increase in our debt.

Senator GLASS. The total outstanding bonded indebtedness of the country at that time was less than $1,000,000,000.

Doctor WILLIS. It was; so that provision was naturally made there, as in all other central banking countries, for loans designed to facilitate operations in the public debt, since the reserve banks were to be fiscal agents of the Government.

When the war was over, however, the present policy of short-term Treasury financing became definitely rooted, and was continued; and the obligations which were thus sold were put back into the banks out of which they had been, in part, driven during the years 1919 and 1920.

The banks then used these notes and bonds as collateral for the purpose of borrowing against their own direct obligations, so that the Federal reserve bank became practically a supplier of cash to any bank that wanted it, provided that it stood in possession of the eligible paper, which in this case was the obligations of the Government; and since such obligations could be borrowed for a small commission, any bank, practically, could get accommodation in that way. At one time it happened, if I am not wrong in my memory, that a single bank has had as high as $100,000,000, which it used directly in the market.

That is the situation. It is, of course, a complete breach of the spirit and the purpose of the Federal reserve act, and undoubtedly is—not wholly but in some measure—responsible for the inflated condition of the loans we have at the present moment.

Senator FLETCHER. Do you believe, Doctor Willis, that steps should be taken to restrict further loans for speculative purposes?

Doctor WILLIS. Speaking now, you mean, from the standpoint of the Senate, or of the reserve system? I can answer only in this way: I think there are too many loans now being made for that purpose. I think we have too large a volume of our bank credit involved in stocks, and I think we have far too large a proportion of reserve bank credit, in one way or another, involved in the stock market.

As to whether immediate steps should be taken to curtail it, that is a very difficult question. We have made these loans. We do not want to pull the props out from under the market at the present time. That would help nobody. But I am distinctly of the opinion that the further extension of this type of loan should be rigidly restricted, and as soon as the volume can be safely reduced it should be.

Senator FLETCHER. As to the suggestion in the last resolution, that the board be directed to report to Congress what legislation is needed, perhaps we ought to have some other agency to make that report. What agency would you suggest there?

Doctor WILLIS. I should think that your own investigation here and the inquiries that you will direct, no doubt, to properly qualified bankers, will give you the information without delay. The situation is one that is well known and is widely discussed all over the country, and I believe that the banking community is—well, I was going to say that they are a unit, but that is too strong. I will say I believe that the banking community is very much in agreement as to the need of a more conservative policy.

As to how far it is agreed just what should be done, that is another question; but undoubtedly the opinions of bankers on the subject would lead to a general consensus of opinion as to the steps to be taken.

Senator GLASS. Doctor, with respect to what appears to be the inordinate use of the funds of banks throughout the country in speculative centers, what would be the effect, in your judgment, of either a direct limitation, or a prohibition, upon the payment of interest on the deposits of one bank with another bank?

Doctor WILLIS. That is a question that has been discussed a great deal. It is very difficult to say what the effect of that would be. One effect that it might have would be to aggravate this situation, in this way. Bank A, we will say, of Keokuk, Iowa, has a balance of $500,000 that it thinks it does not know what to do with at the present time. It sends that balance to New York, to a correspondent, and gets a small rate of interest on it. Later, on hearing that the call loan rate has gone up somewhat, it orders $250,000 of that loaned at call.

Now, suppose that you prohibit the payment of interest by one bank to another; it would be fair to suppose that the Iowa bank would thereupon loan its entire $500,000 in the call market, if it were still disposed, as before, to keep it in New York at all.

Senator GLASS. Might it not have the effect of causing the Keokuk bank to reduce its rate of discount to its local industries and business men, so that it might contribute to the activity of business in its own community?

Doctor WILLIS. It conceivably might do that; but my thought about that is that if the bank has not done that already, but has preferred to send its funds away from home, or to put them into the bonds of Greece and Czechoslovakia and Germany and other countries——

Senator GLASS. Approved by the United States Government here at Washington.

Doctor WILLIS (continuing). That then it is not likely to make a drastic change in its policy solely because of an alteration in rates of interest on deposits. I think there is an impression among bankers that the present competition for bank deposits has been very bad, and that the effect of it in raising the rates of interest paid on deposits both by one bank to another and by banks in general to customers has been injurious, and that if it could be checked in some way it would be desirable.

That, I think, is a thing that the reserve system might take in hand for the purpose of correction. It is a thing that could be largely corrected, undoubtedly, as is shown by the fact that the board did at one time, a good many years ago, correct the evil in New York City. It did that in this way: The New York banks had fallen into the habit of bidding against one another for country money, and as the war was going on at that time and London banks had also taken to bidding against them for money from the United States, the board then intervened and obtained an agreement between the New York banks whereby they all undertook to pay only a uniform rate of interest upon out of town deposits, such rate to be regulated as a percentage of the rate of discount of the reserve bank at that time.

That had apparently a wholesome effect, because when the rate of the reserve bank was very low, then a corresponding reduction was worked in the rate that the banks paid for country money. That tended to drive some country money away when the rate was eased in New York.

Whether that is lived up to at the present time or is not fully lived up to, as many think, it would be only conjecture for me to say; but the use of some means of negotiation on the subject is open to the reserve system, and undoubtedly would be more effective than legislation.

Senator PINE. Have you determined why it is there is so much idle money in the country; so much money available in the country for use in New York City?

Doctor WILLIS. So much spare funds?

Senator PINE. Yes.

Doctor WILLIS. One important reason is the thing I have spoken of; that is the change in the type of financing, which has shifted the obligations of the larger concerns from direct bank loans into securities. I saw a computation—I could not say how accurately it was made, but apparently it was carefully made—some weeks ago, which indicated that upward of two billions of dollars, I think, was now being loaned by corporations in various ways, which meant that they had overfinanced themselves to that extent and were carrying that amount along either as investment in securities, or in some cases, perhaps, in call loans, or in other cases simply as idle money on hand, the reason being, as you see, that they had now gone into banking themselves. They had issued their securities to the public, and then, when business was slack, instead of canceling the loans in bank, they had to find some use for them, and found it advisable to carry them along in that way. I think the whole country has fallen into a condition of overcapitalization which results in what appears to be a large volume of money, but which is really inflation; and the inflation is illustrated by the fact that the actual coin reserve now is so low as compared with the outstanding deposits. I think it is figured now only about 6 or 7 per cent of outstanding bank deposits.

Senator GLASS. The Federal reserve bank is not compelled by law to make a given loan—to make a given rediscount. Suppose the board of the Federal Reserve Bank of New York would first admonish and then demand of the rediscounting banks that there should be a curtailment of loans for speculative purposes, what would happen?

Doctor WILLIS. I think there would be a curtailment.

Senator GLASS. So do I.

Senator FLETCHER. In an instance such as you mentioned, where the Federal Reserve Board was able to get an agreement among the banks in New York, suppose the banks refused to make any agreement, what recourse would the board have then?

Doctor WILLIS. Of course, if they absolutely refused to make an agreement, I think the board would have no recourse. It is a matter of negotiation and adjustment. I believe, though, that that would not be their attitude, because I believe that each of them admits that the interest on deposits evil is a great one, and they only want collaboration and encouragement to cut it off.

I was in Minneapolis and St. Paul a few weeks ago and discussed this whole situation with some of the bankers there, and one or more of them immediately referred to the payment of interest on deposits as a principal evil in the present situation.

Senator FLETCHER. How much interest do they pay?

Doctor WILLIS. I could not give you the rates. Some of them in the West are very high.

Senator FLETCHER. I mean in New York, on the country money sent there.

Senator GLASS. It is 1½ per cent, is it not? It used to be 2 per cent.

Doctor WILLIS. I do not think it is as low as that. It is not less than 2 per cent on demand deposits. Just how much money is carried there at higher rates than that it would be interesting to know.

Senator FLETCHER. I thought it was 2 per cent.

Senator GLASS. I think they have reduced it either one-quarter or one-half of 1 per cent.

Doctor WILLIS. There has been no condition there in which the open or official rate was too high. That is not the case. The danger comes from violations of the rule, I should say, and from the actions of banks that are perhaps not members of the system in bidding against others.

The CHAIRMAN. What per cent of the prevailing rate is being paid on these deposits officially? You spoke about it being elastic and in harmony with the fluctuating rates of money?

Doctor WILLIS. Yes.

The CHAIRMAN. How does it compare? Is it one-half or less?

Doctor WILLIS. I do not think I quite understand you.

The CHAIRMAN. The payment that the banks make on deposits received has a certain relation to the prevailing interest rate?

Doctor WILLIS. At the reserve bank it formerly had, and to-day there is some such a relationship between the open-market rate and the deposit rates.

The CHAIRMAN. What per cent is it?

Doctor WILLIS. I can not give you that from memory. Shall I state my recollection?

The CHAIRMAN. Yes.

Doctor WILLIS. My recollection is that when the reserve-bank rate was 4 per cent the member-bank rate was not to exceed 2½ per cent under the old arrangement; but to-day there is no official relationship, though a cut in the deposit rate often occurs when the open-market rate is reduced.

The CHAIRMAN. You laid stress upon the influence of the rates prevailing under these brokers' loans. Would you care to go into that?

Doctor WILLIS. The rate that is charged, you mean?

The CHAIRMAN. Yes; the increase in brokers' loans under a low rate of interest, and the causes for the lower rate at certain periods.

Doctor WILLIS. The effect of the rate on brokers' loans is one that has been, of course, greatly controverted. One view of it is that it is largely psychological, and that a change of one-half of 1 per cent at reserve banks does not have very great effect on the market. The fact remains that such changes in rates have invariably been followed by contraction or expansion; so that, so far as history goes, in our short history of the reserve system it has apparently been a very effective thing.

Thus, for example, last September the rate was cut to 3½ per cent, and there was a steady—almost steady and continuous—expansion of brokers' loans from that time on until the raising of the rate to 4 per cent, last month. Since that increase, about a month ago, there has been a decline of, I suppose, $100,000,000, or perhaps more. So that, superficially at least, the volume of speculative loans seems to follow more or less closely the changes in the rate.

Reserve banks state that a more effective influence is found in the open-market operations, and that they have prepared the way for changes in the rate by buying and selling government securities and acceptances. I have no doubt that that helps and makes the change in the rate more effective. So that the change in the rate is an announcement that a cycle of operations has been completed, and that thereupon the influence growing out of those operations makes itself directly felt.

Now, whether you take one view or the other, it comes to about the same thing; the advance in the rate is a notification that credit has been shortened to some extent.

A more important thing than that, however, is the variation of rates between the districts. Under the early organization of the reserve board, it was intended to have a variation of rates, first as between districts, second as between maturities and kinds of paper; so that before the time that we went into the war we had a rather elaborate rate structure—it was too elaborate, probably, but still a rather extensive and carefully worked out rate structure—so that there were differences of rates as between New York, the Middle West, the Pacific slope, and the South. It was then put forward by advocates of the Federal reserve system as one of the great merits of the system that we had rendered possible an adaptation of rates to the necessities of local communities.

During the war we had to abandon that plan because our rates were then made such as to correspond to the coupon rate of Government bonds, in order to stimulate the subscription to Liberty bonds and to enable people to carry them without loss.

After the war an effort was made to restore something like the old rate structure. That was unsuccessful; and of late years we have had a single uniform rate structure, so that a rate of 3½ per cent or 4 per cent is made on all maturities and kinds and classes of paper, no matter what they may be, in each district.

In addition to that, in the last two years there has been a growing effort to have a uniform rate throughout all districts, so that whatever was done in New York was the same in other districts, and where western bankers did not care for the policy of adapting their rate to an eastern rate, some pressure was placed upon them to do it.

Senator GLASS. And that administration by the board has been in complete defiance of the avowed purpose of the act when it was passed?

Doctor WILLIS. Yes; I think so; that is my opinion.

Senator GLASS. It is a fact.

Doctor WILLIS. The effect of the uniform rate sturcture is, of course, to siphon money out of the interior and drive it to New York, because money tends to flow away from the place where the rate is below the normal rate; so that if you have 3½ per cent in Chicago, and it ought to be 4, the effect is to drive it to New York where the rate is also 3½ per cent. If you raise it in Chicago, the tendency is to draw it back from New York into the interior.

All of that was definitely contemplated when we were forming the Federal reserve act, and that was the reason—or an important reason—for maintaining a district reserve system, so that each district would be the master of its own resources, and keep them there if it wanted to. Of course, if it did not do so, it had the right to do as it chose; but if it wanted to have its own rate correspond to the local rate—that is the rate in the open market, locally—it could do it.

Senator GLASS. One of the outstanding controversies of the time, as you will recall, one of the bitterest contentions with which Congress had to deal was on the question of a uniform rediscount rate, and Congress utterly rejected that idea.

Doctor WILLIS. The so-called monetary commission bill had provided for a uniform rate of discount throughout the country, undoubtedly with the intention of building up and protecting the New York money market in its preponderating importance. There was, perhaps, nothing wrong in that. It was simply a difference in point of view.

Senator GLASS. There was a difference in degrees of acquisitiveness. That is what we are doing now, is it not?

Doctor WILLIS. The reserve act was modeled upon an entirely different basis, which was the development of each local market and giving each part of the country control of its own resources, so that if it wanted to have a local speculative market, say, and float its own issues of bonds and be self-sufficient it could do it.

Senator GLASS. And the board has chloroformed the philisophy of that.

Doctor WILLIS. The thought was, of course, always repugnant to the large issuing houses in New York, which wanted to have control of the issue business of the country.

Senator GLASS. The board, however, was not appointed to take that point of view.

Doctor WILLIS. The formation of the reserve act was upon the other philosophy, and in order to carry that into effect the local discount rates should be formed under a set of local conditions. And since we have here a great country with immensely varying natural resources and climate and corporate activities, I should say, according to the mathematical doctrine of probabilities, it would be a very rare thing when you would have a uniform discount rate all over this country. It certainly would be rather difficult to arrive at a uniform discount rate all over the continent of Europe in all the central banks there.

Now, as a matter of fact, we have had a uniform rate throughout this country for a long time, and the effect of it, in my judgment, is seen in the siphoning off of funds from the interior markets to the New York market, which naturally tends to build up there the securities business and the general powerful control of finance which has been developed there.

Senator PINE. Inflation.

Doctor WILLIS. Inflation has been pretty common everywhere from time to time, but we have it now, especially in the stock market.

Senator PINE. It is not in the agricultural regions.

Doctor WILLIS. It was at one time. It is a good thing that it is not prevalent in the agricultural regions, in my opinion.

Immediately after the rediscount rate changed, when Chicago put its rate up to 4 per cent, New York remained for a few days at 3½ per cent. Transfers, as I understand, were at once initiated through the gold settlement fund. In other words, money began to move sharply back to Chicago; whereupon the New York rate was raised to 4 per cent, leaving the rather grotesque situation of 3½ per cent at such places as Kansas City and Dallas, while it was at 4 per cent at New York. But the return flow of money was stopped as quickly as if one had turned a faucet in a pipe.

The CHAIRMAN. Speaking of deflation, I am sorry the Senator from Iowa is not here. The other day he put in the record a statement along the line that while Iowa land values had increased to a point where it would show an index of 240, commodities as a whole had even taken a little higher level; and, therefore, the land deflation in Iowa was not a deflation at all; it was just a little lower than the general mark of exchange.

Senator GLASS. Yes; but he did not come back to-day, because I pointed out the other day that he was sending $500,000,000 of the people's money in Iowa to New York for speculative purposes.

The CHAIRMAN. He said that he protested against that, and wanted to stop it.

Senator FRAZIER. That is not because the farmers out there do not want the money right now, but because the banks will not loan it to them.

Senator GLASS. You ought to correct the banks at home.

Senator LA FOLLETTE. Would you enlarge a little, for the benefit of the committee, upon what you regard as the evils of this system of financing upon the part of industrial and other corporations through the market rather than through the banks?

Doctor WILLIS. I will be glad to give you my thought about it; with which you may not agree. I think, in the first place, it diminishes the desirable control by the banks, and their regulation of business expansion. My thought about a bank is that it is in a sense a public-service corporation. One of its functions is that of shifting capital into the various lines in which it ought to go. A wisely managed, able bank is a bank which gives to every man according to his necessities, and withholds from everyone capital when he is not likely to use it, on the whole, for the best interests of the community. In our capitalistic society we measure success in business on the basis of profit and sound credit. Consequently, if a business is not doing well, or is not wisely handled, the banker's duty is to shut down on its credit until changes are made, there. If the business house now gets its capital not from the bank but from thousands of investors who never look into the statements, who never attend a stockholders' meeting, and never do anything except draw their dividends and spend them, the tendency in business is to separate itself from this kind of supervision, and consequently to do things that are not, on the whole, in the interest of the community. I do not mean by that that it consciously acts in an antisocial manner, but simply that it has been released from one of the types of control that under our capitalistic system has been established for the purpose of regulation.

The effect of that is that that business tends to push ahead and expand largely, to adopt methods of selling its goods, etc., and to act in ways that it would not if it was subject to satisfactory banking control.

Perhaps the best illustration of that is the overcapitalized condition of much of our manufacturing industry in the United States to-day. We have a great deal of idle plant capacity, and that is due, of course, to the fact that businesses have been allowed to get more capital than they really needed. That, to my mind, is one major evil growing out of this condition of affairs.

The CHAIRMAN. You feel, doubtless, that it is due rather to an overdevelopment than to a falling off in the consumption of the country?

Doctor WILLIS. Yes; I think there has been overdevelopment in certain classes of productive capital, so that we have idle plant capacity; and one result of that, incidentally, of course, is that men are drawn off from the farm to the factory, while excessive expansion is going on.

Then, of course, it is necessary to provide an outlet for goods that are thus overproduced, and we do that by installment selling or high-pressure salesmanship, or in any way we see fit. The outcome of that, of course, is to bring about a still further one-sidedness in the development.

The CHAIRMAN. Can we consume any substantially larger amounts under the partial-payment plan than under the older system?

Doctor WILLIS. The country has undoubtedly anticipated its income——

The CHAIRMAN. It did that for a year or two. Will it, in the long run?

Doctor WILLIS. It did it at first. In the long run it can not do it.

The CHAIRMAN. We are suffering from that now?

Doctor WILLIS. Yes; I think that the spurt is having to-day a bad effect in the overspeeding-up of manufacturing, and the reflex effect of that on the types of business I spoke of.

The CHAIRMAN. And from a demand which in its nature was temporary.

Doctor WILLIS. Yes; quite so. We had supposed that the establishment of the reserve system had been to supervise our banking and make its action more public spirited than it was under the old banking system; but the actual working out shows how difficult it is for anyone to foresee the future. It has not done it.

Senator La Follette. You expressed your opinion as being opposed to that portion of the resolution which calls on the Federal Reserve Board to take such steps which may be necessary to curtail this present situation.

Doctor Willis. By member banks, Senator.

Senator La Follette. I take it your criticism is rather based on the theory of either the Senate or the House—or the Congress—getting into the habit of advising the Federal Reserve Board as to what it ought to do in specific situations, rather than on any disagreement in so far as the graveness of the present situation, or the necessity for some action being taken either by the Federal Reserve Board or by Congress through legislation to remedy it, is concerned?

Doctor Willis. Yes; it is based essentially on what you speak of as the undesirability of having Congress take over the direction of practical banking.

It is also based, and I think this is the point that the Senator from Florida—am I not right—asked me about some time ago when I spoke about indirect control by the board. It is also based upon the thought that the reserve board has not any right, so far as I understand, to act directly to restrict the expansion of loans by member banks. It can only do that indirectly through its management and the reserve banks; that is, by requesting the reserve banks to follow a policy of discouraging applications by banks that want to use the money in speculation, or whose statement shows that they already have a large sum in the market.

Senator La Follette. Do you feel that the exercise of that indirect power, if I may term it so, is an unsound policy?

Doctor Willis. The exercise of it by the board, do you mean?

Senator La Follette. Yes.

Doctor Willis. No. On the contrary, I think it is a perfectly sound policy, judiciously to do just that through the reserve banks; but not through direct orders to member banks, over which I conceive they have no positive jurisdiction at all.

Senator La Follette. In other words, the board, if it viewed this situation, might under existing law take steps to remedy it through this indirect control?

Doctor Willis. I think so. I think there is a great deal that the board could do to cut that off, if it was impressed with the necessity of doing so.

Senator Glass. It might if it would.

Doctor Willis. We gave authority to the Federal reserve banks to control their rediscounts to the banks—their member banks—as the board should generally indicate.

Senator La Follette. If that paragraph of the resolution was amended to conform to the suggestion which we have just been discussing, would you still feel that it was unwise for the Senate to take that action in view of the gravity of the present situation?

Senator Glass. That goes back to his previously expressed opinion that he does not think that Congress ought to undertake it; that either branch of Congress should undertake to instruct or suggest to the board.

Doctor WILLIS. I can only say, Senator, that to answer your question directly, yes or no, is very difficult, because that all depends on how it is done. I think that unwise action or heavy-handed action by the board now might produce very serious results.

Senator LA FOLLETTE. I think we could agree about that.

Doctor WILLIS. Yes. That the board should by proper methods and by steady but determined exercise of authority gradually bring about the reduction of loans, I have no doubt whatever. As to the passing of this resolution, of course, that is practically putting up a signboard to the country that something is going to be done, and anything like that is immediately taken advantage of by speculators who want to profit by the decline, and there are plenty of those just as there are on the other side. I have no more affection for the man who wants to make a profit by beating down prices than for the man who wants to make a profit in the other way, and it seems to me that the situation is one that should be corrected through internal management, if it can be, rather than through action by Congress.

Senator LA FOLLETTE. Apparently we are confronted with the situation where we can not get action.

Doctor WILLIS. Yes.

Senator LA FOLLETTE. I do not wish to draw you into any criticism of the present board, because I realize you would not care to do that.

Doctor WILLIS. I have not hesitated to criticize the present board. I have felt authorized by reason of my former position as a member of their "banking family," and have uttered a great many friendly criticisms of them.

Senator LA FOLLETTE. But we are confronted with a situation which I think most people agree is a grave menace.

Doctor WILLIS. Yes.

Senator LA FOLLETTE. And no action seems to be forthcoming. I agree with you that I should not like to see Congress get into the habit, or the Senate, of passing weekly resolutions directing the activities of the Federal Reserve Board. That is contrary to the whole theory upon which the board was created.

Doctor WILLIS. Yes.

Senator LA FOLLETTE. But I might say that I was prompted to introduce this resolution by the extreme gravity of the situation which I felt was growing up.

Doctor WILLIS. I think you did right, Senator, and I think the resolution has already done good. If you will permit me to say so, perhaps it has done all you intended. I do not know. On what date did you introduce this resolution?

Senator LA FOLLETTE. It was introduced on the 17th of January.

Doctor WILLIS. Since that time there has been an increase in the rates of the Federal reserve banks.

Senator GLASS. I think the resolution has done a great deal of temporary good; but I think it ought to prompt this committee to consider if there may not be some modification of the act itself which will do a permanent good; which will prevent, to some extent at least, a recurrence of the situation we are complaining of now.

Senator LA FOLLETTE. That was the next question I was going to ask the doctor. At the time you were ill, Senator, and could not be here, and when we had the first hearing, I stated to the committee that I felt that if the introduction of this resolution would result in the direction of the attention of this able committee and of the Congress to the gravity of this situation and to the necessity for some permanent legislation to remedy it, I should feel highly gratified by the result.

Doctor WILLIS. Senator, I should like to say there, although not in direct answer to any question you have put, that I have for a long time felt that this act needs a thorough revision and overhauling. There are certain portions of it that are not being observed at all and never have been observed, and whenever the question is raised in official quarters the answer is, "We do not think it is worth while to observe them. We do not like those provisions of the act."

Then there are other features of it that have been observed, but in a rather unsatisfactory way and in a way that is quite foreign to the original purposes of the act.

In addition to that we are all of us wiser than we were when the act was passed. We have had 10 years or more of real experience under it, and they have been years of remarkable financial transformations in the financial world.

The Canadians are in the habit of revising their banking act every few years, and that gives opportunity for an exchange of opinions and to round out these things. This act needs revision.

Needless to say, it should be a revision without any partisanship at all. It should be a revision that is not made under the influence of the Federal reserve banks or by them. It should not be made by the governors of the reserve banks, furnishing sections on this, that, or the other topic for incorporation in it. If you make it in that way, it will be of no use. It should be a real, bona fide, careful revision of the whole act; not because it has been injurious or bad, because it has been the one thing that all over the world has set this country up as a financial example. It has been copied in many countries and its practice has been adopted in many others. It is mere commonplace to say that we could not have financed the war without it. But it needs revision, because it has been as serviceable and as good as it has and because in the way that it is being operated now it is dangerous and it needs modification. To undertake that is a great piece of work, but it is a piece of work urgently needed. The sooner it is begun the better off we shall be.

Senator GLASS. Mr. Chairman, I am sorry I have to leave, but I am in the hands of my doctor and I have to go now.

(Senator Glass here left the committee room.)

Senator FLETCHER. Doctor, that brings up another question. What is the use of amending the act if it is not observed? Would not the whole effort be futile?

Doctor WILLIS. Of course, we can only struggle along with our legislative efforts as best we may.

Senator FLETCHER. I think we are getting this country very much into the position of continental Europe, where they have what they call the "droit administratif," where the laws are administered by bureaus and commissions without regard to the express provisions of the statutes.

Doctor WILLIS. Undoubtedly there is danger of that kind; and yet the express provision of Congress, especially if what it orders is right, has a great effect on public opinion.

The CHAIRMAN. I am much interested in your suggestion that revision might be advisable; it might be an advisable thing to undertake in the not too distant future.

Doctor WILLIS. Yes.

The CHAIRMAN. Would you care to enlarge on that?

Doctor WILLIS. You mean as to the way it should be done?

The CHAIRMAN. Yes; the changes that you have in mind.

Doctor WILLIS. Yes. I think that, if my memory serves me correctly, you have amended this act some sixteen or seventeen times since it was adopted, and that they have usually been made without any regard whatever to the main structure of the original act. During the war the amendments were run through by machinery, so to speak, because they were called for as phases of war finance.

The CHAIRMAN. And one was to put a dirt farmer on the board.

Doctor WILLIS. That certainly was one of the things I thought was unwise; unless the dirt farmer had other qualifications.

Incidentally I might say that you took away the provision that two members of the board should be men of learning in banking and finance. So that a good deal was done there that was at least open to question.

It seems to me you might appoint a small committee whose duty it would be to codify this act and its amendments, to take up all these different amendments, and to analyze the national bank act in the same way and eliminate conflicting provisions, of which there are many, and embody such administrative rulings as may have been made—that is such as may have proved themselves of permanent value—in the law, thus putting the whole thing into workable shape.

If it should be that you want to provide something about this rate of interest on deposits of banks, it seems to me you might very well enact a proviso connecting the rate with the reserve bank discount rate.

Among these amendments, a number have been introduced that are directly at war with the original purposes of the act. A great change has been made in the acceptance provisions of the act, and that has been for the worse.

The change in the treatment of commercial paper and gold held behind notes, I think, has not been beneficial.

In the same way, the failure to establish branches of the reserve system abroad I regard as a direct ignoring of an important provision of the act, which would have saved us much of the difficulty that we are now having with our foreign loans. Either that should be left out, if we are never going to apply it, or provision should be made for establishing those branches.

Then, I think you may very well consider, of course, whether the time has not come to make the reserve system a voluntary organization of banks; that is, to eliminate the compulsory quality. The small country bank complains to-day because the keeping of its reserves without interest is so great a burden upon it. It wants to use its funds where it can get the most for them. I am not especially in sympathy with that, but I am inclined to think that the reserve system has had only a very slight, lax control over country banks, anyhow. There have been more failures under the reserve system than there ever were before, and we are not at the end, I think, of this failure epidemic.

The original conception of the reserve act was that of a voluntary association of banks. The compulsory feature was put in because of the extraordinary resistance which all banks offered, so that in order to get it started at all we had to take rather drastic measures; and yet now, should we not have better results if you made it a voluntary association?

The CHAIRMAN. You think the attitude of the banks is such that they would still have a strong system without any compulsion?

Doctor WILLIS. I think so; I believe so. It may be that that change should be hedged about by some limitations. It may be that you should restrict membership to banks of less than a certain capital. I am not prepared to say now. But I am convinced that a relaxation of that compulsory provision might well be studied to advantage.

When you have done that, of course, you have greatly changed the working of the system; and then you will need to have the reserve banks administered with real ability, so that there is an object and a purpose for the banks to remain in, and to get in. Some of these reserve banks, at least, are now in the habit of resting on their oars and saying that it makes no particular difference whether school keeps or not, because they have their membership tied up. I do not mean that that is characteristic of the whole system, but that is human nature; so that that, among other things, should come in for a very serious consideration.

All of those things, it seems to me, might very well be intrusted to a subcommittee of your body here, with due notice to the public that you are going to do it, so that you will get suggestions from anybody who wants to pass them in.

Senator PINE. Would you give the board the powers of the Comptroller of the Currency, and abolish that office?

Doctor WILLIS. Yes; I think so, without doubt. The Comptroller of the Currency is obsolete. I think either the board should have that, or else we had better recast the system of supervision entirely.

Senator LA FOLLETTE. Would you care to express any opinion to the committee as to the lines along which a legislative remedy against this excessive condition of speculative use of credit might run?

Doctor WILLIS. I do not see how you can correct it by legislation. It seems to me a thing that must be corrected by good banking. Perhaps I am old-fashioned in that attitude, but I think that a vigorous administration of the reserve board and the reserve banks can easily prevent it from happening. We have prevented the development of inflation in the agricultural districts since 1922.

Senator PINE. Killed them.

Doctor WILLIS. Killed them?

Senator PINE. Well, the bank failures killed agriculture.

Doctor WILLIS. It was bank failures, then.

Senator PINE. Let me ask you this: Did the open-market policy of the system have anything to do with the development of these speculative loans?

Doctor WILLIS. The open-market policy?

Senator PINE. Of the system; yes. They were buying bonds.

Doctor WILLIS. Yes; Government bonds.

Senator PINE. At the time these loans reached their highest point.

Doctor WILLIS. Yes. Well, that is very hard to say. The system must have an open-market policy in order to be an effective, going system. Every other central bank has one. Of course, ours is based on an entirely erroneous plan; so that if you would modify your question in such a way as to ask whether the present open-market policy tended to aggravate things I think I should say yes, with some limitation. A wise open-market policy would not have brought on these bad results.

Senator PINE. It would not have compelled Chicago to reduce its discount rate at the time they did. Would not Chicago have drawn some of this money away from New York?

Doctor WILLIS. I think so.

Senator PINE. And reduced the loans?

Doctor WILLIS. I believe so.

The CHAIRMAN. I, for one, certainly appreciate your coming here, Doctor, and I am certain that the other members of the committee do, also.

Doctor WILLIS. Thank you, sir.

The CHAIRMAN. I think you have thrown a good deal of light on this problem.

(Thereupon, at 4.10 o'clock p. m., the committee adjourned, subject to the call of the chairman.)

BROKERS' LOANS

WEDNESDAY, MARCH 7, 1928

UNITED STATES SENATE,
COMMITTEE ON BANKING AND CURRENCY,
Washington, D. C.

The committee met, pursuant to the call of the chairman, in the room 301, Senate Office Building, at 10.30 o'clock a. m., Senator Peter Norbeck presiding.

Present: Senators Norbeck (chairman), Edge, Glass, Brookhart, Pine, Barkley, La Follette, and Steiwer.

The CHAIRMAN. The committee will come to order. The first witness will be Doctor Sprague, of Harvard University.

STATEMENT OF OLIVER W. M. SPRAGUE, ESQ., PROFESSOR OF BANKING AND FINANCE, HARVARD UNIVERSITY

The CHAIRMAN. Doctor Sprague, we would like to have your views on what, if anything, can be done along the line of Senator La Follette's resolution, toward preventing in the future, if possible, what seems to be an abuse of the present system.

Mr. SPRAGUE. I should wish, if I may, at first to consider the matter rather generally, in order to indicate somewhat regarding the character of business represented by the brokers' loans and the influences which seem to lead to the growth of loans of that kind.

There are at the present time 26,000 banks in the United States. Five years ago there were nearly 30,000. Between 3,000 and 4,000 have failed in that period of five years. It is, therefore, I think, pertinent to inquire whether banks have failed because of brokers' loans, and also to inquire whether, if obstacles are placed in the way of using funds for brokers' loans, the number of bank failures might be affected, either to increase or to decrease them.

Senator GLASS. Doctor, might there not be another phase of discussion? The security of banks is not the entire program.

Mr. SPRAGUE. Oh, no. It is simply one phase, Senator, and as I must begin somewhere it occurs to me to begin by indicating the reasons for the employment of bank credit in brokers' loans, and to inquire whether that is a safe use, and whether some other use would be equally safe.

I suppose the first requirement of any satisfactory banking system is that it should be reasonably safe from the point of view of the depositors. Now, all of these 26,000 banks are constantly endeavoring to employ their funds fully, to find a satisfactory use for all the credit which they have at their disposal.

Senator PINE. Satisfactory to whom?

Mr. SPRAGUE. That depends upon the policy which they adopt. I now wish to inquire whether it would be possible to find a use for all of the funds of all of the banks in the absence of some such use as that which we find in the case of dealers or brokers' loans.

Senator EDGE. It would be one that was satisfactory to the board of directors, would it not?

Mr. SPRAGUE. And safe from the point of view of the depositor.

These 26,000 banks are in the main local banks. The principal business which they handle is local business, and it is the most important business and the most profitable business which they have. The rates on their local business are in general higher than the rates upon brokers' loans. Banks are not tempted to invest in brokers' loans primarily by the rate of return since the rate is regularly lower than the rate on local loans. They invest in brokers' loans primarily because they do not find in the local situation a volume of satisfactory loans sufficient to absorb all of their funds, consistent with safety.

Senator PINE. Are you certain of that position?

Mr. SPRAGUE. I am.

Senator PINE. Where does that condition prevail at this time?

Mr. SPRAGUE. That prevails throughout virtually the entire country.

Senator PINE. Does it prevail in Oklahoma?

Mr. SPRAGUE. Surely, it does, and I will explain my reason for thinking that is the case.

Senator BROOKHART. Is not part of that condition due to the fact that the bank examiners disapprove the local loans, but do approve of these brokers' loans, and also of loans on listed bonds, and things of that kind?

Senator PINE. Do you have in mind the fact that that was not true before 1920, when we did not have any bank failures in the West?

Mr. SPRAGUE. Before 1920 we had a period of inflation, during which prices on lands and of commodities were rising rapidly, and it was practically impossible during that period of abnormal advance in prices for banks to fail; but those banks which put all of their funds into a local situation, especially where that local situation was one of a single industry or a single occupation, and where values of land and values of inventories were inflated, have either failed or experienced exceedingly great difficulties.

Senator EDGE. Your point, if I follow you, is that if, even in those days where there was plenty of demand for local loans, the policy had been followed that a certain proportion of their loans had been made on other types of securities, the failures would not have occurred?

Mr. SPRAGUE. I think that is a reasonable assumption.

Senator PINE. For 50 years the banks did not fail.

Mr. SPRAGUE. During those 50 years there were numerous failures at times, notably after 1893 and 1907. The record of bank failures in part indicates the hazards that are incurred when banks invest all of their funds in a local situation. Sound banking policy requires that a bank hold reserves in cash, and in addition hold at least some assets which can be readily liquidated without affecting unfavorably the business of the bank.

Senator BROOKHART. Do you mean other types of securities that were less inflated than land values?

Mr. SPRAGUE. I wish to come to that in a moment. There is a difference in the effect of inflation in one kind of business from that which obtains in another. A well-conducted bank holds in part customer loans. These loans ordinarily can not be liquidated in any large measure without loss of standing of the bank as a going concern. In order to meet the regular requirements of its local customers, if a bank is fully to utilize its resources at all times, it must ordinarily invest a part of its resources outside, in an impersonal way, if you please, holding a quasi reserve, and that is one of the reasons for the shifting of funds to the large money centers from the small money centers.

Senator PINE. Was that done for the purpose of protection of the banks, or for the purpose of building up the great money centers?

Mr. SPRAGUE. For the purpose of protecting the banks.

Senator PINE. The national banks were protected for 58 years without that shifting.

Mr. SPRAGUE. It is by no means a recent practice. Formerly the banks deposited their surplus funds with other banks, and the other banks paid interest on these deposits. That practice still continues, but, in addition, many of the banks lend directly. It has always been the practice of banks in Boston and Chicago and Cincinnati and so on to lend to some extent directly through correspondent banks in New York, and also to maintain balances in New York. The practice now is somewhat more general of lending directly. A larger number of outside banks now lend some of their surplus funds in New York, and at the same time continue to maintain balances in New York banks.

Senator BROOKHART. Are they not doing both?

Mr. SPRAGUE. They are doing both.

Senator BROOKHART. The same banks are doing both?

Mr. SPRAGUE. Oh, yes; unquestionably.

Senator PINE. To a greater extent than ever before?

Mr. SPRAGUE. To a greater extent than ever before.

Senator PINE. Draining the money from the agricultural regions?

Mr. SPRAGUE. Now, the query presents itself whether they are draining money which might be properly and desirably utilized in their own locality or whether they are sending money there because they do not find a safe and reasonably liquid use for those funds in their own locality. Now, I will say that, by and large, beyond the point of a quasi reserve, which would mean a moderate amount of money transferred to New York, either to be carried as a balance or to be lent on call, the balance, the increasing amount, represents funds which the banks, in their best judgment, do not find it feasible and safe under existing conditions to employ in their own localities. If, for example, a bank in Indianapolis, let us say, at the present time does not find that it can employ all its funds locally, as large a volume of funds in local use as it would wish to do, the reason is a very simple one. It is due to the abundance of savings that are being made throughout the country, and have been for the last five or six years—savings which have reduced materially the rate of interest. I notice in this resolution the statement that commercial loans have fallen. The assumption is implied that they were reduced because the banks are indisposed to invest in commercial paper on account of superior attractiveness of the call-loan market.

Senator BROOKHART. How about loans to farmers?

Mr. SPRAGUE. Just let me finish this, if I may.

Senator BROOKHART. Go ahead.

Mr. SPRAGUE. Now, the reason for the contraction in commercial loans is simple enough. It is due to the abundance of funds in the capital market. Large corporations which formerly marketed commercial paper through note brokers among numerous banks have found it quite possible to secure additional funds through the capital market, in part through the issue of additional stock and in part through bonds. If the volume of savings had been much smaller, rates in the capital market would have been higher, and these concerns would have gone to banks and secured funds on a short-time basis. Throughout the entire country business is now financed to a greater extent than formerly on a permanent basis by stock, profits put back in the business, bonds, and notes, while bank loans are relatively smaller than they were five years ago.

Senator EDGE. To what do you attribute this large increase in the savings department? We hear so much about unemployment now.

The CHAIRMAN. Do you want to know whether it is the Volstead Act?

Senator EDGE. I do not want to interrupt your argument, but would like your view on that question.

Mr. SPRAGUE. It is due to several causes, in my judgment. It is due in part to the greater efficiency of industry, the larger output of industry in recent years, which has made it possible for many to earn a larger income. And I am willing to say that it is, perhaps, to some extent, at the expense of agriculture to the advantage of urban communities. I believe the urban population of this country has been securing its food at prices which have been, on the whole, unremunerative to the farmer. If, for example, the city population gets its milk at 2 cents a quart less than is a remunerative price, it has just that much more either to save or spend in other directions.

Senator BROOKHART. That proposition has my full approval. I know it is true.

Senator PINE. You maintain that the withdrawal of this money from the country will assist in preventing bank failures in the country?

Mr. SPRAGUE. Yes.

Senator PINE. I think it has been responsible for the great number of bank failures. The banks failed where the money came from, and the banks have not failed where the money went.

Mr. SPRAGUE. The bank failures, in my judgment, in large part, were because of the investments in the various localities where banks have failed, using a larger amount of bank credit than the economic conditions of the locality justified. It is speculation in land and speculation in inventories that I fear more than speculation on the stock exchange. Speculation on the stock exchange may be an evil, but it is an evil which is quickly corrected. In the event of a sharp decline in securities on the stock exchange various individuals who have been speculating in the hope of a rise, may lose money, actual money or paper profits; but the loss in the main is confined to those individuals. When, however, the volume of bank credit is extended to an excessive extent to those who are engaged in industry, leading to inflated inventories, you have a collapse of a large number of industrial concerns and resulting unemployment.

The situation is even worse if it happens in the case of agricultural lands. If agricultural lands reach a price which is not justified by current income, actual or prospective in the immediate future, the damage is tenfold greater than it would be from a decline on the stock exchange, and much greater than in industry, because the farmer's home is attached to his occupation, and often he can not liquidate, without breaking up his home, as well as his occupation. Thus you have in the case of inflated farm-land values a long and painful period for which you have no analogy whatever in the case of industry, and much less in the case of the stock exchange.

Senator BROOKHART. On that proposition I want to call your attention to some figures from the Department of Agriculture showing that land values in Iowa were about as high as anywhere—not quite, however, as several States were higher than Iowa—and reached an index figure in the peak of 1920 of 213. That is a little more than double the price compared with pre-war prices.

Mr. SPRAGUE. Yes.

Senator BROOKHART. But at the same time the general index figure of all products was 241.

Mr. SPRAGUE. Yes.

Senator BROOKHART. So that land inflation never did reach the stage of inflation of other things. Then I find on page 3 of this bulletin that the farm values continued to fall, while city realty continued to hold its own and rise. The point I wish to call attention to is that land values in industrial centers continued to rise, while they continued to fall in agriculture.

Mr. SPRAGUE. True; but my point is that inflation is a more serious evil in the case of agriculture than it is in the case of industry.

Senator BROOKHART. Yes; but if we had a fair deal and this were controlled by the United States instead of being controlled by the brokers and gamblers, would not agriculture and other business go up and down together?

Mr. SPRAGUE. No; for the reason, as it seems to me, that there is not an elastic demand for farm products, while there is a more or less elastic demand for many of the products of industry. You can not induce the population of the United States to eat very much more by a reduction in prices, whether that is brought about by an excess in supply or whether it is brought about by increased efficiency in production. If you can reduce the prices of a great variety of manufactured articles, for whatever cause, you can stimulate the demand for those articles; but you can not maintain the prices of these food products, as to which there is an inelastic demand. An urban population on the whole eats less, and our machine methods of production mean that we do not exert ourselves physically to the extent that the population did 30 years ago.

All these influences are tending toward a contraction of the per capita consumption of food, and in my judgment it means that the acreage under cultivation in the United States is unlikely to increase appreciably in the next decade; and that means that we have a situation quite different from that which prevailed for decades prior to

1920. In 1900 a farmer could buy land at a price that was not justified by the then yield, and he might hold it on the expectation, which would generally be realized in four or five years, that the land would appreciate in value enough to make the transaction worth while; but if land prices are declining that does not work out.

Now, we have had no difficulty of that kind in New England, my own part of the country, where no one has thought for years that land values were going to increase. People do not buy land in New England on the basis of an expected appreciation. They rather buy it on the supposition that it may be less valuable in a few years rather than more valuable. So that the current income from the land will in general support the price paid for the land. Now, I hold very definitely that it would have been immensely better for all the people west of the Mississippi River if the supply of funds available for farm mortgages and for other purposes had been decidedly less between 1916 and 1920 than in fact it was.

Senator PINE. Did not the best authorities in the world approve the prices at which Iowa land sold in 1920; the insurance companies and the Federal reserve banks and others?

Mr. SPRAGUE. I would not wonder if that were the case, but it simply proves again that not only may people be mistaken, but that more credit may flow into the economic situation than is desirable for a community.

Senator PINE. Did they not consider the earning power of the land at the time they approved these loans?

Mr. SPRAGUE. Everybody was in more or less of a feverish state at that time, but the point which I am making is that it is particularly important that credit be employed conservatively in agricultural sections of the country, because of the difficulty in making an adjustment if errors are made and inflation develops.

Senator BROOKHART. Do you consider that brokers' loans are a conservative employment of capital?

Mr. SPRAGUE. I would like to come to that in just a minute, if I can finish with the proposition which I consider basic.

Senator GLASS. Concerning land speculation, do you think anybody is ever sane in a community where there is a land boom, whether it is a bank or money lender or what not?

Mr. SPRAGUE. The First National Bank of Miami, Fla., held $66,000,000 of deposits at the height of the boom, and it had $8,000,000 lent in Miami, and the rest of its funds were in balances in New York banks, in call loans, and in United States bonds and other available bonds. When deposits went off from $66,000,000 to, I think, $23,000,000, it was able to meet that situation.

Senator GLASS. That was so exceptional that you remember it and cite it as an isolated instance.

Mr. SPRAGUE. That is sound banking.

Senator GLASS. I know it is, but does sound banking prevail where there is a land boom? If it does, I would like to know where it is. I never heard of it before.

Mr. SPRAGUE. That being the case, it does not seem to me altogether wise to create by legislation conditions which will confine the employment of bank funds to local uses.

Senator GLASS. Of course not; but what I am saying is that when the land booms occur, nobody is sane, bankers or anybody else. I once paid $3,000 for a corner lot that afterwards sold for $1.38 for taxes. Do you think I was sane when I did that?

Mr. SPRAGUE. No; but if the banks had been compelled to employ all their money locally, perhaps you would have paid $3,500.

Senator GLASS. I am not talking about it with reference to that proposition. Your contention is that if the banks are loaning their money for speculative purposes in New York they could get it back, whereas they lost it in the land boom?

Mr. SPRAGUE. Yes; and to the greater advantage of the community. I am considering it also on the part of the community.

Senator BROOKHART. Recently in New York I checked 13 big corporations. I will bring the check here for the record. I found that during the last nine months of last year their earnings declined on an average of 11 per cent, but at the same time their stock went up 27 per cent.

Mr. SPRAGUE. I will come to that in a short time, if I may, as one of the hazards of the brokers' loans. All I want to emphasize at this point is that it is not at all certain that you can employ all of the funds of a bank locally; that it may not be to the advantage of the community, and may be unsafe for the bank; and that, upon the whole, the inducement is very strong on the part of the bank to employ all of their funds locally that they consider to be safe.

A great many of our 26,000 banks clearly have employed more funds locally than was in fact safe. They misjudged the situation. Whether there are some bankers who are unduly pessimistic about their own localities, lacking in enterprise, and who fail to put an adequate amount or a reasonable amount into the local situation, is probably true, but I think such cases are exceptional.

Now, there is one other aspect of the local situation. It may be contended that in order to maintain the going rates of interest on loans in a locality, the banks put funds in the New York market which they might have employed at home had they been willing to reduce the rate a bit.

Senator BROOKHART. Do you approve that method of banking?

Mr. SPRAGUE. Let me go on a moment.

Senator BROOKHART. Very well.

The CHAIRMAN. If you would rather proceed with your statement until you have completed it, that will be agreeable.

Mr. SPRAGUE. No; I prefer questions if I may be at liberty to throw out those I will come to later.

The CHAIRMAN. Very well. Proceed.

Mr. SPRAGUE. Suppose the going rate in a locality is 6 per cent on a variety of local loans, mortgages, and other loans, and a bank is meeting all satisfactory applications for loans at that rate. It has surplus funds and shunts them to New York. It is possible that if that bank were prepared to lend at 5½ per cent rather than 6, an additional volume of satisfactory applications for loans might be made to that bank. I think, however, that this additional business would only be developed very gradually.

Senator BROOKHART. They are sending the money from my State now to New York and getting 1¾ per cent on bank balances, but are charging the farmers 7 and 8 per cent.

Mr. SPRAGUE. The banks are perhaps lending to the full extent of all loans that they considered satisfactory at that rate and might get a larger volume of satisfactory loans if the rate were reduced—drop to 6. I think that would be true in the course of time. I am not certain that it would initially, right off the bat, develop any appreciable amount of additional satisfactory business. It would take some time for the policy of getting funds at a lower rate to influence the economic condition of the community. But in the course of time I think it would have an effect. The obstable, in my judgment, however, is the rigid rate of interest which banks pay upon deposits. Throughout the country various rates have become rather firmly fixed as the interest which banks pay upon deposits. At some places it is 4½ per cent, some places 4, and others 3½; but whatever the rate is, it is a fairly rigid rate.

Senator BROOKHART. You spoke about one rate being 4 per cent?

Mr. SPRAGUE. Yes.

Senator BROOKHART. Then they send it down to New York at 1¾ per cent and charge the local people 7 and 8 per cent, more 8 than 7, to make up the loss.

Mr. SPRAGUE. Now, if the interest rates which banks pay were flexible, then the rates which they charge customers might become somewhat more flexible than in fact they are. I think the rates of interest on deposits generally throughout the country are unduly high at the present moment, and I think the rates charged on the best class of local loans are unduly high. A reduction of both would be, upon the whole, of advantage to the community—not immediately of great advantage, but in the course of time I believe it would have a favorable effect upon the industries in different parts of the country. But, taking the situation as it is, with the rigid deposit interest rate, it tends to maintain a fairly rigid rate on customer loans.

Senator GLASS. Is not the call-loan market responsible for the rigid discount rates?

Mr. SPRAGUE. It rather seems to me it is like this: You start with your rigid deposit rate. You are endeavoring all the time to maintain a fair spread between your local loans and your deposit rate. If you could not invest in call loans the general effect, I think, would be upon the bank to take less satisfactory loans at the rate of 7 or 8 per cent, whatever the rate, rather than reduce it in the hope of developing satisfactory loans.

Senator GLASS. Might it not result in a reduction of the rate of interest on deposits?

Mr. SPRAGUE. That is the point.

Senator BROOKHART. These loans in these localities that I referred to, that refuse to pay 7 and 8 per cent, are nearly always the most desirable loans. Those are men who size up the situation, and they will not pay the high rate of interest and they stay out of the banks.

Mr. SPRAGUE. Yes. Well, it is one of the factors leading to the resort to the capital market. If you can borrow in the capital market at 4½ per cent you probably will not bother to secure funds from banks if you have to pay 4 per cent or more. You must be pretty certain you can borrow at banks at a rate rather less than the capital-market rate. Otherwise, you will resort to the capital market, and that is what has taken place.

Senator GLASS. Is not the capital market created by this artificial and unnatural flow of all of the surplus funds from the interior to the points on the capital market?

Mr. SPRAGUE. Not mainly by bank credit. I would say no. The net amount of securities issued and marketed last year was $7,500,000,000, a sum very much larger for that one year than all the bank credit that is now employed in connection with securities on the New York market. If it were simply bank credit that was doing that, and not savings, the investment channel would very soon be clogged and the interest rate would go up. The evidence that it is really savings is shown in part by the decline in the rate of interest, and in part the fair degree of steadiness in prices. We could not have had, in my judgment, a series of years of generally active business, accompanied by a decline in the rate of interest, had it not been that actual savings were taking care of the bulk of the capital requirements of the community.

Now, so far as safety goes, I do not think that any serious objection can be raised against the brokers or dealers' loans. The records in regard to losses of banks, though not perfect, clearly indicate that the losses of banks arising out of this class of loans have been very small. Therefore, I rule out, in discussing the desirability of placing checks upon brokers' loans, both the feature of drawing money which is needed in other parts of the country and the matter of risk. I do not believe that any part of the country is suffering from a dearth of needed bank credit because of brokers' loans, and I do not believe that the interests of depositors are jeopardized in the slightest degree by the granting of that sort of loan.

Senator BROOKHART. If these brokers' loans in the accumulation of this capital for this purpose lowers the interest rate to brokers, which is an outlawed business under the Federal reserve law for rediscount purposes, and at the same time raises the rate of interest to the country at large, it is doing some damage, is it not?

Mr. SPRAGUE. We are not certain whether the rate would be reduced throughout the country. All we can say is that perhaps, if a more flexible system of paying interest on deposits were used, and if bankers were ready to adopt a more flexible rate as regards customer loans, some business in the course of time would develop that is not now being developed. You can attack that problem in your various sections with regard to the interest rates on deposits. It seems to me that it would be putting the cart before the horse to endeavor to contract the volume of brokers' loans, trusting to luck that the funds could be advantageously used in different parts of the country. The evidence would seem to indicate that with our present banking organization, with 26,000 banks conducted by people of all degrees of experience, there is far graver danger of the injection of an excess of credit into different local situations than there is of a dearth of credit.

Senator GLASS. You mean banks conducted by people of all degrees of inexperience, do you not?

Mr. SPRAGUE. Well——

Senator BROOKHART. You think it is perfectly safe, do you, to collect this vast sum of money and turn it over to stock speculators?

Mr. SPRAGUE. I understand that is the outcome of an absence of demand throughout the country, of what the bankers consider a satisfactory demand throughout the country for loans which would absorb the full amount of the funds.

Senator BROOKHART. Does not the fact that this great supply of credit goes into such speculation account for these continuing rising stock prices, while the earnings are declining?

Mr. SPRAGUE. It may.

Senator BROOKHART. And is not that an unsound condition that may bring a crash to the whole country?

Mr. SPRAGUE. No. That is my main point. I want to raise the question, what damage would result by the use of the funds in that way?

Senator GLASS. Before you leave the point of securities and bank failures, I may say for myself that I do not think any loan is ordinarily safer than brokers' loans. I think there are fewer bank failures due to that than anything else. Is it not a fact that the great percentage of bank failures arise from inadequate capitalization, and the overpayment of interest on deposits?

Mr. SPRAGUE. It arises in the main, I should say, from the excessive number of banks in a locality.

Senator GLASS. That is another way of saying inadequacy of capitalization, division of the capital of a specific territory. Here is an example: With nearly 500 banks in the Minneapolis Federal reserve district year before last and last year, were not the greater proportion of them small banks?

Mr. SPRAGUE. They were small banks, doing a purely local business, and in general with deposits under $500,000.

The CHAIRMAN. Most of them have no loans except around home.

Mr. SPRAGUE. Yes.

Senator BROOKHART. Let me call your attention to the fact that in 55 years those small banks had fewer failures than the large banks in Massachusetts.

Mr. SPRAGUE. In the State of Iowa—I think I have the figures here—the number of banks from 1904 to 1920 more than doubled, although the population was stationary. You had a division of the resources of banks, an increase in the number of banks, with aggregate resources of from $150,000 to $400,000 or $500,000.

Senator BROOKHART. But we far more than doubled in value.

Mr. SPRAGUE. Ah, but your values were inflated, and there is the trouble.

Senator BROOKHART. But before the inflation the regular growth of values was far more than double.

Mr. SPRAGUE. Yes; and in that period you had a rising demand for agricultural products which supported the increase in the value of land.

Senator BROOKHART. In proportion to the agricultural products, there was a rising demand.

Mr. SPRAGUE. But you did not have the basis for twice the number of banks in 1920 that you had in 1904, and it is impossible to have generally strong and well managed banks when there is one bank for every 1,200 people. That was the situation in Iowa.

I would like to submit for the record, if you care for it, a report which I prepared for the American Bankers' Association on the causes of and remedy for bank failures.

The CHAIRMAN. Without objection, it will be inserted in the record.

(The document referred to is as follows:)

THE CAUSES OF BANK FAILURES AND SOME SUGGESTED REMEDIES

Beginning in May, 1927, the economic policy commission made a careful investigation of the causes of the large number of bank failures in the United States during the past few years. The report which is presented to the Houston convention of the American Bankers' Association, October 24–27, 1927, is here reprinted in full from the American Bankers' Association Journal for November, 1927. Dr. O. M. W. Sprague, professor of banking at Harvard University, assisted the commission in its inquiry. The report was one of the features of the convention.

The Economic Policy Commission, after investigating the problem presented by numerous bank failures, reports that more good can be done by correcting defects in banking structure than through further restrictions on loans and investments.

In the limited time at its disposal, the commission has not been able to make a comprehensive investigation of the particular banking transactions that have involved serious losses and numerous failures. A preliminary examination of this aspect of the matter, however, disclosed great diversity among these unfortunate operations—a diversity so wide that it has forced upon the commission the conviction that it is hopeless to seek for a solution of the bank failure problem in main reliance upon the imposition of further restrictions on bank loans and investments.

Far more promising results may surely be anticipated from efforts directed toward the correction of defects in banking structure and management, of which unsound banking practices are but merely symptoms. The recommendations of the commission are, therefore, designed to bring about the establishment of conditions which will be more favorable than in the past to the conduct of banking along safe lines.

TOO MANY BANK FAILURES

In the supremely important matter of safety the recent record of the American system of independent unit banking has been conspicuously unsatisfactory. During the last six years more than 3,800 banks, somewhat more than one-eighth of the total number of banks in the country, have been obliged to suspend operations, and although a considerable number, after a variety of adjustments and sacrifices, have been reopened, the aggregate of definite failures has been in excess of 3,000.

Many additional banks also have escaped failure only through the absorption of losses on doubtful and worthless assets by directors, assessments on shareholders to restore impaired capital, or by subscriptions to additional capital from wider circles influenced by the desire to avert the damaging consequences of a general loss of confidence in local banking institutions. Still other tottering banks have been taken over by stronger neighbors, in some instances with disastrous effect upon the solvency of the absorbing institution.

These failures and near failures do not imply a weak condition and poor management in the case of the majority of banks throughout the country, but they do indicate, as does experience in earlier periods, that large numbers of banks, which seem to be in a flourishing condition during years of business activity, are unable to withstand the stress and strain incident to depression and a downward adjustment of values in the communities in which they are established.

Aside from scattered failures, due to dishonesty or gross mismanagement, the banking troubles of the last six years have been concentrated in localities which have experienced a prolonged period of adverse conditions or the sudden collapse of a highly speculative local situation. In the Northeastern States, in the territory served by the Federal Reserve Banks of Boston, New York, and Philadelphia, a section which speedily recovered from the industrial reverse of 1920, bank failures were relatively few, only 40 during the six years

1921–1926. The Cleveland district with 36 failures and San Francisco with 158 also show at least a comparatively low casualty rate. In the four Southern districts of Richmond, Atlanta, St. Louis, and Dallas, on the other hand, there 1,117 failures during this six-year period, while the three remaining districts present a still more unfavorable record, the Chicago district with 437 failures, Kansas City with 590, and finally the astounding number of 999 failures in the Minneapolis district.

A variety of adverse local influences, among which may be mentioned a succession of crop failures and the collapse of urban real estate booms, precipitated numbers of these failures, but the great majority suspended because they were unable to meet the stress exerted by the persistence of unprofitable prices for the products of agriculture and animal husbandry—stress which was particularly severe because it was experienced after years of abounding prosperity, and extreme appreciation in the value of farm property, and a large increase in the number of farms mortgaged and amount of mortgage indebtedness.

THE INFLUENCE OF ADVERSE ECONOMIC CONDITIONS

These adverse conditions, it can hardly be too strongly emphasized, do not furnish an adequate explanation of the numerous bank failures of the last six years. By no means all, or even a majority, of the banks in the localities most seriously affected have been obliged to suspend operations. Unfavorable economic conditions are an acid test of the policies which banks have followed during preceding years of business prosperity. Financially weak and unskillfully managed banks are weeded out; strong and well-managed banks experience losses but they survive. Great significance in this connection attaches to the findings of a special committee on the banking situation of the 1927 Legislature of Minnesota, a State in which adverse conditions have been particularly severe and the number of bank failures numerous. Analyzing the causes of bank failures the committee says:

"A survey of the closed-bank situation in Minnesota presents an interesting picture. Certain communities of the State seem to have escaped entirely, or almost entirely, this epidemic of closed banks, while in other parts of the State the proportion of closed banks to the number of banks chartered in the community is very great; nor is this unequal distribution of closed banks due in large measure to different conditions of soil or conditions of the farmers, for in parts of the State where the farming conditions are almost identical one part shows a large percentage of failed banks and another part shows almost none. The cause lies deeper than that."

Unqualified agreement with the view of the matter of this Minnesota committee is not inconsistent with definite recognition that external conditions in many parts of the country during the last 10 years have been abnormally unfavorable to the conduct of banking along safe lines. In the agricultural development of the country, however, the stage is apparently more generally being reached in which farm values will be more closely related to current income, and it is not probable that commodity prices will again exhibit the extreme fluctuations of the last decade. It is therefore reasonable to presume that no future period of similar duration will witness the number of bank failures that have marked the last six years. If these anticipations are realized, the bank-failure problem assumes less unmanageable prpoportions; but in the absence of improvements in organization and practice, it is not to be doubted that a discreditable number of failures will continue to occur, mainly concentrated in periods of trade reaction.

It is also important to note that the inability of many banks to withstand adverse conditions is not a problem that concerns exclusively those areas in which bank failures have been numerous in recent years. Present immunity furnishes no certain assurance that all banks in a locality are and will remain in competent hands. The possibility, if not the probability, must be recognized that adjustments even distantly approaching in difficulty those experienced in agriculture might be accompanied by numbers of banking casualties in communities in which manufacturing is the major occupation.

URGENT NEED FOR GREATER SAFETY IN BANKING

As in earlier periods marked by numerous bank failures, an insistent demand for greater safety in banking is to be anticipated, and this demand is not rendered less reasonable by the presence of strong and well-managed banks in every part of the country. The public must make use of banks, but few are in position to distinguish between the strong and the weak. Bank statements and other external information relating to banks do not furnish an adequate basis for intelligent discrimination. Unless failures become exceptional, it may be expected that all banks will be subjected to an increasing range of restrictions, restrictions that may be quite superfluous for well-managed banks, but which are adopted to curb the weak and incompetent minority.

Numerous failures should be a matter of grave concern to well-managed banks for still other reasons. To those bankers who are strongly opposed to branch banking it should be evident that the recurrence of numerous failures threatens to undermine the system of unit banking. Recognition should also be given to the damaging effect upon the earnings of the better banks during the more or less prolonged period of operation of weak banks before the failure stage is reached. And finally, attention may be called to the unfavorable influence on earnings in consequence of the damage to a community which is entailed by the unsound conditions and unsuccessful undertakings that are fostered by banks under incompetent management.

While the experience of the last six years furnishes ample evidence of serious defects in our present system of unit banking as it is now organized and operated, and compels recognition of the urgent need for its modification and improvement, the Economic Policy Commission is hopeful that no revolutionary change, such for example as the general diffusion of branch banking, will be required to provide adequate protection for the depositor and is also hopeful that this result can be attained with no sacrifice but rather with a positive enhancement of the characteristic advantages of unit banking. The causes of numerous failures are not obscure and difficult to discover, and the commission believes that the number of failures in future can be substantially reduced through the adoption of arrangements definitely designed to meet obvious defects that experience has disclosed in our system of independent local unit banks.

In the judgment of the commission, however, this objective can not possibly be reached through the imposition of further legislative restrictions covering the details of banking operations. Safety in banking will never be secured if reliance continues to be placed primarily and almost exclusively upon restrictions, which even when carried to an extreme point can do no more than somewhat narrow the field within which an incompetent management will manifest its incompetence. A more immediate enforcement of existing legislation would do much, but remedies for bank failures to be adequately effective must be designed to reduce the number of financially weak banks, secure more competent officers supported by responsible and active directors, and above all insure that unsound policies shall be checked long before solvency is endangered.

EXCESSIVE NUMBERS OF BANKS

A system of unit banks is peculiarly subject to the grave danger that a much larger number of banks will be established than is compatible with the requirements essential for safety of financial strength and good management. Under a highly developed branch banking system the large capital and, even more important, the extensive organization needed from the outset, effectively restrict the formation of new banks. Branches may indeed be overdeveloped, but experience indicates that the consequent inroad on earnings is not serious enough to impair capital, much less jeopardize the position of depositors.

Strikingly different is the situation under a system of unit banking. In order that all communities may enjoy the benefits of banking facilities under competitive conditions, the minimum capital required for the establishment of a bank is necessarily set at a low figure, and operations can be handled by a simple organization that can be readily improvised. Profits during years of business prosperity are reasonably satisfactory, and the temptation to enter the banking business is made more alluring by the exaggeration of these profits under the faulty accounting practice that is followed by most banks. Reserves are not created to take care of future losses, but all undistributed earnings are allocated to surplus and undivided profits, from which deductions are subsequently made, often most unwillingly, when losses have been unquestionably realized. In addition to anticipations of profits, a certain measure of power and dignity, especially outside the large cities, that seems to attach to the management of banks, does much to enlist an active interest in proposals for additions to their number, and the possibility of securing liberal accommodation through relationship with a bank, as officer, director, or shareholder, is a consideration that is by no means uncommon.

Public opinion also has in general looked with positive favor upon an unlimited increase in the number of banks. That men of good character and average business experience should be as free to engage in banking as in other occupations seems to have been taken for granted. Insufficient account is taken of the special characteristic of banking that it exposes to risk of loss not only shareholders and business creditors but also the wide circle of depositors who are not in position to protect themselves by the exercise of reasonable care and foresight. Moreover, the misconception is widespread that additional banks in a community will increase the available supply of credit, a motive particularly strong in communities where the local supply of credit regularly falls short of the local demand for accommodation.

It is not clearly perceived that the volume of credit in any community is determined by the wealth and banking habits of its people, and that an increase in the number of banks subdivides but does not appreciably augment the aggregate amount of banking resources. A community with aggregate banking resources of, say, $4,000,000 will be better served in every way, including safety, by two or three banks rather than by six or more. An excessive number of banks induces cutthroat competition and tends to undermine conservative standards in the granting of credit, which in turn subjects the better borrowers to the necessity of paying higher rates for loans since they are obliged to compete with a demand for credit that properly should not receive favorable consideration.

COUNTRY IS OVERBANKED

During the decade and a half preceding the trade reaction of 1920, these various influences brought about the organization of a large number of new banks in most parts of the country, and, in the judgment of your commission, the resulting overdevelopment of banking is more responsible than any other factor for the banking disasters of the subsequent years. Between 1904 and 1920 the number of State banks and trust companies increased from 7,508 to 22,054 and the number of national banks from 5,331 to 8,123. Aggregate resources had, indeed, increased enormously, so that average resources at the close of the period were greater than at its beginning. But an average of resources is most misleading, since the gain in resources was by no means evenly distributed among the banks. Many banks had become larger and stronger, and the thousands of newly chartered banks served mainly to provide the country with an unprecedented number of small banks employing resources of from $100,000 or even less to $500,000.

The strength of any particular bank can not, of course, be determined by its size. There are hundreds of small banks throughout the country that are ably managed and abundantly strong. These banks are commonly subject to the handicap of an absence of industrial diversity in the communities which they serve—a handicap which they can only overcome by the exercise of exceptional caution and judgment. On the other hand, while there is no exact relationship between the number and size of the entire group of banks in a locality and the strength of its banking position, it is certain that no community can hope to enjoy the benefits of safety in banking if the business is organized in units so numerous as to exceed the available supply of competent officers and responsible directors, and with insufficient earning power to be able to absorb inevitable losses. Ample evidence of the unhappy consequences of excessive numbers and inadequate size in banking is clearly to be found in the geographical distribution of the failures of the last six years.

In the three Federal reserve districts of Boston, New York, and Philadelphia there were but 40 failures during these years. It is an area of 150,000 square miles, with a population of 33,000,000, and was served at the close of 1926 by less than 3,300 banks (3,265). The Chicago district, with a slightly larger area of 190,000 square miles but with a population of only 17,000,000 is provided with 2,000 more banks (5,268), and had a record of 437 failures between 1921 and 1926. Again, the Minneapolis district, it is true with a much greater area, 414,010 square miles, but with a population of only 5,500,000 still had 2,780 banks in operation after 999 failures.

Comparison by States tells the same story, only the more forcibly. The 11,000,000 people of the State of New York, with an area of 47,000 square miles, managed very comfortably with 1,056 banks in 1920, and there were 8 failures in the 6 subsequent years, while the slightly less than 2,500,000 occupying an area of 55,000 square miles in Iowa, was served by 1,763 banks, of which 263 failed. North Dakota supplies an even more extreme example of the over-development of banks and its inevitable sequel; 317 failures among 898 banks having been established to meet the needs of a population of about 650,000 on an area of 70,000 square miles.

No community can possibly provide adequate resources, competent officers, and experienced directors for one bank to every 750 of its inhabitants as in North Dakota, or to 1,400 as in Iowa. Banking troubles were inevitable with the advent of adverse conditions, and for the severity of these conditions the unwise use of credit administered by an inordinate multiplicity of banks is in no small degree responsible. And, as may be seen from the table below, the situation in these States was not exceptional.

State and National bank failures, 1921–1926

	State banks failed	National banks failed	Total	Banks in operation, 1920		
				State	National	Total
Alabama	14	3	17	251	101	352
Arizona	27	3	30	67	20	87
Arkansas	42	3	45	404	83	487
California	9	9	18	420	303	723
Colorado	51	15	66	262	141	403
Connecticut	2	1	3	154	66	220
Delaware				28	19	47
District of Columbia				30	15	45
Florida	28	1	29	212	53	265
Georgia	155	9	164	645	93	738
Idaho	41	19	60	141	81	222
Illinois	45	3	48	1,130	480	1,610
Indiana	31	3	34	803	254	1,057
Iowa	236	27	263	1,405	358	1,763
Kansas	104	8	112	1,100	249	1,349
Kentucky	26		26	450	134	584
Louisiana	25	1	26	229	38	267
Maine	2		2	98	63	161
Maryland	4	1	5	190	92	282
Massachusetts	16	1	17	306	159	465
Michigan	31		31	588	112	700
Minnesota	186	29	215	1,184	331	1,515
Mississippi	22	1	23	324	30	354
Missouri	145	2	147	1,532	136	1,668
Montana	130	59	189	286	145	431
Nebraska	112	17	129	1,008	188	1,196
Nevada	1		1	23	10	33
New Hampshire	1		1	70	55	125
New Jersey				176	212	388
New Mexico	39	21	60	76	47	123
New York	7	1	8	565	491	1,056
North Carolina	68	9	77	536	87	623
North Dakota	279	38	317	717	181	898
Ohio	8	3	11	775	370	1,145
Oklahoma	140	42	182	611	356	967
Oregon	18	5	23	187	90	277
Pennsylvania	21	5	26	695	851	1,546
Rhode Island	1		1	31	17	48
South Carolina	97	8	105	379	82	461
South Dakota	212	38	250	558	136	694
Tennessee	23	2	25	448	98	546
Texas	137	23	160	1,026	556	1,582
Utah	10	3	13	105	28	133
Vermont	1		1	59	49	108
Virginia	19	1	20	323	165	488
Washington	32	6	38	307	87	394
West Virginia	10	1	11	218	122	340
Wisconsin	30	5	35	809	151	960
Wyoming	49	11	60	113	47	160
Totals	2,687	437	3,124	22,054	8,032	30,086

LIMITATION OF BANK CHARTERS TO COMMUNITY NEEDS

A long and essential first step toward the attainment of safety in banking will have been taken when the number of banks charactered is limited to the needs of the community, based upon clear recognition that development of every community is best served by strong banks that employ conservative standards in the extension of credit.

An increase in minimum capital requirements would do much to hold the number of banks within safe limits. When account is taken of improved means of transportation and the general advance in prices of the last decade, a minimum capital of $25,000 surely, and presumably of $50,000, would not deprive any community of adequate banking facilities. But capital requirements alone are too mechanical and rigid to be made the sole factor in the determination of the desirable number of banking institutions in a locality. Needed elasticity in the granting of charters requires that approval shall be made contingent upon evidence of a community need for additional banking facilities.

A provision of this character has already been adopted by a number of States, and the most comprehensive of these requirements, that of Wisconsin enacted in 1923, is here presented, preceded for the purposes of comparison by the conspicuously inadequate provisions of the Iowa law.

Iowa: "Incorporation—articles—contents.—State banks may be hereafter organized by not less than five persons of lawful age, who shall, prior to the commencement of business, sign and acknowledge articles of incorporation before some officer authorized to take acknowledgment of deeds. * * *

"Commencement of business—certificate of authority. No such association shall have the right to commence business until its officers or its stockholders shall have furnished to the superintendent of banking a sworn statement of the paid-up capital, and when the said superintendent is satisfied as to that fact he shall issue to such association a certificate authorizing it to commence business."

Wisconsin: "Any number of adult persons, citizens of Wisconsin, not less than 7 nor more than 20, desiring to associate for the purpose of organizing a banking corporation under this chapter, shall make application to the commissioner of banking in such manner as may be prescribed on a form furnished by him. * * *

"Upon receipt of proof of publication, the commissioner of banking, shall thereupon ascertain from the best sources of information at his command, and by such investigation as he may deem necessary, whether the character, responsibility, and general fitness of the persons named in such application are such as to command confidence and to warrant the belief that the business of the proposed corporation will be honestly and efficiently conducted in accordance with the intent and purpose of this chapter; and whether public convenience and advantage will be promoted by allowing such bank to organize; and he also shall investigate the character and experience of the proposed officers, the adequacy of existing banking facilities, and the need of further banking capital; the outlook for the growth and development of the city, town, or village in which such bank is to be located, and the surrounding territory from which patronage would be drawn; the methods and banking practices of the existing bank or banks; the interest rate which they charge to borrowers; the character of the service which they render the community, and the prospects for the success of the proposed bank if efficiently managed. Such investigation shall be completed within 90 days from the filing in the office of the commissioner of banking of proof of publication and the making of the deposit herein required, but in the event a majority of the applicants and the commissioner of banking mutually agree to it, the time may be extended an additional period of 60 days."

This Wisconsin statute serves to indicate the variety of considerations that may properly be given weight in the determination of community advantage from the establishment of additional banks. Precise tests are lacking. Judgment must be exercised, and it is, therefore, to be presumed that little will be accomplished through legislation of this character unless those entrusted with its execution are supported by a public opinion that clearly and permanently recognizes the damaging consequences of an excessive number of banks.

The problem is further complicated by the presence of two charter-granting authorities, the National and the State, which may be played off one against the other in doubtful cases by eager bank organizers. Both Federal and State officials charged with the administration of the banking laws not unnaturally become imbued with the desire that the system of banks under their jurisdiction shall exhibit both absolute and relative growth. Many banks have unquestionably been chartered in the belief that a refusal would be followed by a more favorable response in the other quarter. It is clearly most advisable that in this matter National and State authorities should work in a spirit of close and friendly cooperation, neither, except in the most unusual instances, granting a charter that has been refused by the other authority.

RESPONSIBILITIES OF BANK DIRECTORS

The organization of unnecessary banks would be a far less easy matter and the management of banks would be subjected to more steady and effective supervision, if the responsibilities involved in the acceptance of the position of director were more generally realized. The risks that are incurred are clearly set forth in the following statement which has been prepared for the commission by an experienced bank officer of legal antecedents:

"A director of either a National or a State bank, by accepting election as such, assumes definite legal liabilities and what is often more important, moral obligations, which he can not evade if he is to maintain his self-respect and position in the community in which the bank is located.

"The legal liabilities assumed by a bank director by his act of accepting election as such, are of two kinds: Express statutory liabilities imposed by the national bank act or by the laws of the State under which the bank is chartered; and the general legal liability imposed by the common law upon every director in any corporation for losses to the stockholders or the creditors of the corporation, caused by his misconduct or negligence.

"The first class of legal liabilities generally relate to excessive loans, wrongful certification of checks, investments of a kind forbidden by law, guarantees by the bank of the credit of some third person. Their exact nature depends upon the terms of the law under which the bank is organized.

"The second sort of legal liability which no bank director can escape is the general liability assumed by every director and every officer of all corporations to use ordinary care and diligence in following the affairs of the corporation and seeing that improper conditions are corrected. It is more difficult to pin negligence of this sort on a bank director in such a way as to make him responsible financially to the depositors than it is to convict him of approving a loan or an investment which the bank is specifically forbidden to make. But there are cases in which directors have been held accountable for negligence in following the affairs of their bank and many cases in which they have been held responsible financially for their assent to direct violations of the act under which the bank is organized. And for every case that reaches the courts, there are a dozen in which settlements involving the payment of money by directors have been made out of court, to avoid suit.

"Directors of banks are frequently, perhaps generally, asked from time to time to give guaranties or bonds in connection with the bank's business. There is no legal obligation, of course, for a director to give such guaranties or bonds. Such guaranties by directors are generally given to secure the deposit of public moneys in the bank. They are frequently given on the borrowings of the bank from its city correspondent. The directors may be asked to go on the official bond of a public official, who in return, promises to keep public money in the bank. In any of such events a failure of the bank is practically certain to convert the guaranty or bond into a real liability. And the existence of such contingent liabilities on the part of directors, which become very real and direct liabilities in the event of failure, is perhaps the main reason why in case after case directors have paid or underwritten voluntary assessments and contributions far in excess of any double liability on their stock to keep banks open.

"The moral obligation assumed by a director of a bank differs, of course, from community to community, and with the moral standards of the director himself. A bank directorship in most communities is regarded as an honor. If the bank fails, that honor is generally converted into a disgrace. The community expects a bank director, even at personal financial sacrifice, to keep his bank from failing. This is quite apart from any legal liability of the director. And in the case of thousands of small banks that have suffered severe losses the directors have, at great personal sacrifice, put in new money in an effort to protect depositors and without any hope of recovery. The average farmer or small-town director of country banks is entitled to a degree of credit for meeting the moral obligaitons of his position, that the general public does not give him, particularly if his sacrifices and those of his fellow directors do not eventually save the bank from failure."

In banking, as in other branches of business, the character and policies of the organization will commonly be largely determined by some one individual, but in banking and especially in the case of the smaller banks, the supervision of an active board of directors is peculiarly necessary. In many instances the bank is by no means the most important business interest of its chief officers. There is consequent danger that an undue proportion of the funds of the bank may be employed in undertakings in which officers and perhaps some of the directors are deeply engaged. As an effective means of enabling all directors to become more fully conversant with the condition of their respective banks, this commission strongly recommends that the American Bankers Association undertake to work out model forms for the presentation of business at meetings of the boards of directors of the banks.

GOVERNMENT SUPERVISION

Restraint in granting charters together with somewhat higher minimum capital requirements, and more regular and careful supervision by directors will do much to strengthen our unit banking system, but by no means all that is needed to afford adequate protection for the depositor. Among the thousands of banks, large and small, throughout the country, wide differences in the skill and competence of management are inevitable. Dishonesty and the employment of an unduly large proportion of the funds of banks in the other undertakings of officers and directors subject the solvency of banks of small or of modest size to risks from which large banks are practically immune. And it is also, perhaps, pertinent to observe that the qualities required to handle successfully a small bank, where there is little local diversity in loans and an intense demand for credit, are not more common than the qualities that are needed in the management of much larger city institutions.

To meet these managerial elements of weakness in a system of unit banking, reliance hitherto, outside a few cities, has been placed almost exclusively upon legislation covering the details of banking operations and upon Government supervision through periodic examinations. It will not be questioned that both legislation and supervision have been necessary and serviceable. It is evident, however, that they have fallen far short of the accomplishment of their primary purpose—the prevention of numerous bank failures. While this commission is convinced that something more than Government action is needed, and that little or no advantage can be anticipated from additional restrictive legislation, it is at the same time confident that unsound tendencies in many banks would be checked under improved methods of supervision and a somewhat more immediate enforcement of those provisions of existing statutes which deal with operations that undermine the solvency of the banks.

In reaching its conclusion that additional legislation at the present time is inadvisable, at least in the case of the national law and of those of most of the States, the commission has been influenced by three considerations. It has noted that when allowance is made for differences in location and size, the number of national banks that have failed, banks subject to the most restrictive of our banking laws, has been relatively not appreciably less than the numer of defunct State institutions. Again, a widening of the range of restrictions will ordinarily increase the numer of instances in which determination of a failure to comply with the law involves the exercise of judgment. Numerous situations of this nature breed dissatisfaction with the statute and work against the effective enforcement of the law by administrative authorities.

WHAT CAN NOT BE DONE BY LEGISLATION

And, finally, it should be evident that in any event legislation can never include within its scope all of the operations that may prove disastrous to a bank. It can only deal with large classes of loans that are usually undesirable. It can not take account of difference in time or place, or go very far in prescribing well-balanced proportion between various classes of loans and investments. Loans that may be unwise at one time may be entirely satisfactory at another, or for one bank and not for another. Much must be left to the discretion of management, and the unwise use of this discretion can not be adequately checked by Government supervision which is mainly concerned with the enforcement of statutory requirements. In many jurisdictions, moreover, the salaries of examiners as well as those of bank commissioners have been far too meager to secure and retain men with proper qualifications for the responsible and difficult work of bank supervision. The better men speedily find more remunerative employment elsewhere.

CLEARING HOUSE EXAMINATIONS

Recognizing the limitations of Government examinations and supervision, the banks of 33 cities, already organized in clearing houses, have set up their own system of examination. and in general with highly satisfactory results. This experience serves to indicate the large possibilities of improvement in banking practice that can be brought about through associated action on the part of the banks themselves. For such associated action, however, it is not necessary to adopt exactly similar arrangements everywhere. The one essential is definite recognition by bankers that active participation in banking supervision is necessary in order to furnish adequate protection to depositors.

In the larger cities, where the clearing house is an indispensable adjunct of banking, a more complete system of examination and supervision can be established than is perhaps feasible elsewhere. Through the clearing house arrangements favored by a majority of the members can be adopted. In the case of country banks, the initial difficulty is encountered that an organization for the specific purpose of supervision must be created, and the burden of additional expense presents an evident further difficulty. It is also important to note that the clearing-house system of supervision does not include within its scope all of the banks of the cities in which it has been established. Some bansk are unwilling to submit themselves to examination on account of the burden of expense or for other reasons. In reserve-bank cities little or no pressure can be exerted to secure the adherence of these banks since clearing facilities are unfortunately available through the reserve banks. The admission of others is withheld on account of their unsatisfactory condition.

POWERS UNDER CLEARING HOUSE EXAMINATION PLAN

The clearing house examination system is not only initially selective: it also includes the power of expulsion from the group of criticisms of the examiner are persistently unheeded. By the assumption of these powers of selection and exclusion, the banks accepting the arrangement practically place themselves in the position of guarantors against loss to the depositors in any bank that is a member of the group. If insolvency is allowed to involve loss to depositors, public confidence in the system is weakened, and its permanence is seriously threatened.

With all its unquestioned merits, then, the clearing-house system of examination has limitations which must always interfere with its adoption by all of the banks of the country. There are cities in which it might now be established with every promise of decided advantage to the community, and the system may well be considered a goal ultimately to be reached everywhere. The adoption of the system in any locality would, however, be most inexpedient at a time when there were a considerable number of banks in a weak condition, since exclusion of these banks might precipitate failures while their inclusion would endanger the successful working of the plant itself.

REGIONAL ORGANIZATIONS

In view of these obstacles to the general adoption of an additional system of examination of the clearing-house pattern, this commission has examined alternative suggestions and finds large promise in a less ambitious plan, which would subject the banks to no appreciable expense, is flexible, and involves no implication of a guaranty against loss to depositors. The basic feature of this proposal is the organization of all banks, both State and National, in regional groups of from 50 to 100 banks for the purpose of improving and making more effective use of the present system of State and National examinations. While there are doubtless large possibilities of improvement in these examinations, we believe that, aside from a few instances of exceptionally skillful dishonesty, and the special situation presented by chains of banks, successive examinations preceding failure have regularly disclosed an increasingly unsatisfactory condition. More immediate and effective use of the information secured through examinations is certainly not less important than improvements in the examinations themselves.

To improve and make more effective use of the examinations, it is essential that examiners should be assigned for a period of at least two to three years to the banks of a definite area by the banking departments of the States, and that reports of examinations should be considered with the directors of the banks before they are forwarded to the office of the bank commissioner. These are two essential features of the clearing-house examination system, and to them much of its benefit may properly be attributed. A permanent examiner of the State banks, working with the cooperation of the national examiners, with intimate knowledge of local conditions and personalities, would be in position to exert a potent influence, corrective of unsound banking policies.

Under this territorial organization of government examinations much might be accomplished even without a corresponding regional organization of the banks. But the benefit is small in comparison with that which may be anticipated if the examiner is supported by the banks organized for this definite purpose. The moral support thus afforded would be a factor of large significance, and perhaps initially to attempt more would be inadvisable. The commission believes, however, again following clearing-house experience, that a carefully chosen committee of the regional organization should be authorized to receive representations from the examiner regarding unsatisfactory conditions in a bank that have not been corrected at his suggestion by its officers and directors.

It is important to note the proposed organization would not assume the responsibility of excluding or of expelling any bank from the association. The exercise of such power implies some measure of responsibility for the solvency of the banks, a responsibility which can not be too explicitly disavowed. The public should understand that the organization includes all banks, the weak as well as the strong, and that its sole purpose is to bring about a gradual but permanent improvement in banking standards, and by this means reduce the hazards to which the depositor is now exposed.

The difficulties that may be anticipated in securing general assent among the bankers of a locality to enter a regional organization are by no means inconsiderable, and the commission is therefore gratified to be able to report that in one instance these difficulties have already been surmounted. During the last few months the banks of eastern Nebraska have worked out the details and completed the organization of the Fremont District Credit Clearing House Association, and it is significant to note that, with a single exception, all of the 70 State banks of the area have become members, membership of national banks being temporarily deferred. An examiner has been assigned to the territory, who, with the hearty approval of the State bank commissioner, is to cooperate with the association to reduce losses and in general to improve banking standards and practice. The operation of this pioneer organization will be watched with keen interest, since it may well prove to be the beginning of an improvement of vast consequence in the conduct of banking throughout the country.

SUMMARY OF CONCLUSIONS

The conclusions of the commission may be summarized as follows:

1. A few banks fail on account of dishonesty or gross mismanagement.
2. Adverse conditions precipitate numerous failures of banks that are financially weak and unskillfully managed.
3. An excessive number of banks is the most potent single cause of numerous failures. This situation can be corrected in part by increased capital requirements, and more completely by the limitation of new charters to the needs of the community for additional banks.
4. In view of the heavy responsibilities, both legal and moral, of bank directors, closer supervision by them is desirable in their own interest, and would serve to correct much that leads to insolvency. It is recommended that the association prepare standard forms for the analysis of the condition of banks and for the presentation of business to be brought to the attention of bank directors.
5. While additional restrictive legislation covering loans and investments is not favored, the more immediate enforcement of existing statute is approved.
6. The clearing-house examination system has been in general highly advantageous, and its further growth is to be anticipated.
7. As a plan, more feasible for immediate and general adoption, the organization of local regional associations of banks for the purpose of supporting and securing the more effective use of the existing system of government examinations is strongly recommended.

Senator GLASS. The principal cause is the excessive number of banks and small capitalization of those banks?

Mr. SPRAGUE. Yes.

Now, I turn to the consequence of the use of funds in brokers' loans and on the assumption that the amount is excessive. I suppose we shall all agree that a considerable volume of bank credit is properly employed, first, in financing the marketing of new issues of securities, and, in the second place, in making a market for outstanding issues. Now, a market for outstanding issues is impossible in the absence of a certain amount of speculation.

Senator BROOKHART. I can not understand that proposition. We have outlawed speculative loans entirely in the Federal reserve law for rediscount purposes.

Mr. SPRAGUE. For those purposes.

Senator BROOKHART. And it seems to me that if they should be outlawed for rediscount purposes they ought to be outlawed for original loans from the banks.

Mr. SPRAGUE. From that point of view we have outlawed mortgage loans of all kinds in the Federal reserve system.

Senator BROOKHART. We did not outlaw mortgage loans. They were not suitable to the business, because they were not flexible enough; but the reason for outlawing speculative loans was because that was an illegitimate business. There was no other reason.

Senator GLASS. We did not outlaw mortgage loans in the Federal reserve act. They permitted a certain percentage of mortgage loans for a period of five years.

Mr. SPRAGUE. As an investment by national banks, but not for rediscount at the reserve banks. The reasons, I should say, for not including collateral loans in the Federal reserve act are these: That under our rigid reserve system, before the Federal reserve act was established, call loans were pretty much the only resource that banks had for adjusting their reserve position. We had placed a premium upon that particular class of loans in this country under our legislation of previous years. Commercial loans took a back seat, if you please, as an indirect consequence of our rigid reserve system. It seemed desirable to emphasize the importance of commercial loans. It was also desirable to make certain that a kind of rediscountable materials should be available all over the country, and in the ordinary course of business of any bank that it will have loans commercial in character.

In the third place, there was the possibility of a greater expansion of brokers' loans than of any other kind of loans. On the other hand, the Federal reserve act showed a decided misapprehension about the nature of credits. It presupposed that a demand based upon a commercial loan, a rising demand, is a satisfactory demand. Now, commercial loans may be most unsatisfactory from every point of view. They become unsatisfactory when speculation is widespread in inventories throughout the country. If, for example, wool advanced from 60 cents to $1.20 a pound, it would require in handling a larger volume of commercial loans, and yet that may be an inflated price. It may be highly undesirable that the banks should lend as freely on wool at $1.20 as at 60 cents, and these commercial loans under such circumstances may become frozen and it may lead to the failure of a large number of concerns. There is no single class of loans which can be defined in such a way that in all situations it would be entirely safe.

Senator GLASS. But that does not mean that we embodied in the Federal reserve act any misconception of the value of commercial loans. We regarded commercial loans as the normal activity of business transactions.

Mr. SPRAGUE. But it was held that they were always liquid.

Senator GLASS. A sound commercial loan, even at a limit of 90 days as prescribed by the Federal reserve act, is liquid.

Mr. SPRAGUE. It may be liquid, but it may involve and frequently does a renewal.

Senator GLASS. A speculative loan is not always liquid.

Mr. SPRAGUE. I quite agree. All classes of loans may be susceptible of deterioration through a wild speculative situation.

Senator GLASS. Does not industry and commerce constitute the legitimate and normal business of the country?

Mr. SPRAGUE. Quite true.

Senator GLASS. Then, how do you arrive at the conclusion that we embodied in the Federal reserve act a misconception of the value of commercial loans?

Mr. SPRAGUE. I think there was a misconception, so far as it was assumed that the demand for rediscounts, because it was based upon commercial loans, would necessarily be a safe loan.

Senator GLASS. The conception was that it was primarily, if not the only, legitimate loan that ought to be made.

Mr. SPRAGUE. It is a legitimate loan.

Senator GLASS. We did not propose to recognize any form of stock gambling.

Mr. SPRAGUE. No.

Senator GLASS. We proposed to recognize the ordinary and indispensable industrial and commercial conditions.

Mr. SPRAGUE. My study of the legislation led me to the view that it was rather anticipated that, if borrowing at the Federal reserve banks were limited by the commercial loan requirements, in some way or other the volume of reserve bank credit would be kept within desirable limits, and that does not seem to me to be the case. The volume of eligible paper, define it as you will, is very large, and if discounts were granted to its full amount it would bring into use an enormous volume of reserve bank credit which would presumably lead to a dangerous amount of inflation.

Senator GLASS. That is a criticism, as I take it, not of the statute or of the system but of the administration of the system.

Mr. SPRAGUE. I think that we might not disagree on that.

Senator GLASS. Of course, if the Federal reserve bank is going to indiscriminately rediscount commercial paper, whether it is sound or unsound, that is a perversion of the system rather than an adherence to it.

Mr. SPRAGUE. I will finally say that I do not believe that the exclusion of any particular class of business from eligibility in reserve banks means that kind of business is outlawed. It simply means that from the point of view of a sound banking policy it may be undesirable to admit that particular kind of business as a basis for accommodation at the Federal reserve bank.

Senator BROOKHART. You say there were few losses from these speculative loans? As a matter of safety they may be just as desirable in the rediscount field as in the original field, if there is no reason for excluding them, because they would not be safe. The only reason is becauses they are an illegitimate business.

Mr. SPRAGUE. No. The reason is that it may lessen somewhat the danger of an excessive use of reserve bank credit.

Senator GLASS. As I recall the situation, the thought which the proponents of the Federal reserve system had was that we should have a system that would meet the requirements of legitimate industry and commerce, and not a system that would lend itself to what many of us regard as an unproductive operation of stock and commodity gambling.

Mr. SPRAGUE. Let me try to show you how it seems to me to work in that connection. First, I want to conclude what I have to say about the effect of the use of a hypothetical excessive amount of credit in connection with brokers' loans. I assume that you will all agree, as I said before, that the marketing of securities involves, and properly so, the use of some amount of bank credit. That is a merchandising operation, and these brokers' loans, so called, include also the loans made to dealers.

Senator BROOKHART. There is a difference between legitimate marketing and speculating and gambling.

Mr. SPRAGUE. Yes.

Senator BROOKHART. Those are two different fields.

Mr. SPRAGUE. True; but I am just pointing out that part of the so-called brokers' and dealers' loans consists of accommodations granted to those who are engaged in the business of marketing securities. In the second place, I should hold that bank credit is legitimately employed in connection with dealing in the securities market, in connection with stock exchange dealings, in so far as such transactions are necessary or desirable in order to create a market for outstanding issues for securities. The point at which it may be said that undesirable speculation is reached is that at which the volume of credit is such that it permits and accentuates dealings on the exchange which give rise to prices of large numbers of securities which are not reasonably justified by the earning power of the company.

Senator GLASS. Is not that the exact situation?

Mr. SPRAGUE. Yes; but I narrow it down to this point: In the absence of the stock market, if I own General Electric stock, it would be rather more difficult for me to dispose of it, and if that is a condition which appeals to me and other investors, then I should suppose you will agree that a stock exchange with some volume of dealing is desirable. It is the excess that is perhaps a matter of concern.

So I come to the inquiry of what the consequences are of a supply of credit so large for stock-exchange dealings that it encourages and makes possible and results in, if you please, inflated prices for many securities, and by that I mean prices which subsequently sharply decline. It is obvious that declines of the kind I have indicated subject certain individuals to losses, those who have been speculating for a rise, and especially on a margin basis. The amount of loss which those persons experience is exceedingly difficult to determine, because presumably they may have been making money while the market was moving up, and the subsequent sharp reaction may simply mean a scaling down of paper profits and not very much loss of actual money.

At all events, it does not appear to me to be a matter of vital concern to the community the losses that some individual may experience from unwise operations in securities which reach inflated levels. These operations are only of serious consequence from the point of view of the community in the event that inflated prices followed by a sharp reaction on the stock exchange tend to bring about a general reaction in trade and industry. If that be the case, then I think it is obviously of vital important that somehow or other an effort be made to control these operations.

I do not think, however, that the evidence indicates that a decline on the stock exchange is an independent cause of business or industrial reaction. It is undoubtedly true that almost invariably when there is a period of trade reaction it is accompanied and perhaps preceded by a decline on the stock exchange; but there are plenty of other instances in which declines on the stock exchange have not been accompanied or preceded by a decline in general business. If the undue advance in prices of securities is purely a credit matter, and business in general is in a sound condition, the reaction in the market would not plunge the country into a period of business depression. I therefor reach the conclusion that the brokers' loan evil at the most is an evil of minor consequence, not one of such serious import that we need to sacrifice any other desirable interest in the community in order to hold that matter in leash.

Senator BROOKHART. How about this proposition? The present situation shows there has been a constant rise in stock values on the stock exchange since 1920.

Mr. SPRAGUE. Yes.

Senator BROOKHART. And the country has been in a constant agricultural depression all the time.

Mr. SPRAGUE. Very true.

Senator BROOKHART. What effect or relation has the one to the other? What is the cause of that condition, if it is not to some extent that the credit has been taken away from the country, and what they buy is costing them too much, and turned over to these speculators at a low rate of interest?

Mr. SPRAGUE. I do not think there is the slighest probability that if the volume of brokers' loans at the present time were $500,000,000 less than in fact it is, that the agricultural situation would be appreciably other than it is.

Senator BROOKHART. Suppose they were three billion less?

Mr. SPRAGUE. Then I think perhaps the agricultural situation would be worse than it is.

Senator BROOKHART. We could probably get our money then at 5 per cent instead of having to pay 8 per cent.

Mr. SPRAGUE. No. The capital market would have been seriously affected. You would in all probability have made all sorts of securities unsalable. You would have introduced, in other words, a disturbing factor into the financial situation of the country, which would have its reaction, I should expect, upon all classes in the community.

Senator BROOKHART. You just pointed out that a reduction in those stock values would not bring that general depression.

Mr. SPRAGUE. Yes; but a three-billion-dollar contraction would have an effect upon those desirable uses of brokers' funds that I have mentioned: First, the ordinary marketing of new issues of securities; and in the second place, the saleability of the many issues of stocks and bonds now outstanding.

Senator BROOKHART. But would not the proper use of this $3,000,000,000 give a legitimate market for these things, instead of a gambling market, such as we have now?

Mr. SPRAGUE. I do not think so.

Senator BROOKHART. Here is what drives the money to the money centers, is it not: A member bank in the Federal reserve system must deposit its reserve, but it gets no rate of interest, no redeposit rate?

Mr. SPRAGUE. True.

Senator BROOKHART. It is permitted to deposit the reserve, if it wants to, but again it gets no interest?

Mr. SPRAGUE. True.

Senator BROOKHART. Therefore, in an attempt to employ these funds when they are idle, they have no other place to send them except to New York. Is not that true?

Mr. SPRAGUE. Yes.

Senator BROOKHART. So they send them there, and the New York fellow fixes the rate they will receive for it, which is at present 1¾ per cent, for bank balances?

Mr. SPRAGUE. Yes.

Senator GLASS. Do you think the Federal reserve banks should pay interest on reserves?

Mr. SPRAGUE. Oh, no.

Senator GLASS. That is what Senator Brookhart's question leads up to. He wants the Federal reserve bank to pay interest on reserves, and if they did it would smash the system all to pieces.

Mr. SPRAGUE. Yes. I think I shall come to that in a minute.

Senator BARKLEY. Were you trying to finish an answer to some question?

Mr. SPRAGUE. I was going on to whether it would be possible to control brokers' loans. I am holding so far that they are at the most a minor evil on the assumption that the amount is excessive. I think Senator Brookhart was directing his remarks to the possibility of syphoning these funds back into the agricultural situation.

Senator BROOKHART. I also want to ask some questions about the proposition suggested by Senator Glass. You said you would come to that.

Mr. SPRAGUE. I shall come to that soon.

Senator GLASS. The reason Senator Brookhart's people pay 8 per cent is that his State permits it. If he wants these usurious rates reduced, and he would exert one-tenth of the influence on the State legislature that he exerts here, he would get them down to a reasonable rate.

Senator BROOKHART. Let me concede that is a part of the reason, but that is not the whole reason. Part of it is due to this situation in the Federal reserve bank depriving itself of that market, Senator.

The CHAIRMAN. That does not fully explain why the Iowa banks would rather take the low New York rate than the Iowa rate of 8 per cent.

Senator GLASS. Oh, no. I do say that 8 per cent on normal commercial paper is usurious, and that Iowa ought to correct its own situation before coming here and asking us to correct it for them.

Mr. SPRAGUE. You never will correct it unless you modify your banking organizations. If you support and maintain a system in which you have a large number of banks with resources of under half a million dollars, you are bound to have something like an 8 per cent rate. If in Iowa you had at Cedar Rapids and Des Moines and other places a system of large banks operating branches within 50 or 100 miles of those centers and if your average bank in Iowa had resources of from $5,000,000 to $10,000,000 or $20,000,000, they would be in a position to lower the rates charged on the best of loans in your rural communities. But if you have banks with resources of $500,000 and they get 8 per cent on the average, they are only getting $40,000, and then if you pay $15,000 of that for interest, you have only got $25,000 for operations.

Senator GLASS. If a bank in Virginia, capitalized at $50,000, is limited to a rate of 6 per cent, why is it that banks capitalized at less than half a million dollars in Iowa could not live on the same rate?

Mr. SPRAGUE. It is purely because of the greater stability of values. In Iowa the average farm is worth, I suppose, from $40,000 to $60,000, including the land and equipment. When a business is operated with a unit of that size, it is almost absurd that the banking business should be conducted by institutions having $200,000 or $300,000 of resources.

Senator BROOKHART. You are in error about that average value. In 1925 the average farm was practically 160 acres, and the average value $149. That would make it about $24,000.

I want to give you a concrete situation out there. You mentioned Cedar Rapids a while ago. In August I interviewed one of the largest bankers in Cedar Rapids, who is one of the best-known men in the State. He told me he had $3,000,000 of deposits in his bank, and he said:

> At this moment I have $1,600,000 of that in New York. Part of that is in bank balances and I am getting 1¾ per cent. Part of it is invested in listed bonds, for which I am getting 4¼ per cent, charging my farmer neighbor 7 per cent, and charging the best business loans 6 per cent. I am doing that under this system because if I lend money to a farmer and he does not pay when it is due, and we lose it or put it on the slow list, it is no longer rediscountable, and I am under suspicion, and in order to keep myself in good standing according to the New York rules, I am forced to run my bank that way.

Since that I saw one of the big bankers in Waterloo, Iowa, who has a little larger bank than the other man, and his story was the same as the Cedar Rapids banker. I saw one of the two biggest bankers in the State at Des Moines, with $15,000,000 of deposits, and he was in the same condition. I saw one from Boone, just recently, and he told me that was the general condition throughout the State.

Here is the point with me. They are getting 1¾ per cent for a good deal of that money and charging that high rate of interest to the farmers and business people at home. They would be better off if that money was loaned at home at 5 per cent than they are under present conditions.

Mr. SPRAGUE. Do you not think that, human nature being as it is, with the large number of bank failures and runs and so on, it is very natural for bankers, perhaps for the moment, to go to the opposite extreme? They want to be certain they can meet the demands of their depositors. I think you will find in a few years, when this has blown over, that there will be a somewhat better situation. I think it is a reaction from what that part of the country has been through in the way of bank runs and bank failures.

Senator BARKLEY. Doctor, I would like to ask you this question: Of course, taking human nature as it is, it is the desire of every bank to make all the profit it can properly make by the lending of money, which is their chief source of income. Is there any reasonable inducement to a sound bank to send its funds, or any appreciable part of them, to New York and receive 1¾ per cent, if those funds could be loaned in their own community for 5 or 4 or 3 per cent?

Mr. SPRAGUE. I quite agree. That was the statement which I started with. However, I repeat, it is somewhat in the form of a tradition. Bankers will cling to a traditional rate in the rate charged to borrowers and the rate of interest they pay on deposits.

Senator GLASS. Do they not cling to the standard rate because they are unable to shift these funds to New York at a nominal rate of interest?

Mr. SPRAGUE. But, I repeat, if they did not do that, I fear that many undesirable loans would be made in order to get the 8 per cent. You can always get your 8 per cent or 6 per cent or whatever the rate is if you are willing to take the risk. The opportunity for depositing funds in New York moderates that inducement a little. The question is whether you think there would be a loss of safety, through a limitation on the employment of funds in New York, which would more than offset any advantage the good borrower might get on a lower rate. My judgment is that the loss in safety would be too great a price to pay.

Senator BARKLEY. Suppose a given bank, the one mentioned by Senator Brookhart which had $1,600,000 in New York, was compelled to return that money to its own vaults and to its own community, and assume that it was denied the privilege of obtaining that 1¾ per cent for it, and assume that it had made all the safe loans it could make in the community, would not the situation of compelling that money to remain idle tend to increase the rate upon other loans in the community rather than lower them?

Mr. SPRAGUE. It might have that effect.

Senator BROOKHART. It is that long-time accumulation of that standard rate that has brought about the condition which has destroyed our land values and rendered our securities unsafe. I think there is no doubt in the world but what that had more to do with it than anything else.

Senator GLASS. As a matter of fact, I think it must be realized that the other end of the proposition has never been experimented with. The banks have never extended to their borrowers any other rate than the standard rate of interest.

Senator BROOKHART. That is correct.

Senator GLASS. They have never yielded one hair's breadth in that respect. It is the only business on earth that does not yield to the law of supply and demand.

Mr. SPRAGUE. I think it might be said in that connection that there is a slow growth of elasticity in rates; that an increasing number of customers of banks are getting rates which move to some extent up and down with the rates on the market. That is true, at least, in the case of the large borrowers in our cities, and it extends as far as Dallas and Denver. It is only beginning.

Senator GLASS. It is hardly appreciable so far.

Mr. SPRAGUE. It is true, if you take the communities with populations of under 50,000, there is very little evidence of it, but there is a beginning in that direction.

Now, if I may turn to the possibility of influencing the volume of brokers' loans through the operation of the Federal reserve banks, I want to inquire whether it is possible through the operation of the reserve banks, without undesirable results in other directions, to control the volume of brokers' loans.

Senator GLASS. Right on that point I would be obliged if you would explain to the committee precisely how the facilities of the Federal reserve system are made available for brokers' loans, when it was the fixed purpose of the act to prohibit the use of the facilities of the Federal reserve system for that purpose?

Mr. SPRAGUE. That is along the line I was going to speak. The Federal reserve banks are in position when an application is made for a rediscount to grant the accommodation or to decline it. They grant it ordinarily in the event that the borrowing bank presents paper which meets the eligibility requirements of the statute—that is, loans that are commercial in character or United States Government securities. The operations which led the bank to resort to the Federal reserve bank for accommodations are not subject to control by the Federal reserve bank, and it is all of the operations of every kind and description of any member bank that brings it to the Federal reserve bank for accommodations. A bank ordinarily borrows because it finds itself with a deficient reserve, and that deficient reserve is the result of all the transactions passing through the bank The eligible paper requirements simply limits the possible borrowing of any member bank to the amount of eligible paper that it happens to own, but in no way does it affect the operations of the bank beyond that point.

Now, the Federal reserve bank might conceivably say to a borrowing member bank: "You have outstanding various loans, brokers' loans in particular. Your paper is perfectly eligible, but we will not rediscount it for you, because of these brokers' loans which, if you liquidate, will render it unnesessary for you to borrow." A policy of that sort, of course, would mean that the reserve bank in every instance would have to inquire into all the operations of the borrowing bank.

Senator GLASS. Does it not do that anyhow?

Mr. SPRAUGE. It does to the extent of finding out whether the bank is upon the whole in a safe condition.

Senator GLASS. It finds out all of the details of the business?

Mr. SPRAGUE. It knows that, but it does not act upon that information, and the query is whether it would be desirable in the functioning of our system that the Federal reserve bank should generally and frequently require the scaling down of brokers' loans or any other kind of loans, rather than extend credit to a member bank in the form of rediscount. I should hold that if the Federal reserve banks were to do that, it would almost completely destroy the effectiveness of the Federal reserve bank system as an instrument for the control and regulation of credit. At the present time the banks are not particularly eager to appear as rediscounters at the Federal reserve bank. In general, the banks that borrow do it for a comparatively short period of time, often simply for a day or two. If you were to eliminate rediscounts, in the event that the bank had these outside call loans, the reserve bank would be of still less service from the point of view of the large member banks throughout the country.

Senator BROOKHART. You say these banks are not eager to rediscount their paper at the Federal reserve bank. The only reason for that is that right now they have to pay four per cent, and if they can get these vast deposits from Iowa and other States at 1¾ per cent, that is better than rediscounting at the Federal reserve bank.

Mr. SPRAGUE. Yes; but consider the situation in Minneapolis, where the rate is also 4 per cent, and rediscounting at the Federal reserve bank is in the neighborhood of but $3,000,000. Take the Dallas Bank with a similar small volume of rediscounts. In both those districts the average rate on the business of the member banks is very much in excess of the rediscount rate, but there is no particular disposition on the part of the member banks to borrow. They do not wish in general to appear as continual borrowers at the Federal reserve bank. I think that is one of the features of the working of the system that was hardly realized by anyone when the act was passed. It was very generally assumed that banks would be rather eager to borrow from the reserve banks, unless the rate at the reserve bank was decidedly above the average rate at which the banks were lending.

Senator BROOKHART. Another reason is that a good many of the member banks are in competition for this rediscount business.

Mr. SPRAGUE. Yes.

Senator BROOKHART. The Continental & Commercial National Bank of Chicago does an enormous rediscount business.

Mr. SPRAGUE. Certainly. There is a very considerable amount of business there in competition with the reserve banks. But let us suppose that the reserve banks did not absolutely refuse rediscount if a bank had any brokers' loans, but that they would raise difficulties and very frequently reduce the amount or decline. I doubt very much whether that would have any appreciable effect upon the volume of brokers' loans. It would probably mean that the rate, the call-loan rate, would be less stable than it has been in recent years. It might be that you would have the rate going up sometimes to 6 per cent or more, because a number of banks which would under existing arrangements have rediscounted for a few days might find it necessary to liquidate their call loans.

But I do not believe that it would have any appreciable effect upon the aggregate amount of these loans. The only case in which the policy of the Federal reserve bank in that matter might be expected to have some influence would be in the very limited number of instances of banks that have borrowed for considerable periods at the reserve bank, and have at the same time been employing money on the street. Cases of that sort are regarded, I believe, with disfavor by the management of the reserve bank, and are infrequent.

In general, it can be said that the banks that are making these brokers' loans are not borrowers for appreciable periods of time at the Federal reserve banks, and if they find themselves for some unexpected reason under the necessity of borrowing considerable sums they pretty speedily reduce their call loans and other commitments.

Senator BROOKHART. Is not the chief reason why they can carry on these operations without rediscounting at the Federal reserve bank the fact that they get these redeposits from banks in the country generally at 1¾ per cent, or about that?

Mr. SPRAGUE. If the New York banks did not get those deposits, if they did not pay interest on them, there would be a large volume of direct lending by outside banks. At the present time, these banks are lending nearly a billion and a half dollars through the New York banks, an amount that is three hundred millions larger than the direct loans of the New York banks themselves.

Senator BROOKHART. How does an out-of-town bank make those loans?

Mr. SPRAGUE. The process is very simple. An outside bank has a balance in a New York bank, and it instructs by telephone or telegraph the New York bank to lend a certain amount of that balance on the exchange, upon proper collateral. The New York bank arranges the loan and takes in the collateral and generally supervises it and charges a commission. If it were not done by the New York bank for an out-of-town correspondent, it would be a perfectly simple matter for the out-of-town bank to arrange a direct loan on the exchange.

Senator BROOKHART. It is usually done through the New York correspondent?

Mr. SPRAGUE. Yes.

Senator GLASS. It seems to me that the argument you have made for the last 10 minutes implies the belief on your part that the Federal reserve system was established primarily to offer its facilities for stock and commodity speculative purposes, rather than primarily to afford the commerce and industry of the country assurance against speculation and all the attendant evils. For example, would you have us abolish the Federal reserve bank at Minneapolis, merely because the stockholding banks of that particular district have not engaged in the practice of rediscounting?

Mr. SPRAGUE. Oh, I would hardly wish to express an opinion. I would rather answer the first part of your question.

Senator GLASS. To go back to Mr. Warburg's oft repeated simile, would you destroy the reservoir simply because some people do not use the water?

Mr. SPRAGUE. Oh, no; I am not proposing anything of the sort. I am simply using that as an illustration. I would rather answer the first part of your question.

The Federal reserve system was doubtless established primarily to meet the requirements of commerce and industry and agriculture; and in the second place, to meet situations in the case of emergencies. But in the process of doing these things it is impossible for the Federal reserve bank to control in complete detail the entire use of the aggregate amount of credit throughout the country.

The Federal reserve banks can readily reduce the total of brokers' loans, but in the process of doing so they will inevitably bring about a reduction in the supply of credit available for other purposes. If the Federal reserve banks to-morrow were to begin to sell rapidly their holdings of Government securities, the immediate result would be to force the banks into the reserve banks as rediscounters. If the rate were raised, we will say, to 5 per cent, that would accenuate unwillingness on the part of the banks to remain as borrowers of the reserve banks, and you would have a decided contraction in the volume of brokers' loans. But the contraction would not be confined altogether to brokers' loans. It would have a reaction to a greater or less extent upon all other kinds of loans.

Senator BROOKHART. Would not the reaction be more severe on legitimate business than on brokers' loans?

Mr. SPRAGUE. It would, if persisted in, I think.

Senator BROOKHART. Is not the broker or gambler more willing to pay a high rate of interest than one engaged in a legitimate business?

Mr. SPRAGUE. Nevertheless, the desire of banks to accommodate their own customers is very strong. It is possible for the reserve banks from time to time to test the situation by a moderate stiffening of rates and moderate sale of Government securities. Let us consider. for example, the last eight months. Last summer, as I understand the matter, a policy of somewhat easier rates was adopted by the Federal reserve banks, partly to influence the gold flow, in the belief that a further importation of gold to this country was not desired for us, and might have a serious disturbing effect on countries recently reverting to the gold standard or contemplating returning thereto; and also influenced by the consideration that fairly easy money here and the avoidance of monetary difficulties on the other side would be favorable to the market of exported staples, such as cotton. These results seem to have followed that policy. It has been an incidental result of that policy that an enlarged volume of credit has to some extent drifted into brokers' loans.

Now, if the expansion of brokers' loans is a matter of major consequence, threatening the foundation of prosperity in this country, then it was an unwise policy to have permitted fairly easy money last autumn. On the other hand, if the expansion of brokers' loans is a matter of secondary significance, perhaps undesirable, but still of secondary importance, it was not too high a price to pay for the strengthening of the gold-standard position on the other side and for such stimulation as that may have given to the export trade in a variety of our staple products.

Senator GLASS. At the time the Federal reserve statute was enacted the total outstanding bonded indebtedness of this country was less than a billion dollars, somewhat more than $900,000,000. We had that in view in enacting section 13 of that statute. Suppose there had never been this inconceivable increase in the bonded indebtedness of the country, how would these brokers have availed themselves of the facilities of the Federal reserve system?

Mr. SPRAGUE. The banks in general use United States bonds as a basis of borrowing at the Federal reserve banks, because they can be handled more readily than the ordinary commercial paper.

Senator GLASS. Because it is permitted by the act.

Mr. SPRAGUE. Yes; but they have the commercial paper. I have in mind, for example, a bank that has as a matter of policy something like $50,000,000 of eligible material. A part of that consists in Government bonds and a part consists in commercial loans of one sort or another, but about which there is no question of eligibility. Then they have $50,000,000 or $100,000,000 more which they can use, but which the reserve authorities might want to examine a little more carefully. If that bank has occasion to borrow, as it frequently does, $6,000,000 or $8,000,000, it simply puts up the Government securities.

Senator GLASS. Because it gets a lower rate of interest on its bonds and a higher rate of interest on its commercial paper?

Mr. SPRAGUE. The borrowing bank would get the interest on either the bonds or the commercial paper in any event. It simply is a little more convenient to put up 10 Government bonds to borrow a million dollars than it is to put up a miscellaneous lot of commercial loans.

Senator GLASS. What would it do if it did not have the Government bonds?

Mr. SPRAGUE. It would put up the commercial loans. It has the $50,000,000. Its present holdings of commercial paper it regards as perfectly eligible, a character of paper about which there would not be the slightest question at the reserve bank. It is a purely routine matter in regard to the examination of the collateral, and the use of Government bonds, in my judgment, is a mere convenience. But the obstacle is not sufficiently great in the use of commercial paper to have, I believe, an appreciable effect on the amount of rediscounting.

In conclusion, I wish to simply leave my judgment on the matter with the committee, that the matter of brokers' loans is not a matter of serious or first-rate consequence, not of sufficient consequence to demand a change in legislation which might in other directions prove exceedingly damaging.

Senator GLASS. You think, then, that the activities on the stock exchange in New York have no reflex influence whatever upon the business of the country outside?

Mr. SPRAGUE. Comparatively little.

Senator GLASS. Do you think an upheaval there does not attract the attention, psychologically, of business men throughout the country, and have an appreciable effect upon business conditions?

Mr. SPRAGUE. I am inclined to take that view, with this further statement that, assuming that the financial structure of business is tolerably sound, and that economic conditions are fairly satisfactory, I do not believe that the credit situation alone would create or lead to an upheaval on the stock exchange. If, for example, the business structure of this country had been as unstable as it sometimes in the past has been, and if the range of securities were as narrow as it was 30 or 40 years ago, all subject to the same influences, favorable or unfavorable, then I should feel it would be possible for an extreme upheaval upon the stock exchange under the impact of credit stringency. I do not think that is the case under present circumstances. I think that was illustrated a couple of years ago, when the volume of stock-exchange loans was reduced by about $500,000,000 in the course of two or three months, without any serious accompanying disturbance in business.

Senator GLASS. In the last few months, measurably speaking, you have had frightful fluctuations there, in which, as reported by financial newspapers, millions of dollars were lost or made, as the case might be. Do you think that has no depressing influence upon the general business of the country?

Mr. SPRAGUE. Very little.

Senator BROOKHART. But you think, if we should reduce them by several billion dollars, leaving them about what they had when the reserve act was established, that would bring about trouble?

Mr. SPRAGUE. It would. The range of securities now handled on the stock exchange is immeasurably wider than it formerly was.

Senator GLASS. Is it not immeasurably wider than it has any business to be?

Mr. SPRAGUE. I do not think so.

Senator BROOKHART. The principal idea in the reserve act was that speculation had reached an unreasonable stage and was a cancer on the system, that must be cut out, and now it is five or six times as great.

Mr. SPRAGUE. But the proper dealing in the transfer of securities between individuals has enormously widened in that period. A much larger proportion of the industries of the country is owned by numerous individuals than formerly. If you examine the stock exchange list, for example, of 1894, you will find that it covers about a page and a half in the Financial Chronicle, and nearly all the securities were railroad securities. They moved up and down with the same kind of influences. The market was an unsafe place for lending, more unsafe than it now is.

Senator BROOKHART. Is it not now an unsafe situation?

Mr. SPRAGUE. It is unsafe in some securities for particular individuals. In general, however, I should be inclined to say that the average quotations on the stock exchange largely represent a revaluation based upon a decline in the rate of interest. The rate of interest is declining, as measured by any test you would like to use.

Senator BROOKHART. In the same way, if you get a declining rate of interest, the farms should increase in value the same as these other commodities have increased.

Mr. SPRAGUE. Yes; but the way to do that is not to try to force funds out of a use in which after all the rate is moderate. If the rate on call loans were 7 per cent and the volume was what it is, I should think there would be a fair case for the assumption that other people were being deprived of needed accommodation; but in so far as people are deprived of needed accommodation in any part of this country, I would say it was due to defects in banking organizations and to the persistence of certain traditions, such as interest on deposits, together with the reaction from the numerous bank failures which have affected some sections of the country. Those seem to me to be the matters to attack rather than to attempt to withdraw funds from one use on the chance that they might be available for some other use.

Senator GLASS. You believe in branch banking, do you not?

Mr. SPRAGUE. To a limited extent.

Senator GLASS. You were limiting it a while ago to fifty or a hundred miles. Congress limited to the corporation limits.

Mr. SPRAGUE. Yes; with the result that is not satisfactory, in my judgment, in the first place, because you allowed an unlimited number of banks in any one institution in a large city. I do not believe a city bank should be allowed to have 50 or 100 branches in any one city. It preempts the situation too much. I believe in large cities like Detroit and Cincinnati, it would be very much better if no bank should have more than 20 or 25 branches in its home city.

Senator GLASS. You should make your plea to the Comptroller of the Currency. It is in his discretion. Congress never supposed he would dot them all over the country.

Mr. SPRAGUE. Then the situation is unsatisfactory in that no consideration was given to the problem presented by chain banks, which is the most undesirable and dangerous kind of branch banking.

Senator GLASS. That is not branch banking. It is banking without responsibility, whereas branch banks have concentrated responsibility.

Mr. SPRAGUE. Chain banking has all the disadvantages of branch banks, with none of the advantages.

Senator GLASS. Not a bit in the world. If you and I could legislate instead of Congress, we could fix it all right.

Mr. SPRAGUE. No doubt.

Senator BROOKHART. There is another matter that I want to inquire about. That is this redeposit business of the banks of the country. Now, a redeposit by one bank in another is the same banking business which is presented by the rediscount, naturally and logically.

Mr. SPRAGUE. Yes; it is a reserve, though it does not become a legal reserve.

Senator BROOKHART. The legal reserve is compelled to be redeposited in the reserve bank.

Mr. SPRAGUE. Yes.

Senator BROOKHART. At no rate of interest.

Mr. SPRAGUE. No.

Senator GLASS. We rescued the legal reserve from the stock market.

Senator BROOKHART. Yes; but the redeposit business of the country is two or three times as great as the legal reserve.

Senator GLASS. I know it is.

Senator BROOKHART. Probably four times, counting in the legal reserve. There is not more than one-fourth of the surplus money that is redeposited from one bank to another in the legal reserve.

Mr. SPRAGUE. I have not the figures before me. I should have thought that is rather high. It is large, in any event.

Senator BROOKHART. My thought has been that that is the best resource, the surest resource, of these particular funds, is this redeposit business which does not go into the Federal reserve banks, and that it ought to be taken in.

Mr. SPRAGUE. Taken into the Federal reserve banks?

Senator BROOKHART. Yes.

Senator GLASS. Taken in how and used in what way?

Senator BROOKHART. My thought is that it ought to be taken in and that we ought to limit these things to the Federal reserve bank and make our market there instead of the stock exchange, and get rid of this gambling business. I think we could do it easily.

Senator GLASS. It looks to me like your proposition would transfer the gambling business to the Federal reserve system.

Senator BROOKHART. I do not propose to do that. I would prohibit it by law.

Mr. SPRAGUE. May I say that in the absence of some amount of speculative interest in any kind of property you do not have a satisfactory market. One of the troubles in the matter of farm lands is that there are very few people prepared to buy at bargain prices.

Senator BROOKHART. You just complained that our speculative prices is what has ruined us.

Mr. SPRAGUE. Yes; when you go up. You have in your area a situation in which at times pretty much everybody is speculating for a rise, and when the decline comes there is practically no one in a position, though prices go down, to take the land off the market. A satisfactory market is a place in which there is sufficient public interest so that when prices decline buyers will come in. At the present time, for example, if certain securities were to drop 10 or 15 points there are large numbers of individuals eagerly waiting for that to happen, because they wish to buy those securities at a price. When inventories of raw materials are thrown on the market, buyers are often conspicuous by their absence, and the same is even more true in the case of urban real estate or farm land. If you should close the stock exchange and these other exchanges, no one would feel as well satisfied with the securities that he holds. He would find it exceedingly difficult to market them, and, consequently, would in all probability not continue to hold them.

Senator BROOKHART. I will concede that, unless a new market is established; but if we would have all these fast redeposits put in the Federal reserve system, we would have the funds, the reserve and everything, to create a new and legitimate market for those securities. It seems to me it could be done more safely through the Federal reserve bank system than it could through bank investments, listed bonds, or the stock exchange. If we merely prohibit one bank from paying another for these deposits, it seems to me that would destroy our reserves. We would get the use of the legitimate surplus funds in these banks, and they would be kept at home. I want to keep that fund at home. But there would be a certain amount that could legitimately go into the reserve all the time and benefit everybody. I do not believe the United States Government has to furnish a banking system to a bunch of gamblers that are buying on stock margins.

Senator GLASS. You are proposing to have the United States furnish a system for conducting gambling operations.

Senator BROOKHART. No. The Senator assumes that I am going to transfer the gambling feature of it into the Federal reserve system. I would cut it out of the Federal reserve system.

Senator GLASS. They are using the facilities of the system now for that very purpose, and that is what I want stopped, if anybody will tell me how to do it.

Senator BROOKHART. I agree that should be stopped, but I do not so understand the administration of the Federal reserve system. It seems to me they are living up pretty well to the law as to rediscount and speculative loans, but they are helpless, because there are approximately three-fourths of the redeposits of the country that are going down there at a rate fixed by the gamblers themselves—1¾ per cent.

The CHAIRMAN. Suppose we adjourn until 2.30. We will hear Governor Young and some members of the Federal Reserve Board then.

(Whereupon, at 12.45 p. m., a recess was taken until 2.30 p. m.)

AFTERNOON SESSION

The committee resumed its session at 2.30 o'clock p. m., at the expiration of its recess.

The CHAIRMAN. The committee will come to order.

STATEMENT OF R. A. YOUNG, GOVERNOR FEDERAL RESERVE BOARD, WASHINGTON, D. C.

Mr. YOUNG. Professor Sprague has covered this whole situation so well that there seems very little more for me to say.

I would like to have it understood by the members of the committee that any statement that I do make is a personal statement, my own personal view, and not necessarily a view of the Federal Reserve Board.

Now, with reference to the La Follette resolution, Resolution 113, it is perhaps best to consider some of the statements in the preamble of the resolution; and in order to bring that out properly, it is perhaps best to review some of the credit conditions that have developed in the United States in the last five years. I will have to approach this entirely from the mechanical and operating standpoint rather than the standpoint of theory.

During the last five years a large volume of gold has come to this country. The banks have been able to expand credit on that gold basis in large amount. The information that we have up to June 30, 1927, which is the last date upon which figures are available, shows that for the five-year period there has been a total increase in bank credit in the United States, represented both by investments, loans, and discounts, of approximately $14,000,000,000. Of that increase we estimate that approximately $8,500,000,000 is represented by loans to customers of banks; $4,600,000,000 is represented by the increase in investment holdings, bonds, securities, etc. There has been an increase of $950,000,000 in brokers' loans in New York City; an increase in acceptance holdings of $150,000,000; and a decrease in holdings of commercial paper of $200,000,000.

It is not necessary for me to explain again to the committee the reason for the decrease in commercial paper held by the banks. That was very fully covered by Professor Sprague this morning.

That leaves the picture on June 30 just about this: The total loans and investments of all banks in the United States were in excess of $54,000,000,000. Of this amount it is estimated that $34,000,000,000 had been lent to customers; $17,000,000,000 represented bonds and investments; $2,275,000,000 represented brokers' loans in New York City; $380,000,000 represented acceptances; and $570,000,000 represented commercial paper.

Senator GLASS. What is the amount of brokers' loans?

Mr. Young. $2,275,000,000.

Senator Brookhart. That is just the members of the Federal reserve?

Mr. Young. All banks. I will explain those figures a little later, if I may.

Senator Glass. Yes. Because there seems to be a very great discrepancy between that and the figures we have had.

Mr. Young. That is true, and I will bring that out a little later, Senator, if I may.

Now, I have used these figures for two reasons. One is to show the tremendous increase in bank credit in the United States in the last five years. The second is to remind the members of the committee that there are no legal restrictions that I know of as to how a bank may lend its money, other than the legal restrictions as to the amount it may lend to any individual person, or firm, or corporation; or the amount it may lend on real-estate security.

Section 13 of the Federal reserve act, an excerpt of which is quoted in Senator La Follette's resolution, defines the character and kind of paper that a Federal reserve bank can rediscount, and I think Congress properly defined the kind of paper that could be rediscounted. Nevertheless, there are many investments that member banks can make that are safe and liquid that are not included in the kind of paper that a reserve bank can rediscount.

In an attempt to interpret that part of section 13 of the Federal reserve act, I can see where the officers of a reserve bank might properly say to a member bank that came to it with eligible paper and stated to the reserve bank that their sole object in rediscounting the eligible paper was to lend the proceeds on call in New York—I can see where a Federal reserve bank could properly discourage that procedure, and I do not think it makes any difference as to whether the funds were to go into speculation on the New York stock market, or whether they were to go into speculation in commodities. I think in any event the reserve bank could take that position. From a practical standpoint, however, that is not what happens. What happens is that the lending always precedes the rediscounting. In other words, the banks make their loans, and then because of the withdrawal of deposits, they come to the Federal reserve bank and ask for assistance. Now, even though a member bank has legally made loans on real-estate security, or upon installment credit, or otherwise, I hardly think that the Federal reserve bank is in a position to deny credit to that bank when it comes with eligible paper. What really happens in the entire banking system of the country is that the loans are first made by the banks, and then, because of the withdrawal of deposits, if they are short in their reserves, they come to the reserve bank for assistance, and tradition takes care of the situation in 99 cases out of 100; that is, the tradition that has been established in America, which is, that banks do not want to show money borrowed from the reserve banks. In a great many cases the banks will get out of debt promptly by calling street loans, or other advances, and no action is necessary on the part of the Federal reserve bank.

Senator Glass. Well, Governor, you, of course, have a system of bank examinations?

Mr. Young. Yes, sir.

Senator GLASS. A thorough system of bank examinations?

Mr. YOUNG. Yes, sir.

Senator GLASS. Which apprises the management of the Federal reserve bank of the exact condition of the member banks?

Mr. YOUNG. Yes, sir.

Senator GLASS. If the administrative officers of the Federal reserve bank should judge, from the report of its examiners, that the bank is doing an unsafe business, do you think it is within the discretion of those administrative officers to deny it rediscounts, even though it presents eligible paper?

Mr. YOUNG. I think, Senator, that a reserve bank would have that discretion. What actually happens is that the reserve banks generally advance credit on the bank's eligible paper, and call the officers of that bank in and talk the situation over.

Senator GLASS. They do that?

Mr. YOUNG. They do that; yes, sir.

Senator GLASS. Then what would be the objection, the officers of the reserve bank seeing that a member bank has excessively extended its call loans, to calling the officers of that bank in and suggesting that a greater proportion of its loans be withdrawn from the market?

Mr. YOUNG. No objection to it at all in ninety-nine cases out of one hundred. There might be some emergency in the country where it might be well to let them go on. But there is no reason why the reserve banks should not do that, in my opinion.

Senator GLASS. I have understood they had a very great aversion to doing anything of that kind.

Mr. YOUNG. I do not think so, Senator. I will cover that a little later.

Senate Resolution 113 has to do particularly with the brokers' loans, and in the preamble of the resolution figures are stated that were published by the Federal Reserve Board on January 11, 1928, $3,819.000,000. Of that amount New York banks had lent $1,321,-000,000. The banks outside of New York had lent $1,502,000,000; and the others, the corporations, individuals and foreign governments had lent $996,000,000.

Those figures are a good bit higher than the June figures referred to earlier.

I have recently been appointed a member of the Federal Reserve Board, and what I am going to say from here on is information I have gathered largely from the records of the Federal Reserve Board. I find that brokers' loans first came seriously to the attention of the Federal Reserve Board in October, 1917. They were under discussion continually from then on. It took quite a time to set up the machinery so that these figures could be secured. On January 6, 1926, the Federal Reserve Board felt that it had some information that it could give to the public, and one of its reasons for giving the information to the public at that time was that the information itself might have a deterrent effect on any undue expansion of brokers' loans. Shortly after January, 1926, there was quite a reduction in the volume of brokers' loans in the United States. Whether the action of the Federal Reserve Board in publishing the figures brought about the reduction or not, I am not prepared to say; but, in any event, that is what happened. Starting with the middle of 1926, there was a gradual increase in the volume of brokers' loans until they reached the figures mentioned in Senator La Follette's resolution.

It is interesting to note that on February 29, 1928, the last figures that are available, the total volume of credit extended to brokers by banks in New York and outside of New York was actually $4,000,000 smaller than on January 6, 1926. In other words, on January 6, 1926, the banks had lent to brokers and dealers $2,577,000,000; on February 29, 1928, the volume amounted to $2,573,000,000. Now, the increase in brokers' loans between January 6, 1926, and February 29, 1928, came about entirely in the advances that were made by corporations and individuals. That shows an increase of $585,000,000.

With that picture before the Federal Reserve Board of the increase in this particular form of credit, naturally the board made some investigations through such channels as it could. My own idea of investigating was to answer several questions. The first question was, are brokers' loans safely and conservatively made? From all the information I can gather, I do not think there can be any question about the safety of those loans at this time and of their liquidity.

The second inquiry that I made of myself was this: Is this volume of credit that is going to the stock market denying commerce and industry credit? I can find no evidence of credit being denied to commerce or productive industry.

The third inquiry I made of myself was this: Are brokers' loans a part of the necessary credit structure of the country, or are they based upon unwarranted speculation? I find that you can answer that both ways. Part of the brokers' loan account is a legitimate credit function in America at the present time. Some of it no doubt is based upon marginal accounts, which borders very closely upon speculation, if it is not actual speculation. It is sometimes extremely difficult to say where speculation starts.

Assuming that some of this credit has been used for speculative purposes, the next inquiry I made of myself was: Is any of the reserve credit of the Federal reserve system being used for that purpose. Naturally, we look to the rediscount functions first. We went to the comptroller's office and made inquiries there, and we find that they have no evidence at all of banks borrowing from the Federal reserve system and simultaneously lending on call on the New York stock market, except for very short periods. That I will cover a little bit later. So I think that the board is safe in saying at this time that, in so far as the rediscount facilities of the Federal reserve system are concerned, that they are not being used to further the brokers' loan account. I do not mean by that that a bank never borrows from the Federal reserve system when it is a lender on call. It frequently does, but it is of very short duration, a day or two or three or four days; possibly, in some extreme cases, 30 or 60 days.

Senator GLASS. Coming back to the volume of brokers' loans in February, 1928, contrasted with the total of such loans in January, 1926, what is the relative increase in brokers' loans with respect to the increase in commercial loans for the same period of time?

Mr. YOUNG. In dollars and cents or percentage?

Senator GLASS. Well, either would give me the information I seek.

Mr. YOUNG. Well, I have not the figures, Senator, to give you that. I have the figures between 1922 and 1927.

Senator GLASS. Well, that would practically cover it. I just wanted to see whether the amount of loans to brokers was, by comparison, greater now than it was in 1926.

Mr. YOUNG. Well, I have not those figures, Senator, between 1926 and 1928. I can make this statement to you, that between 1926 and 1928 there has been no increase in brokers' loans so far as banks are concerned.

Senator GLASS. I understand, but the individual and corporate loans had increased the total volume.

Mr. YOUNG. Doctor Goldenweiser will furnish those a little later on, if that is all right.

Senator GLASS. Oh, yes. It is not very material. I just wanted to find whether there had been a greater increase in loans to brokers on the stock market than there had been an increase in commercial rediscounting, relatively.

Mr. YOUNG. I might explain that this figure in the preamble of the resolution, where it shows that the commercial paper outstanding decreased from $925,000,000 in October, 1924, to $610,000,000 in October, 1927, that those figures only cover paper that is issued by concerns that float their paper through note brokers; that would not include the paper of the jobber or wholesaler, or country merchant, who do not deal with a note broker; it would not cover any agricultural and livestock paper, of course. Those figures would be included in the figures that I furnished a little earlier, showing that between 1922 and 1927 there had been an increase in the loans to customers—that would include the country merchant, the livestock man, the jobber, and the wholesaler, and in that there has been an estimated increase in five years' time of $8,500,000,000.

Senator GLASS. Yes.

Mr. YOUNG. Unfortunately the Federal reserve system has not a strict classification, and it would be almost impossible to give it.

Now, if I may repeat, I think, in so far as the rediscount facilities of the Federal reserve system are concerned at the present time, there is very little, if any, reserve-bank credit obtained to be relent on brokers' loans.

The only other possible influence that the Federal reserve system might have on the volume of brokers' loans is through its open-market operations. In other words, if for some policy reason the Federal reserve banks should elect to buy securities in the market, in the great majority of cases that would have a tendency to ease the money market. Whether as a result some reserve-bank credit drifts into the stock market or not, it is very difficult to say. The probabilities are that some of it does get there. But, on the other hand, if the Federal reserve system elects at some time to sell securities in the market, they take a corresponding amount of credit out of the market. That, in like manner, may affect the brokers' loans, or may not affect the brokers' loans.

Senator GLASS. What is the primary purpose of the Federal reserve bank in going into the open-market activities?

Mr. YOUNG. The primary purpose——

Senator GLASS (interposing). Is it to enforce its rediscount rate in some instances, or is it to use its idle funds in other instances in order that it may defray the expenses of the system?

Mr. YOUNG. No, sir, Senator; it engages in open-market operations for many reasons, the primary reason is the gold movements.

Senator GLASS. You know there was a very bitter complaint and very persistent objection to the Federal reserve banks engaging in open market transactions, as being in competition with the activities of member banks and individual banks. The instant response to that early objection was to the effect that the open market provision of the act was intended to enable the reserve bank, in the one case, to make its rediscount rate effective in its district; and, in the second place, to afford it an opportunity to utilize its idle funds, in order that it might be sure to defray the expenses of the system. I just wondered whether or not other reasons for open market activities had developed in the course of the administration of the system?

Mr. YOUNG. I think the open market operations tend a great deal to make effective a rediscount rate. That, I think, has been demonstrated several times. The open market operations of the last five years, I should say, have been based largely upon gold movements.

Now, if credit has expanded too rapidly, that is, bank credit in the United States recently—and there is evidence that it has expanded too rapidly, and it has not been required by commerce and industry—the resolution inquires as to what corrective measures the Federal reserve system can adopt. In the first place, we can resort to some publicity, which we already have done. There is a question whether that produces beneficial results or not.

We can, through the open market, sell securities, which has a tendency to tighten credit. Since November 15, the market has lost $150,000,000 through the earmarking, or exportation of gold, and these withdrawals have not been offset by the reserve system. In addition to that the system has sold $150,000,000 of Government obligations. That is a total of about $300,000,000 out of the market. In addition there has been a raise in the rediscount rate at all of the Federal reserve banks during the last three months. There has been some contraction of credit and money rates have firmed somewhat.

Senator GLASS. Why should not the rediscount rates be raised in all the Federal districts? Are there not differing conditions in the various Federal reserve districts?

Mr. YOUNG. I am not a believer in the uniformity of the rediscount rate at all times and under all conditions at all of the Federal reserve banks. The fact that the rate is now 4 per cent at all the banks comes about as the result of the action of their directors.

Senator GLASS. Does not that come about because the directors have been taught to believe that the Federal Reserve Board here at Washington has established the policy of uniform rediscount rates throughout the United States?

Mr. YOUNG. Well, I would be very sorry, Senator, if they did have that feeling. I can see why they possibly might have felt that way, but I think that at the present time the directors of the Federal Reserve banks do not have that feeling.

Senator GLASS. I can readily see how a rediscount rate on the Atlantic coast, in Boston, New York, and perhaps at Philadelphia might have some reflex influence on foreign exchange, and how it might have an influence on the general credit system in European nations; but do you think the rediscount rate at Minneapolis or Dallas or Atlanta could possibly or appreciably affect the foreign situation?

Mr. YOUNG. No, sir; I do not. That is my own opinion, Senator. I think that the fact that there is a uniform rate in the Federal reserve system now of 4 per cent comes about largely because 4 per cent is closer to the normal rate in the interior than a 3½ per cent rate. If the uniform rate idea is to be discontinued in the future, I think we will not see any evidence of that until there is a reduction in rates, and the reduction may come from the east and not from the interior. I am expressing my own opinion, and not necessarily those of my associates.

Senator BROOKHART. What is the effect of this lowering and raising of the discount rate on price levels?

Mr. YOUNG. Oh, that is a big question, Senator. I am not prepared to answer.

Senator GLASS. It is more quickly reflected in call money than it is in ordinary commercial transactions, is it not?

Mr. YOUNG. Yes, sir.

Senator BROOKHART. It is finally reflected everywhere in a general way, is it not?

Mr. YOUNG. If it is continued long enough, Senator.

Senator BROOKHART. Now, Senator Glass suggested that a different rate at Dallas might not have any effect on the whole situation, but it would contribute its little proportion, would it not?

Mr. YOUNG. Under very unusual conditions, it would have a very small effect.

Senator GLASS. Well, does it have a very appreciable effect in the district itself? Do you think the banks generally, where there is an inappreciable change in the rediscount rate in the interior Federal reserve bank, reflect that alteration in their loans to the ordinary customer?

Mr. YOUNG. I do not think so; no.

Senator BROOKHART. Would you not say that this recent raise had caused rates to go up a little?

Mr. YOUNG. I do not think it is the raising of the rediscount rate that brought that about, except the psychological effect it may have on the public. I think it was the actual selling of securities and the contraction of credit that brought the rates up a little.

Senator BROOKHART. It is the psychological effect that puts call money up and down?

Mr. YOUNG. I thought you were speaking of the direct result.

Senator BROOKHART. No; but as soon as a bank has to pay more for rediscount money it will have to get more on its loans to keep even, from their customers?

Mr. YOUNG. That is true, if they can get it, Senator.

Senator GLASS. Well, Governor, when the margin is very great, as it is in some of the Western States, it does not seem to me it has any appreciable effect. If the local maximum discount rate in a given State is 8 per cent and the rediscount rate at the Federal reserve bank is 4 per cent, if the rate is reduced to 3¾, or raised to

$4\frac{1}{4}$, do you think the average banker, authorized by State statute to charge a maximum discount rate of 8 per cent, ever reduces his rate?

Mr. Young. I do not.

Senator Glass. Neither do I. He may do it here and there to a very large borrower to whom an inappreciable change in rate might mean something, but to the average borrower from the bank he does not do it.

Mr. Young. The rate is approximately the same. There are a few cases that you can cite that this man or the other may get a lower rate. But the rate to the farmer, the livestock man, and the ordinary borrower usually is the same rate year in and year out.

Senator Glass. Usually the maximum rate that the State permits.

Mr. Young. Not always.

Senator Glass. Well, I have not seen it differently.

Mr. Young. Well, I was informed on good authority that feeder loans were made in Kansas last year at $5\frac{1}{2}$ and 6 per cent. That was a little under the regular rate. Many of the banks preferred to take that rate on feeder loans than lower rates on call loans, feeling that they had a good loan, and they would rather lend their money to the feeders than on call loans.

Senator Brookhart. Our maximum rate by law is 8 per cent, and I think a little more than half of the banks charge that to the farmers. The farmers always get the worst of it. There are loans in the eastern part of the State which are mostly at 7 per cent, including Cedar Rapids, which has been mentioned. And I have found some loans made as low as 6 per cent on the eastern side of the State, where they do not charge uniformly under the law at all. That is the maximum they can charge by law.

Senator Glass. Well, that is exceptional, because in my intercourse with and observation of banks and bankers I have found that what they call the standard rate of interest is a fetish, and they never abandon it if they can avoid it. Of course, there are exceptional cases where an individual or a concern borrows a great deal of money; he may get some slight concession. But they maintain the standard authorized rate as a general proposition.

The Chairman. Do you not think that is more especially true where the maximum legal rate is more nearly the commercial competitive rate?

Senator Glass. That may be so.

The Chairman. I know in South Dakota we have a similar situation as Iowa. The western part has a higher rate than the eastern part.

Senator Glass. Why is money higher in one part of the State than in the other?

The Chairman. I believe there are two reasons: The deposits in those banks are small; but there is also a big reason in that where the country is sparsely settled, the expenses of handling are large.

Senator Brookhart. On that proposition I want to ask some questions of someone, probably Mr. Platt, of the effect on the Federal reserve system of these interest rates; but I understand Governor Young has been in a very short time with the board. I want to ask questions in connection with why interest is not paid on balances carried with the Federal reserve bank, and its effect on interest rates generally. Would you be able to explain that, Governor?

Mr. YOUNG. Would you be kind enough to repeat that question?

Senator BROOKHART. I say, in answer to the question of why interest is not paid on the reserve balances carried in the Federal reserve bank and the effect on interest rates generally if that were done.

Mr. YOUNG. Well, if the Federal reserve banks paid interest upon deposits they would have to employ much of their reserve funds in the open market to earn sufficient to enable them to pay the interest.

Senator BROOKHART. What effect would that have on the general interest rate?

Mr. YOUNG. It would have the effect, I think, of lowering the rate, creating an unusual and unwarranted expansion of credit throughout the United States. It is hard to tell what it would eventually develop into.

Senator GLASS. Would it not develop into the wreckage of the Federal reserve system very soon?

Mr. YOUNG. I think so, Senator. In other words, you have got to bear in mind that a Federal reserve bank is a reserve bank and not a commercial bank.

Senator BROOKHART. And this redeposit is as much a business as is rediscount, is it not? Naturally and likely a redeposit from one bank into another bank?

Senator GLASS. But the redeposit is with the bank that does a commercial banking business, and not strictly a reserve banking business. It is with the bank that engages in all sort of activities. It is with the bank that is receiving millions of dollars of the deposits, perhaps, from the public which the Federal reserve bank does not receive.

Senator BROOKHART. But it is with a bank that is competing with the commercial banking business.

Senator GLASS. No.

Mr. YOUNG. No; I do not think so.

Senator BROOKHART. Now, the law requires deposits in the Federal reserve members. Of course, there is no interest rate can be paid for the use of those reserves. It permits any surplus funds of the member bank to be deposited in the Federal reserve that wants to do it; but it allows no compensation if it makes such deposit. Under that situation the New York banks have a monopoly, practically, of this redeposit business, except that portion which the law requires to be put into the Federal reserve, and they can take it away from the reserve bank by putting on a very low rate of interest for it. Is not that the situation?

Mr. YOUNG. They can not take anything away from the Federal reserve banks, Senator, that the law requires the member bank to carry with the Federal reserve bank.

Senator BROOKHART. No; but I am complaining now that the law should put all the redeposits into the reserve bank because it is, as Doctor Sprague says, a reserve-bank business.

Senator GLASS. Then do you think the law should also be altered so as to allow the Federal reserve bank to do general commercial business?

Senator BROOKHART. I think one part of the reserve business is to do the big reservoir business, and it does not do its function.

Mr. SPRAGUE. May I answer that question, Mr. Chairman?

The CHAIRMAN. Go ahead.

Mr. SPRAGUE. There are $1,500,000,000, apparently, of balances held with other banks within the reserve banks which might, perhaps, be regarded as additional reserves held by the banks of the country. I take it that the Senator's proposition would be to the effect that these might be transferred to the reserve bank, the reserve bank paying at least the equivalent the existing banks pay, and perhaps to make it certain that they would go there rather than to the New York banks, that that be the only place they could go, but the banks to be allowed 2 per cent, or thereabouts, so that they would lose no money. Now, the banks would have an additional $1,500,000,000, on which they would pay 2 per cent—that is, $30,000,000. That means that it would be necessary for the reserve banks to do about $600,000,000 or $800,000,000 more business in order to pay that interest, since their present earnings are no more than enough to pay their operating expenses and the limited dividends on the stock. The ways in which the reserve banks could use this $600,000,000 or $800,000,000 would be, under the existing law, to buy more acceptances, and buy more Governments. Then you put that money into the market. After it has reached the market the reserve banks would have no more control over it. It would probably drift, in large measure, into brokers' loans, and into other uses which it now finds.

Senator PINE. It is now in the market, is it not?

Mr. SPRAGUE. It is now in the market. You divert it from the banks to the New York banks; they would still——

Senator BROOKHART (interposing). I tell you what I propose to do there, Doctor Sprague. I propose to put the loans on the same ground as the Federal reserve. It would not go into those loans.

Mr. SPRAGUE. You would put it——

Senator GLASS (interposing). How long do you think you would have member banks?

Senator BROOKHART. I should meet that, perhaps, by providing that the State banks should comply with the same rules or be denied the use of the United States mails.

Senator GLASS. You are revolutionizing the entire banking business.

Mr. SPRAGUE. I simply wished to carry it as far as would be necessary, unless there is prohibitive legislation.

Senator BROOKHART. I would concede that unless there is further prohibitive legislation it would do substantially as you say.

Mr. SPRAGUE. Might I suggest then that the transfer to the reserve banks would be surplusage? Why not content yourself by prohibiting these reserve loans?

Senator BROOKHART. I would be glad to get that much. If I could get the committee to report that out I would be glad.

Mr. SPRAGUE. That would be surplusage.

Senator BROOKHART. I would be glad to have the one bank prohibited from paying another bank. I think Senator Glass's course then——

Senator GLASS (interposing). That is the same proposition.

Senator BROOKHART. But Senator Glass's proposition goes further than I do, because that would not permit a sufficient use of this reservoir, which might be legitimate. It would keep the funds at home. Now, here is what I have figured out about the Federal reserve system and what it does now. After all the camouflage, this is what it does: It takes the redeposits and it loans on rediscount when a bank wants to borrow. Those are the only two things that it ought to do. This law, as it stands now, can only meet a part of that business. The doctor says there is $1,500,000,000. I had an idea there was more than that; but that is a vast sum. That business it can not transact under this law, because it can not take anything for it, and the neighbor bank can, and it takes it away from this bank. Now, then, what is its service to the public? The public, in the first place, wants an elastic currency, but that is to enable it to do those two things that are proposed. And then there are the big things, like financing a war, that we need the help of our reservoir. That is all right. But the biggest and most important thing, if it does make a more efficient use of the credit supply of the country, it does it by transferring it from one business to another and from one place to another when needed, and that would have the logical effect of an increased credit supply and would naturally lower the interest rate to the public generally. And if a reserve bank is not going to lower the interest to the public generally, it has no warrant for being created for the public by law. That is my general idea.

Senator GLASS. How can the reserve bank lower the rate in Iowa, where the State legislature says that your discounting bank may charge 8 per cent?

Senator BROOKHART. How does it happen that it is lower in some parts of the State than in others?

The CHAIRMAN. Do you not think it would be better to let the governor go ahead and complete his statement?

Mr. YOUNG. Senator, in reply to your question with regard to commercial loans between January, 1926, and February, 1928, Doctor Goldenweiser furnished the figures that on January 6, 1926, the amount of commercial loans in about 650 weekly reporting member banks amounted to $8,317,000,000. On February 29, 1928—the last date for which figures are available—it amounted to $8,672,000,000. During that time brokers' loans have increased from $3,141,000,000 to $3,722,000,000; but, as I pointed out before, that increase does not come in the bank credit, but in loans by individuals, corporations, and others that make them. The actual figures are, so far as banks are concerned, in January, 1926, they had $2,577,000,000 loans on the call market in New York, brokers' loans, and in February of this year they had $2,573,000,000; in other words, a reduction of $4,000,000 in brokers' loan accounts.

Senator GLASS. That is what I wanted.

Mr. YOUNG. I have consumed a good deal of time, and I want to conclude my remarks in reply to the specific resolution 113, by saying that from all I can observe there has been a tremendous expansion of bank credit in this country, some in brokers' loans and some in other loans at the same time, and I can not discover anywhere where commerce and industry has been denied credit for the benefit of making these brokers' loans. Investment credit has developed in this country at a tremendous pace, and that, no doubt, has resulted in a credit basis that has contributed to the growth in brokers' loans. I am convinced that the rediscount facilities of the system have not been abused to support this expansion. I think it has come about largely by the gold that has come into the country. If there is any action that can be taken to arrest this expansion of credit—the system has already done something by taking $300,000,000 out of the market and raising the rediscount rate.

Now, I am not prepared to say whether the brokers' loans are too high or too low. I do not think anybody else can say so. I am satisfied they are safely and conservatively made.

Senator GLASS. Would you not modify that and say they are safely made?

Mr. YOUNG. Yes; I am, however, speaking from the Federal reserve-bank standpoint. I do not think the Federal reserve should say whether they are too high or too low. Now if there is a further expansion of this brokers' loan account and it gets to the place where it is dangerous and borders on unwarranted speculation, I have enough confidence in the American banking fraternity to believe they can correct that situation themselves. If they can not, however, and it is necessary for them to come to the Federal reserve system, the Federal reserve system has still got the corrective measures I have mentioned. My conclusion is that there is no constructive legislation that I can recommend to this committee at the present time.

The CHAIRMAN. Does that conclude your statement?

Mr. YOUNG. That concludes my statement.

The CHAIRMAN. Is there any other member of your board that wants to say something?

Mr. YOUNG. They are all here. Mr. Platt is here, and so are Mr. Cunningham and Mr. Hamlin.

The CHAIRMAN. Is there any member of the board here that can throw any light on the subject? If so, we will continue a while.

STATEMENT OF EDMUND PLATT, VICE GOVERNOR FEDERAL RESERVE BOARD, WASHINGTON, D. C.

Mr. PLATT. It seems to me, Mr. Chairman, it has been very fully covered. Just two or three things occur to me, not as remedies, but in the line of legislation that might in the long run be a little helpful.

In the first place credit has expanded very greatly because of the growth of time deposits, over which we have no control whatever. They have grown very much faster than demand deposists. Demand deposists are presumably purchasing power for commodities rather than for securities, whereas time deposits are purchasing power which naturally goes into securities or into long-term investments. Through the fact that the Federal reserve system provides a 3 per cent reserve for time deposits, and a varying reserve for demand deposits according to the size of the town, 7 per cent in country banks, 10 per cent in reserve cities, and 13 per cent in New York and Chicago the banks are supposed to have purposely shifted into time deposits so as to take advantage of the lower reserve. I do not think that can be demonstrated. I do not think you can figure how they could make it profitable with the interest paid on time deposits. Up in my territory on the Hudson River the banks are now paying 4½ per cent for time deposits. It seems to me an outrageously high rate. How in the world they can get away with it I do not understand, and I have told some of them that they can not make it pay.

The CHAIRMAN. That is more than in the Northwestern States.

Mr. PLATT. More than in North Dakota or South Dakota.

Senator GLASS. The Virginia General Assembly last week put a limitation of 4 per cent on deposits, and I think that is too high.

Mr. PLATT. I think that is too high myself.

Senator BROOKHART. I want to commend the Virginia General Assembly for exercising their right and power there in doing that.

The CHAIRMAN. What is their legal rate of interest?

Senator GLASS. Six per cent.

Mr. PLATT. In upstate New York they started to pay 4½ per cent themselves because the mutual savings banks pay it. And in New England something over one-third of the mutual savings banks pay 5 per cent. I think 68 out of one hundred and sixty-something—is that right, Professor Sprague?

Professor SPRAGUE. Yes.

Senator GLASS. Mutual savings banks are cooperative investment associations.

Mr. PLATT. Mutual banks are cooperative investment associations, and they have no stockholders, and their depositors are entitled to everything they can make. And furthermore they are limited as to the amount of deposit they can take from one person. In New York State they can not pay interest on more than $7,500, unless the sum in addition to that has been accumulated out of interest that has been added. In my old home town we have a mutual savings bank with $19,000,000 deposits in a city of 35,000 people, paying 4½ per cent, and the average account is about $600. No interest is paid on amounts above $7,500. But in some parts of the country commercial banks pay interest on what they call savings deposits amounting to $50,000 and $100,000. I talked with a banker not long ago who said that he was paying 4 per cent interest I think on one account of $100,000 put in his bank by a corporation. And they call it savings.

Now what I think might be somewhat helpful is that either Congress might give us some more accurate definition of what should be regarded as savings, or give the Federal Reserve Board authority by regulation to prescribe what should be regarded as savings or time deposits. At the present time we feel doubtful whether we have got quite authority to say that a savings account should be an account on which no checks can be drawn. There are in some places savings accounts on which checks are drawn outside and come into the bank through a clearing house. They do not require a pass book to be presented in all cases. We tried to enforce a regulation that pass books must be presented. But our counsel thinks we have not quite got authority to describe definitely that savings accounts shall not be subject to check. It would be some help, not immediate, of course, if we could have some little more authority on that line, or if the act could define savings more fully.

And then there is the matter of the redeposit of one bank in another with relation to the reserve requirements. At the present time New York and Chicago keep a 13 per cent reserve on the deposits of other banks and on all deposits except their time deposits, and time deposits do not figure largely in New York. They keep the 13 per cent of reserve on nearly everything. But there are cities of considerable size, like Providence, R. I., Hartford, Conn., Newark, N. J., and I could mention a good many western towns, that are not reserve cities, where they do have bankers' deposits to some extent on which they only keep 7 per cent reserve. Obviously they are likely to have more surplus funds to throw into the New York market with these redeposits on a 7 per cent reserve than if they had to keep 13 per cent, and where redeposits are made they ought to be made mostly in reserve cities or central reserve cities. They ought not to be made in small banks that often can not loan them locally. So it would be some advantage, probably, if we could have a requirement of 13 per cent reserve on bankers' deposits wherever located.

Then there is one other little item which I might perhaps mention. It seems to me that a whole lot of money is thrown into the investment market all the time by the rather unnecessarily rapid payment of the public debt, and if the Congress could pass some kind of a tax reduction bill and leave in the hands of the public a little more purchasing power instead of bringing it to the Treasury and having it paid out to bondholders who must necessarily reinvest it, that would tend possibly to more moderation in speculation.

I do not say that the present situation is dangerous. I do not believe anybody can tell whether it is or not definitely. I do think that the rate of increase in brokers' loans that was going on in January was enough to make people do some thinking. And as you know, as the governor has pointed out, the board has undertaken to test the market a little. I think that is about all we can do, to test and see whether it is all due to cheap money, or whether there are some other underlying reasons for it.

The CHAIRMAN. Do you feel that this condition that developed in New York led to an inflation where they were paying extremely high prices for those securities?

Mr. PLATT. Well, it is pretty hard to say. Some of them are so high that I do not think I would like to buy them at present prices.

The CHAIRMAN. If evils have developed this may be one of them—the fact that it tends to an absolute inflation.

Mr. PLATT. It looks as if it was an inflation in the price of securities. On the other hand I do not believe anybody can positively and definitely say that a security like United States Steel, for instance, should not sell on a 5 per cent basis. At 140, paying 7 per cent it sells on a 5 per cent basis. Now, maybe we have recovered from the war sufficiently to warrant being on a 5 per cent basis. I do not know. I do not see how anybody could tell. I doubt it myself, but maybe we have. With all the saving of capital that Professor Sprague has told you about and everything, maybe there is so much capital seeking investment that securities that appear to be reasonably sound, with a future prospect perhaps ought to sell on a 5 per cent or even a 4½ per cent basis. I do not see how anybody can tell positively.

Senator GLASS. Do you think that bets are always made with reference to the soundness of the security?

Mr. PLATT. Not always; but I think that is pretty generally true with relation to the higher grade ones—such securities, for instance, as the investment trusts all buy. There is another thing injected into the situation. We have had a tremendous growth in investment trusts lately by which the smaller investor can put in a thousand dollars and have his investment scattered among such stock as American Telephone and Telegraph, United States Steel, etc. His thousand dollars are spread among the whole lot of them so there is not very much risk of loss in the long run.

Senator GLASS. I have in mind just a single security right now among many others that occupy a similar position. It was quoted in last January at 108¼. There has been no change in the management of the corporation, there has been no approximate increase or diminution in the supply and sale of the product. The same security is selling on the market, or was yesterday, at 69.

Mr. PLATT. It was selling at 108?

Senator GLASS. It was selling at 108 in January. It was selling on the market yesterday at 69. Now, what is that but gambling?

Mr. PLATT. I should think that came pretty close to gambling.

The CHAIRMAN. Unless they had a treasury default in the meantime.

Senator GLASS. No; there has been no default at all.

Mr. PLATT. But take a security like the Southern Railway, for instance, that was selling a few years ago at 30 or 40. Now, it is selling at 140, somewhere near there.

Senator GLASS. Well, is it not a common thing to note that more shares of a given corporation are sold in one day than are outstanding?

Mr. PLATT. Yes; I have heard that stated. But, of course, some corporations like the Southern Railway are gradually being improved. They are spending their money in building up the track, in new equipment, etc., and after a while it is bound to show in the price of the shares. As Professor Sprague pointed out this morning the stock market is much broader than it used to be years ago. Not everything is up. The oil stocks, for instance, are down on account of overproduction in oil, and until recently the copper stocks were down. The fertilizer stocks are all down, mostly. Some things are down and some things are up. I think Mr. Lombard, who represents Professor Fisher, once tried to tell me that stock did not go up or down anyhow; that when one thing went up something else went down. I do not think that is true. The whole list goes up sometimes.

Senator BROOKHART. Let me suggest a proposition to you. I recently checked the following companies: Allis Chalmers Manufacturing Co., American Smelting & Refining Co., the Bethlehem Steel Co., Grain Products Refining Co., E. I. du Pont de Nemours, Fleischmann & Co., General Motors Corporation, General Electric Co., National Biscuit Co., North American Co., United States Steel Corporation, United States Smelting & Refining & Manufacturing Co., Youngstown Sheet & Tube Co., and from Poor's Manual I ascertained that the earnings in 1927 declined an average of 11 per cent. That is the net earnings of all those companies.

Mr. PLATT. That is a pretty good list of companies.

Senator BROOKHART. A pretty good list. But the stock values increased an average of 27 per cent.

Mr. PLATT. Well, that looks unwarranted, and yet I do not know those companies well enough to know, but I think the dividends they are paying are pretty well buttressed in most of them, even at the reduced earnings. And, of course, the public that buys them thinks that the earnings are coming back again, which they probably will for some of them.

Senator BROOKHART. But it is a gamble on whether they will or not all the time.

Mr. PLATT. Yes. Well, a good many other businesses are more or less of a gamble.

Senator BROOKHART. I want to inquire something about this power that the Federal Reserve Board has in reference to discount rates. I am not particularly concerned whether it is the central board or the local boards. My view is the general power. What effect does raising and lowering the discount rate have on prices generally?

Mr. PLATT. I do not believe it has much. That is something that Representative Strong of the House is trying to make us admit, that it has some effect. He wants to have the system managed primarily to control the general price level.

Senator BROOKHART. Well, if you raise the discount rate to 7 per cent that would raise interest rates, would it not?

Mr. PLATT. Yes, I should think it would.

Senator BROOKHART. There is not any doubt about that.

Mr. PLATT. Practically, but if we should do that arbitrarily it would not do anything at all but throw——

Senator GLASS. It would stop business.

Mr. PLATT. It would stop Federal reserve business. It would not stop other banks. It would put our rates out of line.

Senator GLASS. Well, I mean it would stop Federal reserve business.

Mr. PLATT. Yes.

Senator BROOKHART. And raising of the iterest rates means a lowering of prices.

Mr. PLATT. That is the theory of Professor Fisher and some other people, but I do not believe that it necessarily follows.

Senator BROOKHART. Well, as far as the land is concerned there would be no doubt about it, would there?

Mr. PLATT. Arbitrary raising of rates?

Senator BROOKHART. Well, any raising of rates, whether it is arbitrary or not, the higher the interest rates the lower the prices of the land?

Mr. PLATT. The Federal reserve system's power to raise or lower interest rates, the rates average borrowers pay, is pretty limited. Unless there is a big volume of borrowing at the Federal reserve banks, what we might do in raising or lowering the rates would not have much effect.

Senator BROOKHART. But would not the raising by you of the discount rate raise interest rates?

Professor SPRAGUE. If you raise the rate of discount of Federal reserve banks to 5 per cent, in so far as that might in the long run affect the volume of credit available, it would affect prices. But the consequence of it, in fact, in this situation would be in the first place a speedy liquidation of rediscounts at reserve banks, and withdrawal of American balances held in London and New York with imports of gold, until in no short period of time the banks, quite independently of the reserve banks, with the reserve banks doing no business whatever——

Senator GLASS. Exactly.

Professor SPRAGUE (continuing). Would have available the means of extending as large a volume of credit as they are extending, and in those circumstances there would be no permanent effect on prices.

Mr. PLATT. I think that is absolutely true.

Professor SPRAGUE. On the other hand if the member banks were heavily indebted to the reserve banks, and had no balances abroad, and you raised the discount rates, that would lead in a short period of time to a contraction of credit in the country itself, with nothing to replace it coming in from the outside, and prices would be reduced. But at the present time it is impossible for the Federal reserve banks greatly to reduce the volume of credit. They could increase it by enlarging the earning assets, but they could not diminish it except very, very temporarily, because there are hundreds of millions of American balances invested abroad that would be brought back to this country in the form of gold, creating the reserves for additional loans for the member banks.

Mr. PLATT. That narrows our field of operation considerably.

Senator BROOKHART. The immediate effect, though, even under the professor's statement, is to affect prices either higher or lower, depending on which way you go with this rate, and then he figures out circumstances which might finally bring us back to the former level. But so far as the economic effect of the reserve-bank action, it is to raise or lower the prices?

Mr. PLATT. I do not admit that it would have any appreciable effect under the present circumstances at all.

Senator GLASS. Well, as a matter of fact, under varying conditions it has different effects. For example, the raising or lowering of the rediscount rate in the Minneapolis district has an inappreciable affect there because the member banks there do not rediscount. It does not bother them the least in the world. The first effect of the raising of a rediscount rate by a given Federal reserve bank is to somewhat diminish the rediscount operations of the member banks of the district.

Mr. PLATT. Yes.

Senator GLASS. In other words, if a member bank had to pay a Federal reserve bank 4 per cent for a rediscount rather than 3½ per cent it will do less discounting; is that not the fact?

Mr. PLATT. That is the theory, but the rate is so low in those western banks that according to the testimony of the managers of the western banks, the governors of the banks, it does not make any difference on the volume of rediscounts whether the rate is 3½ per cent, 4 per cent or 4½ per cent.

Senator GLASS. Not a bit on earth, because the margin between the maximum and minimum legal rate of interest out there is such that it does not affect it.

Mr. PLATT. In Texas the legal rate of interest is 10 per cent.

Senator GLASS. They offer a premium on rediscounting it. That is why I object to this talk about a uniform rate of interest. Why should you offer some bank in some part of the country a premium, a fortune on rediscounting?

Mr. PLATT. Well, the difficulty is the difficulty of administering the reserve banks due to the different classes of banks that we have, the great number of banks that we have, and the fact that some of them are pretty large banks in the cities. For instance, Dallas has some pretty big banks, whereas the west Texas banks are all small. Now it is true that there are some borrowers in Dallas that are big manufacturers, etc., who carry accounts not only in Dallas but in Chicago and in New York, and if they do not get the rate they want in Dallas they will go and borrow in New York. So that to some extent it is difficult to fix a rediscount rate that is related to the big city in which the reserve bank is located and also to the country banks scattered outside. If we had banks with branches it would work differently.

Senator GLASS. Would it be possible or desirable to graduate your rediscount rate according to the rate on discount?

Mr. PLATT. Well, that has been somewhat discussed, mostly with relation to the legal part of it. I think our counsel has said that it might be possible to do that legally, but whether it would be practical or not I do not know. It is pretty hard to find out in the first place just what your member banks are charging their customers on all lines. We ask to have that reported at times and we do make a report of it in our Bulletin. We do not get it on all cases, of course.

Professor SPRAGUE. But might it not be said that it was at least at present unnecessary inasmuch as the banks in Kansas City are borrowing about $10,000,000 and the reserve bank in Kansas City, and in Dallas slightly over $3,000,000, and in Minneapolis slightly under $3,000,000. It is not a problem, because at no rate apparently are these member banks in the interior districts eager to borrow.

Senator GLASS. Well, that is an existing situation.

Professor SPRAGUE. Yes.

The CHAIRMAN. In other words the difference in the rate does not stimulate the business.

Professor SPRAGUE. It does not.

Mr. PLATT. No.

Senator BROOKHART. Now, one of the troubles brought out very clearly is that the legal interest rate is too high in some parts of the country. Now, it seems to me that it is the duty of Congress, when it establishes a banking system, to see that those legal interest rates are not too high in any part of the country.

Senator GLASS. That is the business of your State legislature in Iowa.

Senator BROOKHART. It is so far as the State banks are concerned, but it is the business of Congress so far as the national banks are concerned.

Senator GLASS. Well, but a national bank is not permitted to charge a greater discount rate than a State bank, the legal rate in the State.

Senator BROOKHART. All right, if a State bank is permitted to charge too high a rate Congress is under no obligation whatever to follow that high rate.

Senator GLASS. Yes; it is. If there was a uniform banking system throughout the country, if it was purely a national banking system, there would be some substance to an argument of that sort, but there is a dual system.

Senator BROOKHART. There was a time when the Congress legislated with respect to the State banks of issue, but it has not gone far enough in this national bank system to do justice yet to all parts of the country, and it could easily establish a rate and compel, by taxation or denying the mails, the State banks to comply.

Senator GLASS. Yes; but it could not compel people to take out national bank charters, and if you ever did that they would take out State bank charters, and the national banks would disappear.

Senator BROOKHART. Not if the State banks would have to comply with the same rules. I want to ask Mr. Platt about this question of lowering the rate. I think that is the big function of the bank, and I have here Questions and Answers on the Federal Reserve System, and question 170 on page 135 is:

Why is interest not paid on reserve balance carried with the Federal reserve bank?

And here is the answer:

Because it is wrong in principle and would defeat one of the most important objects for which the Federal reserve system was established, namely, "to afford means of rediscounting commercial paper." If a Federal reserve bank were compelled to use at all times a large percentage of its resources to purchase paper in the open market for the purpose of earning interest to be paid to member banks on their reserve deposits, it is manifest that this would absorb funds to such a degree as to leave it without adequate resources to meet the needs of its member banks in case of sudden emergency or for heavy seasonal requirements.

I want to ask in reference to that answer if those assets would be as basis for issuing Federal reserve notes to meet those sudden emergencies or heavy seasonal requirements?

Senator GLASS. Issue them upon what?

Senator BROOKHART. Upon this money that was invested.

Senator GLASS. Just issue fiat money?

Senator BROOKHART. No, issue the money that is provided by law.

Mr. PLATT. Not as the act stands now, because all we can do is buy Government securities or acceptances, and we can not issue Federal reserve notes on Government securities.

Senator BROOKHART. The notes are not issued on Government securities.

Mr. PLATT. Not on purchased securities. And there is a pretty definite limit on the amount of Government securities we can purchase because of that fact. Every once in a while it has happened within the past few years that we have had to shift from the Federal reserve bank at St. Louis, perhaps, or Minneapolis, some Government securities to New York and take acceptances for them in order that they would have security on which to issue notes.

Senator BROOKHART. Well, that is what I want to get, your authority, what you can invest these funds in, and how much of them are based on the Federal reserve notes?

Senator GLASS. Only commercial transactions in gold are the basis of issuance of Federal reserve notes, and to the extent that the Federal reserve banks have purchased these 2 per cent bonds that authorize circulation.

Senator BROOKHART. Yes.

Senator GLASS. I do not imagine that is a very extensive asset of the Federal reserve bank.

Mr. PLATT. No. Practically none.

Senator GLASS. What?

Mr. PLATT. I think they hold practically none of the 2 per cent bonds now. They have held some in times past.

Senator BROOKHART. What is there you could invest those funds in that would be a basis of the Federal reserve notes? Supposing that the Federal reserve banks had deposited in them the money that is now deposited in the corresponding banks, and suppose you pay interest on what is deposited, and then invested enough to earn that interest, say 2 per cent. You would have to invest around half of it to get the money.

Mr. PLATT. Well, I have not made a calculation, but about all we could do, unless the member banks wanted to borrow, would be to buy Government securities. And we could not issue Federal reserve notes against those.

Senator BROOKHART. You could not issue Federal reserve notes against those?

Mr. PLATT. No.

Senator GLASS. In other words, you would transform the Federal reserve system into an investment system.

Mr. PLATT. Yes. We might exhaust our reserves after a while.

Senator BROOKHART. Now, they say in the next paragraph in answer to that:

> Moreover, even if this were not the case, member banks would probably lose far more than they would gain if Federal reserve banks should pay them interest on their reserve deposits. The reserve deposits held by all Federal reserve banks amount to, approximately, $2,200,000,000. The payment of interest at 2 per cent on this amount would require the Federal reserve banks to keep invested at all times at least $1,100,000,000 at 4 per cent for this purpose. If this sum were invested by the reserve banks in Government securities, it would not only dissipate the reserves as above specified but would have the effect of increasing the supply of credit to such an extent as to force down interest rates.

Now, that is what I want the reserve system to do, to bring down those interest rates.

Mr. PLATT. Where would it bring them down first? Right in New York City?

Senator BROOKHART. Well, if it reaches the farmers finally, why, I would not care.

Mr. PLATT. I do not know that anybody could be sure that it would.

Senator GLASS. You never are going to reach any Iowa farmers unless you get the State legislatures to reduce the rate.

Professor SPRAGUE. Senator, if you did that there are $1,200,000,000 of additional reserve money. On that basis by conservative calculation the member banks could expand their own credit by from six to ten billions of dollars, which would result without any question in inflation of prices.

Senator BROOKHART. That would reduce the interest rates some more.

Senator GLASS. Yes.

Senator BROOKHART. So I would not object to that.

Senator GLASS. But that would increase prices.

The CHAIRMAN. Now, are we not getting away from this bill? We are getting onto the Brookhart banking bill and getting away from the La Follette resolution.

Senator BROOKHART. That is a part of the resolution as far as that is concerned.

The CHAIRMAN. Let us not string it out too long and get away from the subject.

Senator BROOKHART (continuing reading):

If the amount were used in the open market in the purchase of bankers' acceptances and bills of exchange—

Are those the basis of Federal reserve notes?

Mr. PLATT. Yes; but there are not half enough of them in existence to invest that money.

Senator BROOKHART (continuing reading):

It would come in direct competition with member banks and by increasing the supply of credit would likewise tend to force down interest rates under ordinary conditions, * * *.

Mr. PLATT. Those particular answers are not those of the Federal Reserve Board. I do not particularly stand by them.

Senator GLASS. But they are pretty sensible answers, all the same.

Senator BROOKHART. They sound to me like they hit the facts all right.

Mr. PLATT. But let me say this, Senator. The operation of the Federal reserve system does tend to some extent to reduce interest rates, and it has had that effect. Now interest rates have gone down, and that is one reason why, as Professor Sprague said this morning, securities have gone up. Interest rates generally have gone down, and the country banks themselves complain that they can not make a living out of lower interest rates. How can a bank with deposits of $200,000 make money out of lending money at 5 per cent. It can not be done.

Senator GLASS. Let me ask you this question, Mr. Platt: How many of the great banks in New York, or in the East, or in the West either for that matter—in Chicago, St. Louis, Kansas City, or San Francisco—would think of remaining in the Federal reserve system if the Federal reserve system chose to take in a billion and one-half of bank deposits and pay interest on them and use that billion and one-half dollars in open-market operations in competition with its own members?

Mr. PLATT. None of them would.

Senator GLASS. Of course, they would not stay in 24 hours.

Mr. PLATT. No.

Senator BROOKHART. Well, now, the same competition exists on the rediscount side of the business, does it not?

Mr. PLATT. Well, to some extent it does, and yet the banks that do the rediscounting, the big corresponding banks that rediscount for country banks, also rediscount with the Federal reserve bank.

Senator BROOKHART. Yes; they do that, but that means that the Federal reserve bank has gone into competition with its members in rediscounting paper all over the country.

Mr. PLATT. I do not think they regard it so.

Senator BROOKHART. And is there not about as much and maybe more paper rediscounted from one member bank to another, or rather from one bank to another, than there is in the Federal reserve right now?

Mr. PLATT. I do not believe we have any figures on that, but I imagine that is true.

Senator BROOKHART. Yes.

Senator GLASS. Well, not available paper, I would not say. As a matter of fact where your New York bank or any other big bank in a central reserve city does rediscount it is because it has got its country correspondents fooled into the belief that they have to do the rediscounting there in order to get accommodations when they are in trouble, when they do not have to do anything of the kind.

Mr. PLATT. I recently talked with an up-State New York banker who had a $25,000 bank with a surplus of $75,000, a pretty good sized country bank, who told me he was borrowing $100,000 from the Chase National Bank in New York. I asked him why he did not borrow from the Federal reserve. He said he could borrow from the Chase National Bank at the same rate, sometimes a little higher, but the point is he borrows on railroad bonds or something else that he can not borrow on from the Federal reserve.

Senator GLASS. As I say, on available paper.

Mr. PLATT. And he keeps his bonds on deposit with the Chase National Bank, and he telephones down to them and says, "Put $50,000 to my credit" or $100,000. And besides that, the city banks buy theater tickets and entertain the country correspondents in various ways when they come into town, which we are not authorized to do.

Senator BROOKHART. Well, so far as the authority is concerned, we are talking about remedying the thing, and if it needed more authority, that could easily be given so you could do what a member bank could do.

Senator GLASS. Would it go to theater tickets?

Mr. PLATT. We are getting pretty far afield.

The CHAIRMAN. Yes; we are getting pretty far afield. Let us get back and hold to the subject closely or else we will never get through.

Mr. PLATT. I do not believe you can prevent brokers from getting loans somewhere or other. Great increases have been shown by individuals outside of the banks.

Senator BROOKHART. The only point was Senator Glass's suggestion that this great competition with member banks would prevent you from doing this thing, and that would prevent us from having a reserve bank at all.

Senator GLASS. No; you would not have any member banks or you would not have any Federal reserve banks.

Senator BROOKHART. Before this Federal reserve system, all this was done by banks that are now members of the reserve, so that argument would not apply. If it is a better way to handle this reserve business in a reserve bank than in individual banks, it ought to be done, or that is my opinion.

Mr. PLATT. Well, but the reserve banks are made for the legal reserves, for what is supposed to be necessary to set aside to meet extraordinary demands, and to take care of the regular turnover. Now, if the banks have got surplus money above that, there does not seem to be any reason why that should also be in the reserve banks because it is not reserve in the primary sense. It is a secondary reserve, perhaps, but there is no reason why the Federal reserve banks should be converted into corresponding banks themselves just because the banks have surplus funds.

Senator BROOKHART. But they are converted into corresponding banks on the rediscount side of the business.

Mr. PLATT. No.

Senator BROOKHART. That was always done by corresponding banks before the Federal reserve, and we took it away from the member banks when we created this.

Senator GLASS. Yes; because the reserves were pyramided and finally drawn into the maelstrom of speculation so that when the interior banks wanted their money they could not get it and a panic would ensue.

Senator BROOKHART. Supposing we would prohibit by law a member bank from making these speculative loans on the same terms that you are prohibited from rediscounting them in the Federal reserve, what do you say about that?

Mr. PLATT. Well, in the first place, I do not believe you can do it, because it would destroy the safest loans the banks make and throw that business into the hands of private banking or corporations. That is to say, I think it is undoubtedly true that such loans to some extent have got to be made in order to have a market.

Senator BROOKHART. Well, we have plenty of power to reach the private banking and prevent them from doing it, too.

Mr. PLATT. I do not believe you have. Perhaps the State of New York could reach the private bankers, but I do not believe Congress can.

Senator BROOKHART. Well, Congress did do it in the old days when we had the banks of issue.

Mr. PLATT. But they were incorporated banks.

Senator BROOKHART. Yes; but there is not any difference in the authority whether it is incorporated or individual.

Mr. PLATT. Well, could you prevent the Canadian Bank of Commerce and the Bank of Montreal, for instance, from making loans in the stock market in New York?

Senator BROOKHART. Well, that would be perfectly easy. They are foreigners and we could do most anything we pleased about that.

Mr. PLATT. Well, you would shut the money out from coming into the United States; possibly you could do that.

Senator BROOKHART. Well, we are sending billions of it out of the United States, so I do not apprehend that would hurt us any.

Senator GLASS. Well, I am afraid if you were to pass a law prohibiting member banks of the Federal reserve system from making brokers' loans, the State banks would pretty soon have a monopoly of the system, and in a little while you would not have any member banks of the Federal reserve system.

Senator BROOKHART. I concede that, too, Senator, unless we put a restriction that would reach the State banks, too. But I think that could be worked out. Now, how about if we would prohibit one bank from depositing in another bank?

Mr. PLATT. I think that would probably bring about something that has been more or less of a hobby of mine, and probably would force branch banking pretty fast. You would have one system of banks all over the country, so you would not need to redeposit. Banks do not redeposit in Canada.

Senator PINE. You favor branch banking, do you?

Mr. PLATT. Not to that extent. I favor limited branch banking sufficient to strengthen the country banks a little and make them larger and give them better management.

Senator PINE. It also works in the way of taking money out of the country, does it not, and concentrating it all in one place?

Mr. PLATT. No; I do not believe banks take money out of a high-rate territory and lend in a low-rate territory if they can lend in the high-rate territory.

Senator PINE. Does it not have that effect in Canada?

Mr. PLATT. No; I think it has the opposite effect. Money is cheaper in up-State New York than it is in eastern Canada. In my own home town, we have got a surplus of money that we can not possibly loan in the neighborhood, but in Canada when they have a surplus of funds in the eastern towns, it can be loaned out in Saskatchewan. We can not lend our money from a Hudson River town in Oklahoma. If we could we might try it.

Senator PINE. I know a man that wanted a loan at Medicine Hat; he had to go to Montreal to get it.

Mr. PLATT. He must have wanted a large amount.

Senator PINE. He did.

Mr. PLATT. The managers have full authority to make small loans without reference.

Senator PINE. The agent could take in the money at Medicine Hat, but he could not put it out at Medicine Hat.

Mr. PLATT. I was not alluding to large amounts. But that is the same way with our system. One of our little banks with $25,000 capital can not lend more than $2,500 to one person under the law.

Senator PINE. To get back to the subject, I know of a bank in Oklahoma, and this is typical, where the deposits amount to three-quarters of a million dollars. The bank is in a country town, and that bank is lending only $42,000 to the local people. It has $130,000 in call loans, $200,000 and a little over invested in commercial paper, and the balance in bonds.

Mr. PLATT. An over-conservative diversification.

Senator PINE. As I view it that bank is not serving that community as a bank. As I view it that bank is a liability to the community in which it is located.

Senator GLASS. You would like to have some stock in it, would you not?

Mr. PLATT. That is according to whether there is a demand for money there. Governor Young can tell you about a man in Montana, I think, who came out there and established a bank and gave out that he was not going to make any local loans, or pay any interest on deposits, and he got $300,000 or $400,000 deposits right away. Am I correct, Governor?

Mr. YOUNG. Well, he got much more than that. That was really an extreme case.

Mr. PLATT. Yes; people were looking for safety on deposits.

Senator PINE. That bank is a liability to the community. The depositors in that community would be in better shape if the depositors took the money and put it in tin cans and buried it out in the orchard, from the standpoint of the community. Now, I feel that the Federal Reserve Board and those who have authority, who are in control of our banking system, are responsible for that condition.

In 1920 that bank had two hundred and some thousand dollars loaned to local people. When the board started its deflation policy it began calling those loans.

Mr. PLATT. Oh, no; we never called them.

Senator PINE. Well, I am connected with a little bank, and I know that the examiners did call the loans.

Mr. PLATT. Well, that belonged to the comptroller. We had no connection with that.

Senator PINE. But you started the deflation policy, inaugurated the deflation policy.

Mr. PLATT. That is a long story.

Senator PINE. Well, I have read the minutes, and Governor Harding said that the problem, as he viewed it, was to restrict credit and increase protection, particularly on the farms, and to the extent that the Federal Reserve Board accomplished that they are responsible for the farm problem.

Senator GLASS. Oh, well, now, Governor Harding has said something more. You omitted some part of what he said. He said restrict credits for luxuries and things of that sort.

Mr. PLATT. Speculation.

Senator GLASS. Yes.

Senator PINE. But this policy has produced this surplus of funds in my State.

Mr. PLATT. Well, why do not your people want to borrow?

Senator PINE. They have been compelled to pay the loss that they had at that time at the inopportune time. They have been compelled to sacrifice their property in order to pay these loans, and having been burnt once they are out of the market. They are not borrowing.

Senator GLASS. Compelled by whom, Senator?

Senator PINE. Compelled by the banking system of the United States.

Senator BROOKHART. I think I can give you a particular illustration of that.

Senator PINE. By those in control of the banking system.

Senator BROOKHART. This meeting that we are talking about was held on May 18, 1920.

Senator GLASS. Yes; and its real import has been perverted by you more than anything that I know of whatsoever.

Senator BROOKHART. Well, I am ready to meet the Senator on that at any time.

Senator GLASS. Well, I am ready to meet you at any time you want to on that proposition.

Senator BROOKHART. And in October, 1920, the Federal Reserve Board of Chicago held four——

Senator GLASS. Hold on. Let us get to this secret meeting now. When was it held?

Senator BROOKHART. On May 18, 1920.

Senator GLASS. What was the volume of outstanding credit in currency in the Federal reserve banking system six months thereafter—eight months thereafter?

Senator BROOKHART. Of course, I am familiar with that.

Senator GLASS. Oh, yes; you are familiar with that, but you do not make anybody else familiar with it when you are asking the question. No; you do not.

Senator BROOKHART. Yes.

Senator GLASS. As a matter of fact, eight months after that meeting the volume outstanding of Federal reserve notes was greater than it ever was theretofore or ever has been since.

Senator BROOKHART. Yes; I know who got the money.

Senator GLASS. And not only that, but eight months thereafter the credits of the Federal reserve banks, the combined Federal reserve banking system, were higher than they ever were theretofore or ever have been since.

Mr. PLATT. That is true.

The CHAIRMAN. Now, that is deflation.

Senator BROOKHART. That is because the big fellows were able to get the vast sums.

Senator GLASS. That is simply because there was no deflation. It was inflation.

The CHAIRMAN. Governor Platt, if you are through we will close. If you want to go ahead, we will go ahead.

Mr. PLATT. I think I have said everything that I have to say.

Senator BROOKHART. I want to get this in the record.

Senator GLASS. Well, I thought we would have a hearing here on Senator La Follette's resolution.

The CHAIRMAN. We have got to change our methods. We can not call a witness and let the Senate committee do all the testifying. If we do, we will have to let all the witnesses go home.

Senator BROOKHART. Here is what was said at that meeting. I did not raise the question. I want this for the record.

Senator GLASS. Who did?

Senator BROOKHART. Well, I do not know whether you did or not, Senator.

Senator GLASS. Well, you know you did.

Senator BROOKHART. But Mr. McKay, representing the Chicago branch of the Federal Reserve Board, came out in Iowa and held four public meetings. That was in October. This secret meeting—the only part of this meeting that was secret was about raising the discount rate. The general deflation policy was published.

Senator GLASS. There was not any part of it secret, and that meeting could not have raised the rediscount rate to save its life under the law.

Senator BROOKHART. Well, let us see what Governor Harding said; the last thing he said:

> I would suggest, gentlemen, that you be careful not to give out anything about any discussion of discount rates. That is one thing there ought not to be any previous discussion about, because it disturbs everybody, and if people think rates are going to be advanced, there will be an immediate rush to get into the banks before the rates are put up, and the policy of the reserve board is that that is one thing we never discuss with the newspaper man. If he comes in and wants to know if the board has considered any rates, or is likely to do anything about any rates, some remark is made about the weather, or something else, and we tell him we can not discuss rates at all, and I think we are all agreed it would be very ill-advised to give out any impression that any general overruling of rates was discussed at this conference.

Senator GLASS. And as a matter of fact, no bank official on earth ever made a wiser suggestion. Never. The idea of a director of a bank giving out to the public that 60 days hence or 30 days hence the discount rate of this bank will increase to such an extent, when as a matter of fact when that date should arrive they would not have any funds in the bank to lend to anybody.

Senator BROOKHART. Armour & Co. found out about it, though, some way, because Armour's banker was in the meeting, and immediately they went out for a $60,000,000 loan and they got it. They sold the paper all over Iowa.

Senator GLASS. Was there any raise or rediscount discussed at this meeting?

Senator BROOKHART. No; but it was raised shortly thereafter.

Senator GLASS. No. There were two raises. There were raises at three Federal reserves, possibly four, not in excess, and two of them had been raised before that meeting, and that meeting had no more lawful right to raise a rediscount rate of a Federal reserve bank than you have, not a bit. And it did not either.

Senator BROOKHART. Some day I am going to discuss with you all that was said here, but I want to finish this meeting.

The CHAIRMAN. Go ahead.

Senator BROOKHART. On October 7 four meetings were held. I was at the last one at Ottumwa, Iowa. And Mr. Cunningham, of the Federal Reserve Board, was there. And Mr. McKay said to us in substance there that time that "Your allotment of Federal reserve loans to Iowa is $36,000,000. But we have loaned you $91,000,000. That is $55,000,000 more than your allotment, and the time has come now when the people who are entitled to this credit"——

Senator GLASS. The difference between what, is it?

Senator BROOKHART. Between $36,000,000 and $91,000,000; $55,000,000 is the way I have got it in mind. "And the time has come when the people who are entitled to this credit want it, and so you will have to sell some of these crops and reduce these loans." Now, about that time I got into the game and I asked him who made this allotment, and he did not know. And I have never been able to find out.

But here was a representative direct from the Federal Reserve Board in Chicago, claiming it had been made, and we had a crop in Iowa at the prices then prevailing that was worth more than a billion dollars, and a credit allotment of $36,000,000 for the whole State in the Federal reserve, and calling our loans from $91,000,000 down to $36,000,000. That was arbitrary. Now, that did not relate to the discount rate at all. That was simply arbitrary. And the result was the banks called in the farmers—they did it all over the State—and they said, "You have got to reduce these loans," and they forced them to reduce them, and they forced them to dump their profits on the market, and there never was such a panic in farm prices in all the history of agriculture. Corn went down from $1.75 to 30 cents a bushel. It cost more to produce than any crop ever produced in the country. And everything else went down in proportion. Now, then, that is the way it was worked out out in our country. Sixty-five per cent of all the cause of our trouble is due to that deflation policy that was put on us.

I do not think that the administration of the Federal Reserve Board now is to blame for this accumulation of credit—of speculative credit in New York. I think it is due to this provision of the law that does not let them do the redeposit reserve bank business. But I do think that policy of deflation was wrong back there in 1920. That broke our credit and destroyed our values, and everything, that deflation did. And we have not got back; and we have not started back. We are still down at the bottom, practically where we were in 1920.

Senator GLASS. Well, as a matter of fact, does not the Senator know that the Chicago bank did not raise its rediscount rate? It was not one of the banks that raised its rates at all.

Senator BROOKHART. This rediscount business did not bring about the deflation.

Senator GLASS. The Chicago bank did not raise its rediscount rate.

Senator BROOKHART. But they came out there and said, "You have got to pay your loans."

Senator GLASS. The bank said that?

Senator BROOKHART. McKay, of the Federal Reserve Board of Chicago.

Senator GLASS. Well, I would like to hear Mr. McKay's explanation of that.

Senator BROOKHART. Well, Mr. Cunningham, who is now a member of the Federal Reserve Board, was at that meeting, and he knows what I have said is true about it.

Here is what Governor Harding said in that meeting, page 8 of the proceedings:

> Thus the directors of the Federal reserve banks are clearly within their rights when they say to any member bank, "You have gone far enough; we are familiar with your condition; you have got more than your share, and we want you to reduce; we can not let you have any more."

That is what they said to us: "$91,000,000 is $55,000,000 more than your share, and you have got to reduce."

Senator GLASS. Lend me that. Why do you not read all that Governor Harding said? He said particularly that you cattle dealers in that western part of the country should be taken care of, and if there were any Federal reserve banks in all that section of the country which had not ample means of its own to take care of the cattle raisers of the country they should rediscount with some other Federal reserve bank that did have the means. Why do you not give the whole story?

Senator BROOKHART. That applies to the range cattle and not the cattle feeders in Iowa.

Mr. PLATT. We were doing that, Senator. That money that was loaned by the Chicago bank was borrowed from Boston, Philadelphia, and Cleveland, very largely.

Senator BROOKHART. Which?

Mr. PLATT. The money that was being loaned in Iowa at that time.

Senator BROOKHART. Well, I do not care where it came from. It was no excessive loan for the value of our crop. There was no need of calling it.

Mr. PLATT. Well, of course I can not say about that. I do not think it was definitely called. Certainly no one had such authority from the Reserve Board.

Senator GLASS. The State of Iowa got four times greater volume of rediscounts in that postwar period than all of the national banks in the United States combined got three months before the panic in 1907.

Mr. PLATT. I think that is true.

Senator GLASS. That is what it did. That is what the Federal reserve system did for the country.

Senator BROOKHART. The loans were not being called right after the meeting of May 18. There was nothing to be done then. And after deciding on the inflation policy——

Senator GLASS. Which they did not do.

Senator BROOKHART. A lot of big fellows were getting big loans. Sinclair got a $46,000,000 loan. A good part of Armour's $60,000,000 paper was sold by the banks all over Iowa. And they did not know this McKay was going to come out there in the fall and call these loans, or anything of the kind. Swift got a $50,000,000 loan.

Mr. PLATT. Those loans were sold through brokers, were they not? Armour's, I understood, were.

Senator BROOKHART. No; they were sold through banks. That is in our country. They sent them out to the corresponding banks. The Continental & Commercial National Bank sent them out. They said "Here is a good thing." They paid 8 per cent to get that money. "Here is a good thing, take it," and the banks took it. And Armour soon had his $60,000,000 loan. Henry Ford, however, could not get a loan.

Mr. PLATT. I think those Armour loans are all brokers' notes sold by Armour to note brokers and by them to various banks.

The CHAIRMAN. It is getting close to 4.30, and Mr. Cunningham would like to be heard. Let us proceed with the business of the committee. Do you want to be heard, Governor Hamlin?

Mr. HAMLIN. Mr. Chairman, I think this matter has been gone into so carefully that I really have nothing to add to the governor's testimony.

STATEMENT OF E. H. CUNNINGHAM, FEDERAL RESERVE BOARD

Mr. CUNNINGHAM. Mr. Chairman, I can not help but feel that you have had considerable information given to you and a lot of ancient history recited.

Senator GLASS. A lot of ancient fiction recited, not the ancient history.

Mr. CUNNINGHAM. Well, Senator, I hope I will not be drawn into that controversy. I was through some of those meetings and understand some of the things that took place; but I do not want to be drawn into that controversy at this time.

Up to yesterday I think the feeling in the board was that we would come over here and present ourselves and offer any information or testimony we could on this resolution that is before the committee. And after Mr. Sprague had notified us that he was going to be heard, or we heard that he was going to be heard, I thought probably that the hearing would be so lengthy that possibly we would not all be heard, so I prepared just a brief statement on the present resolution, and if it is proper I will just file that statement, Mr. Chairman. I will read it or I will file it, and you can read it at your leisure.

Senator BROOKHART. Will you read it?

Mr. CUNNINGHAM. It does not go into the details about this question. Understand, gentlemen of the committee, that I am not an economist, and I must look at all these propositions from the standpoint of cold-blooded business. I have been a farmer and I am a farmer now. The only home I have got is on a farm, and I understand, of course, considerable of the conditions that have existed in Iowa and exist there at this time. And I would indorse the idea that any reduction in interest rates that is to come to the man that is rediscounting through the small banks in Iowa will eventually come from his State legislature.

Senator GLASS. Yes.

Senator BROOKHART. Well, in my part of the State he generally pays 7, but there is a provision in the note that there is 8 per cent on default of interest.

Mr. CUNNINGHAM. Not all of them.

Senator GLASS. You ought to spread yourself all over the State so that it would be uniform—7 per cent.

Senator BROOKHART. Well, I would be perfectly willing for the Senator to come out to help me to get that legislation to do it, but I think the Congress ought to make its own national bank rules.

Senator GLASS. It does. It says no national bank in Iowa shall charge more than the State's legal rate of interest.

Senator BROOKHART. Yes; but if Mr. Cunningham's statement is correct that is too high. It ought to be reduced.

Senator GLASS. Yes; I think it is too high.

Senator BROOKHART. And Congress is not doing its duty when it fails to reduce it on the national banks.

Senator GLASS. Go ahead, Mr. Cunningham. I beg your pardon.

Mr. CUNNINGHAM. In view of the present status of the so-called brokers' loans account, it is indeed proper and timely that the subject matter of the La Follette resolution have full consideration.

There can be no doubt but what Congress, at the time it had under consideration the bill creating the Federal reserve act, intended to so draft the measure as to prevent, so far as possible, Federal reserve credit being used in support of stock-exchange loans. However, it is evident that the method by which the member banks in the Federal reserve system obtain advances or are privileged to rediscount eligible paper in order to reestablish their deficient reserve accounts, follows a procedure which is in a measure responsible for at least a portion of the credit obtained by such member banks from the Federal reserve banks of their district being used for investment in so-called brokers' loans.

The total amount of brokers' loans at this time is approximately 6½ per cent of the total credit availability of the country.

In 1914 the total credit availability in this country was approximately $20,000,000,000, and the so-called stock exchange loan account at that time has been estimated at approximately $1,000,000,000. While at this time the total credit availability of the country is approximately $54,000,000,000, and the so-called brokers' loans account totals $3,750,000,000.

While I personally do not think that the use of credit for investment in brokers' loans, which are secured by stocks and bonds of an investment nature, has been, or is at this time, so great in amount as to in any way restrict the availability of credit for the needs of agriculture, industry, or commerce, I do feel, however, that the rapid increase of the past three years in the use of credit for speculative purposes is a tendency in the wrong direction. Credit used for such purposes is a part of the credit availability of the country, and, in the event that the credit supply should become curtailed or limited the amount invested in stock loans will naturally have the effect of limiting credit availability, and might possibly, if some measure of control is not provided, reach such proportions as to seriously embarrass the credit requirements of business and commerce.

I do not feel that the Federal Reserve Board should undertake to dictate as to what use the member banks shall make of their own resources; and I take the liberty of suggesting that if this investigation should determine that too great an amount of Federal reserve credit is finding its way into investments which are specifically excluded from eligibility for rediscount or purchase by Federal reserve banks, that any recommendations or amendments seeking to remedy such a condition be most carefully considered; in order to avoid the possibility of complications arising which might be so detrimental in their effect as to more than offset any benefits derived from the change.

That is as brief as I could make it and make a statement on the subject.

The CHAIRMAN. Thank you.

Mr. CUNNINGHAM. If there are any questions, why I will answer them if I can.

The CHAIRMAN. That will conclude our hearing for to-day. It is 20 minutes to 5 now. We will adjourn subject to the call of the chairman.

(Whereupon, at 4.40 p. m., Wednesday, March 7, 1928, the hearings were adjourned subject to the call of the chairman.)