September 23, 1940

To: Board of Governors

From: E. A. Goldenweiser

Subject: Advisory Council's statement on easy money.

There is transmitted herewith a draft of a reply to the Federal Advisory Council's statement of May 20, 1940 on the question of the easy money policy. In addition to the proposed statement there are also attached for the convenience of the Board extracts from official Board publications indicating the positions taken at different periods in the past. There are also attached references to letters and testimony on proposals relating to the Farm Credit Administration, to the Home Loan Bank System, and to silver legislation.

E. A. Goldenweiser

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ADVISORY COUNCIL STATEMENT ON EASY MONEY

(Draft of reply)

In connection with the statement submitted on May 20, 1940 by the Federal Advisory Council on the subject of easy money policy, the Board would like to review its own record in this matter.

One of the difficulties of discussing the easy money policy of recent years and a cause of much confusion is the somewhat loose way in which the phrases "easy money" or "monetary ease" have been used. There are at least three different implications in the phrase "easy money", all of which are sometimes in the minds of persons discussing the subject. First, is the concept of abundance of funds available for lending and investing, second, is the establishment and maintenance of low money rates, and third, the problem of the possible injurious credit expansion or inflation which may be caused by over-abundance of money and by excessively low interest rates.

These three points of view overlap and are not always clearly distinguished.

Availability of funds for lending and for investment

In the Board's usage the term monetary ease as descriptive of credit policy has been employed primarily to denote availability of funds to banks for lending and for investment. A review of the Board's Annual Reports shows clearly that this is the phase of the policy on which the greatest emphasis has been laid. In the autumn of 1929, when the policy began, it was adopted in an emergency for the purpose of enabling New York banks, without having to borrow

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heavily from the Federal Reserve banks, to take over the large volume of security loans previously made by nonbanking lenders. The stock market had collapsed, corporate lenders had withdrawn their funds, there was a frantic liquidation of security loans, and the banks were obliged, in the interest of protecting the money market, to take over these loans. In their efforts to do that they were supported by the Federal Reserve System which placed funds at their disposal both through the purchase of United States Government securities and of acceptances and through the reduction in discount rates which had been raised during the preceding period of speculative expansion.

From the autumn of 1929 to the autumn of 1933 the Federal Reserve System purchased additional Government securities, primarily for the purpose of enabling the banks to meet more or less continuous and large-scale withdrawals of gold for export and of currency for hoarding and at the same time to reduce their indebtedness at the Reserve banks.

Chart I shows that up to the autumn of 1933 a large part of the Reserve System purchases of Government securities did not result in an expansion of member bank reserves or excess reserves, but was absorbed by currency and gold withdrawals from the banking system, and by reduction of member bank indebtedness. This was a period of drastic deflation, numerous bank failures, rapid decline in prices and contraction of business activity all along the line. The Federal Reserve System during this period attempted to ease the pressure on the banking system by providing it with funds to meet

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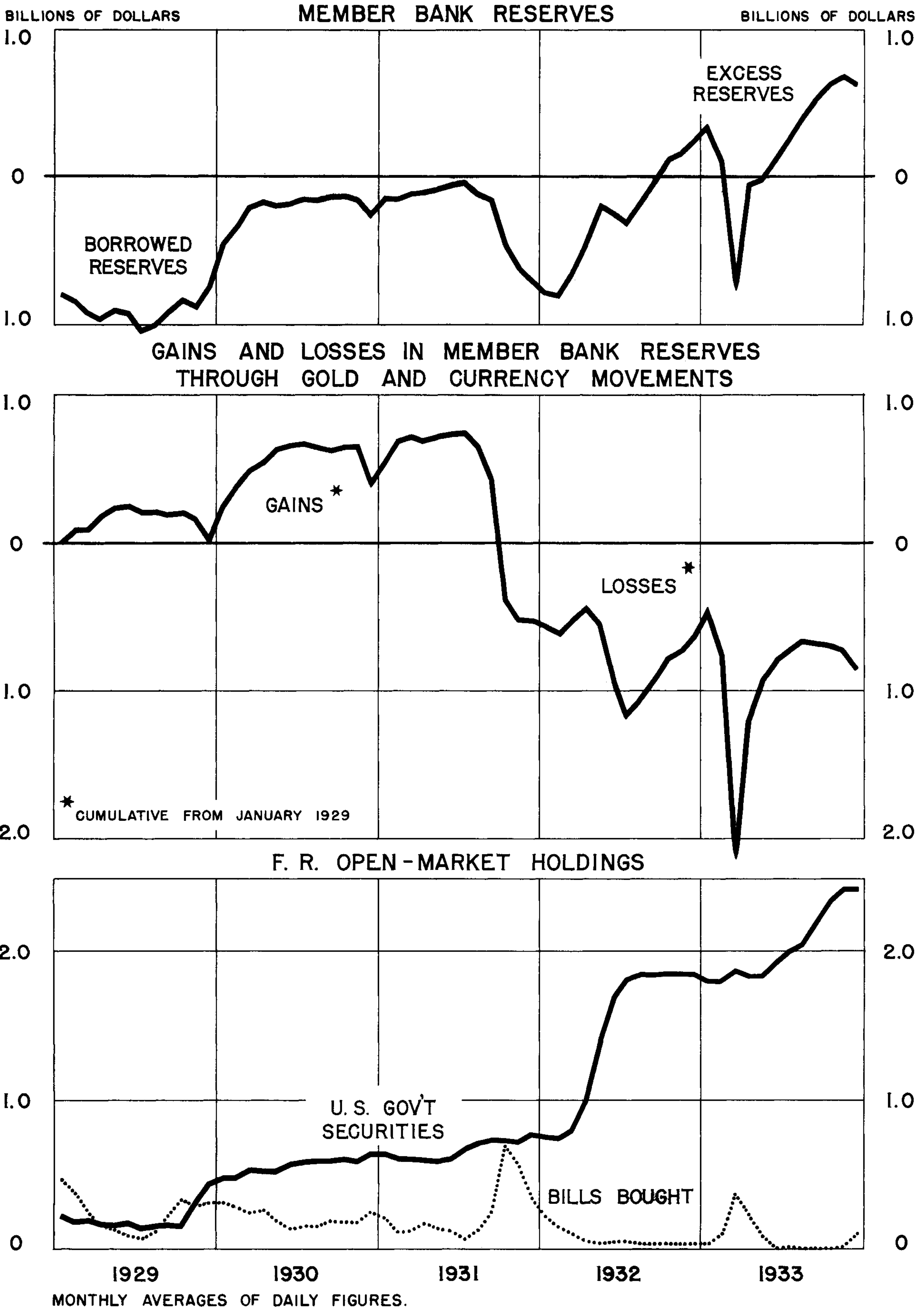
CHART I



MONTHLY AVERAGES OF DAILY FIGURES.

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the demands upon them and thus to help arrest the vicious spiral of deflation. It was not until the spring of 1933 that currency began to flow back to the banks and gold withdrawals were stopped by the Government. By the autumn of that year the banks had accumulated a substantial volume of excess reserves amounting to about $800,000,000. This policy was a factor in the decline of money rates, especially short-term money rates.

From 1933 on the growth in excess reserves was not the outcome of Federal Reserve operations; it was due almost entirely to the inflow of gold from abroad and to a small extent to silver purchases by the Treasury. This is indicated by Chart II. The Federal Reserve System took the position prior to 1936 that, in view of the incompleteness of recovery and the absence of speculative activity or credit expansion, reserves created by the inflow of gold from abroad constituted no immediate danger to the economy.

Decline of money rates

The second concept of easy money, namely, that it means a constant lowering of money rates, or an excessively low level of money rates, has never been an objective of Federal Reserve policy. Federal Reserve policy has been concerned with continued availability of money, particularly of investment money, at reasonable rates rather than with a constant decline of rates to excessively low levels.

Money rates have declined primarily as an incident to the constantly growing pressure of funds in the hands both of bankers and of other investors. Short-term money rates had reached unusually high levels at the end of the speculative boom of 1929 and their rapid decline after that date was a reflec-

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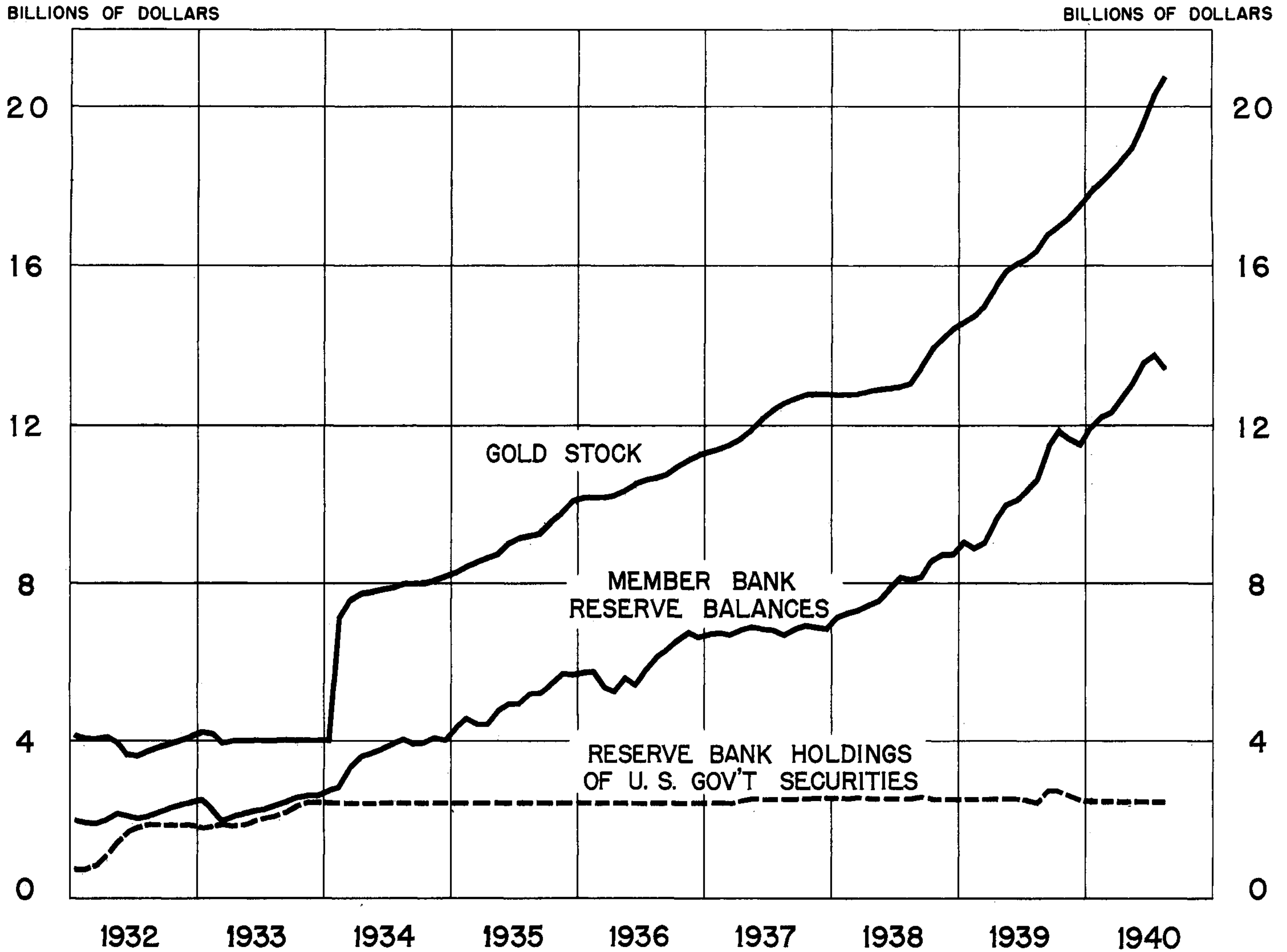
CHART II

SOURCES OF MEMBER BANK RESERVES

MONTHLY AVERAGES OF DAILY FIGURES



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tion of the prooess of deflation through which the country was going. Long-term rates which were at high levels in 1929 did not decline as soon or as rapidly as short-term rates.

While the Federal Reserve System was not actively concerned with money rates it viewed with approval the decline in excessively high rates and particularly the decline in rates on business loans and on long-term money. This decline was caused partly by the general abundance of funds which has already been mentioned and, after 1933, partly by deliberate action of other agencies of the Government, such as the Farm Credit Administration, the Home Owners' Loan Corporation, and the Federal Housing Administration. The first two of these agencies were acting in an emergency to relieve the burden of heavy debt payments on farmers and urban home owners who found themselves saddled with extremely heavy payments while their sources of revenue were drying up. The economic collapse of the country was rapidly making the debtors bankrupt and consequently unable to meet their obligations. Refinancing of farm and urban mortgages by Government agencies not only made the burden of debt more bearable for debtors, but it also protected investors, both banks and others, from loss of principal.

Credit activities of the various Government lending agencies have tended to keep mortgage rates at a lower level than they otherwise would have been, but have not seriously affected short-term rates, which are the ones that are excessively low.

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The Federal Reserve System had no direct connection with this phase of Government policy, but was favorable to its objectives. Even in this field, however, the Board, after the emergency was over, expressed its views that further expansion of credit operations by the Government might interfere with the opportunities for private investment and that excessively low rates, particularly rates fixed by statute or supported by Government subsidy, would not be consistent with the structure of our economy. The Board opposed proposals by the Home Loan Bank Board and by the Farm Credit Administration that would have increased the permanent participation of Government in the field of mortgage financing and would have used a Government subsidy for the purpose of further reducing long-time money rates. Particularly, the Federal Reserve System was opposed to the granting of authority to any of these organizations either to create money themselves or to be given access to Federal Reserve funds without reference to credit policies pursued by the System.

Chart III shows the course of money rates over a period of time and the table at the end of the statement shows different types of interest rates for the years 1929, 1936, and 1940. This material brings out the fact, generally overlooked or ignored, that there has been little decline in money rates since 1936. Furthermore, only short-term open-market rates have declined to excessively low levels. These rates have been too low and the System has recognized this. It was a part of the basis for its action in 1939 allowing all of its holdings of Treasury

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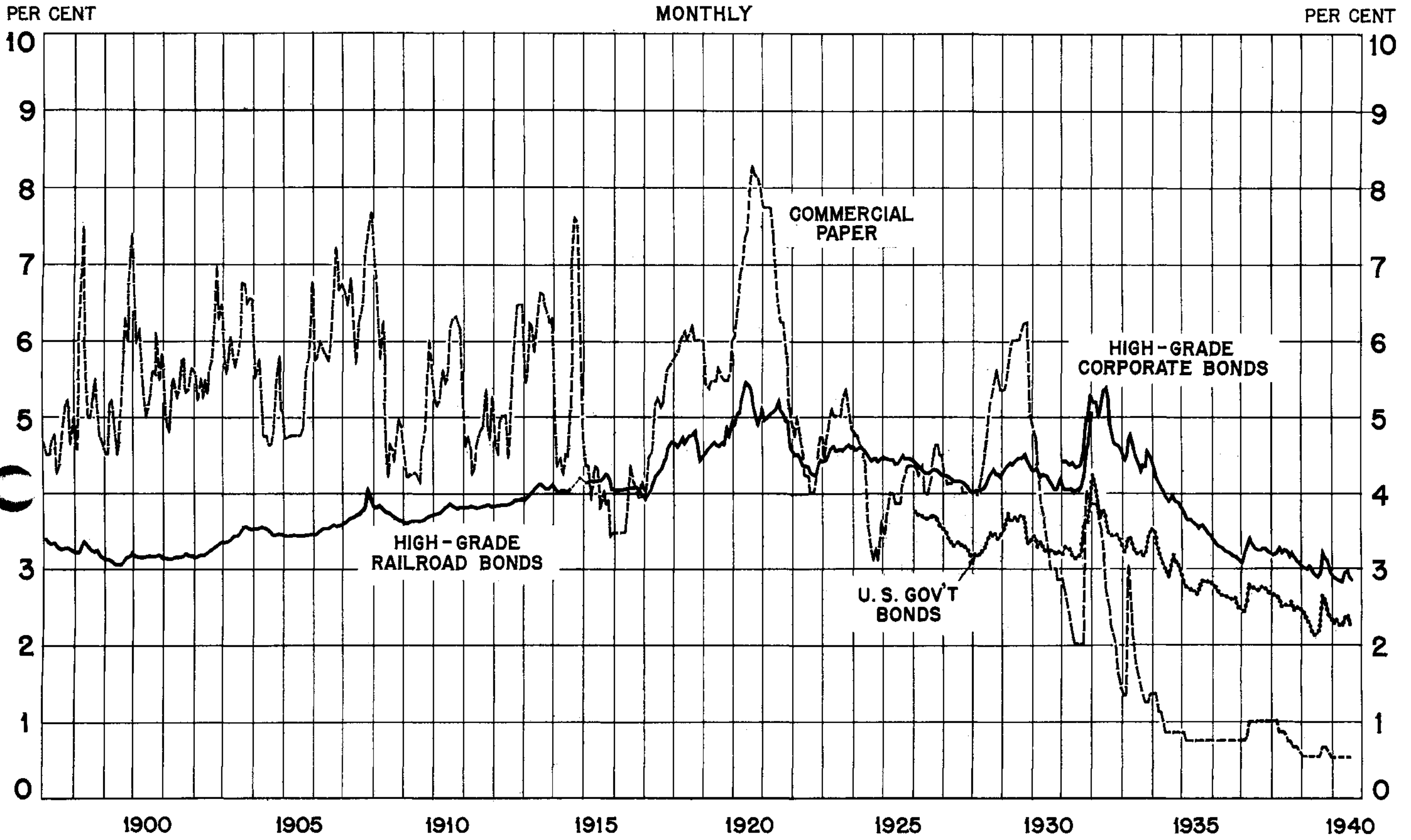
CHART III



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bills to mature without replacement. Rates on bank loans to customers have declined but cannot be considered excessively low. Rates on mortgage loans and even yields on the highest-grade of corporate bonds are at levels which may turn out to be in line with long-term conditions. High-grade corporate bond yields are scarcely lower than in the early years of this century. There is nothing in a 3 per cent return on first-class corporate bonds or a 4 to 5 per cent rate on first class mortgage loans that is inherently contrary to the public interest. A lower level of investment earnings than in the 1920's raises problems for various endowed institutions. These problems may well be a part of the necessary readjustment of the country to the transition from a debtor to a creditor economy, from a scarcity of capital in relation to the demand to an overabundance of savings and investment funds.

Possibility of injurious credit expansion

The third phase of easy money policy, and one to which the Board has continuously paid attention, is the possibility of an excessive or injurious credit expansion based on the available volume of excess reserves. The Board has not been negligent towards its responsibilities in this respect. It was instrumental in suggesting to Congress the necessity of the power to increase reserve requirements of member banks as a means of controlling excessive expansion. A somewhat unworkable provision to that effect was incorporated in the so-called Thomas amendment to the Agricultural Emergency Act of 1933. A perfected and simplified, but more limited, authority was incor-

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porated into the Banking Act of 1935. The Board at that time attempted to have its power over reserves be related to the volume of available excess reserves, but the law as finally enacted limited its power to doubling existing reserve requirements. As is well known, the Board exercised that power by raising reserve requirements in the summer of 1936 and in the spring of 1937. The Board made it plain at the time that the action was a precaution against possible undue credit expansion in the future and that it did not constitute a move in the direction of credit contraction. It was clear that there was at the time no excessive credit expansion or immediate danger of inflation and that the banks would have ample funds for meeting the country's credit needs after reserve requirements had been increased. The Board, however, did at that time clearly indicate its concern about possible uncontrolled expansion in the future.

Aside from actions in its own field, the Board as a body or through its members, has indicated its concern about over-expansion in the future by the Chairman's testimony opposing the purchase of foreign silver and by proposing plans for the prevention of capital movements to this country, which were the principal reason of the inflow of gold.

In its Annual Report for 1938 the Board presented to Congress the problems raised by the large volume of bank reserves, including the factors outside its control, and by the limitations on its power to absorb reserves.

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Federal Reserve policy in recent years has had little to do with the volume of reserves, which has been at all times far beyond the country's needs and far beyond the power of the System to control. System policy in these recent years has been used almost exclusively for the purpose of preventing disorderly conditions in the capital market. On several occasions, notably in the spring of 1937 and in the autumn of 1939, the System purchased Government securities at a time when a wave of panicky selling had developed. The System's view of its responsibilities in the matter was that it should attempt to provide a reasonably stable market at all times and to prevent disorganized conditions.

The System has never considered it its duty to maintain Government security prices at any given level, but merely to prevent too wide and too violent price movements. After substantial purchases in the autumn of 1939, when the shock of war resulted in a selling wave, the System sold substantial amounts of its securities when their price appeared to advance too rapidly.

It may be noted that as a net result of all its operations during 1939, including the liquidation of Treasury bills, purchases of bonds and notes during the war crisis, and the subsequent sales of some of these bonds, the System portfolio was $80,000,000 lower at the end of 1939 than at the beginning.

In the spring of 1938, when the country was going through a serious period of business decline, the System agreed to reduce reserve requirements by one-eighth. This action was not necessitated by credit conditions, but was a part of a general Administration policy of trying to arrest a deflationary movement. From the System point of view there was little to be lost by doing it,

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because the funds were not being used, and the System retained the power of raising requirements again in case undesirable expansion threatened or developed.

Council's statement of causes of easy money

Turning now to the statement that the Council submitted on May 20, it is apparent from the preceding recital of the Board's policy since 1929 that the Council's statement of the causes of easy money is not an accurate portrayal of the Board's position. The Council in general appears to overestimate the powers possessed by the Board and the System.

The listing of the Board's adoption of easy money as a policy and of its continuous advocacy of that policy as the first of the reasons for what the Council considers excessively easy money is misleading in view of the fact that the principal influence for excessively easy money has been the inflow of gold from abroad.

The Council, to be sure, mentions that gold was a dominant influence in the easy money situation but places on the monetary authorities most of the responsibility for the low rates.

The Council gives no indication of the magnitude of this gold problem which, it believes, the authorities should have offset in some manner. As a matter of fact, the total additions to our gold supply, which amounted to about $13,000,000,000 over the past six years, are far in excess of the banks' excess reserves, so that if we had not had the gold we would not only have no excess reserves, but would have a substantial deficiency of reserves.

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The Council gives the impression that the Board has no concern for the problems created by the large volume of excess reserves. The quotation on page 2 of its statement from the 1938 Report of the Board when read carefully shows that what the Board had in mind in its policy was not the encouragement of excessively low money rates, but the availability of adequate funds for the purpose of encouraging the expansion of business. The quotation in the Council's report does not bring out that in the same connection the Board points out the dangers of possible uncontrolled credit expansion on the basis of existing reserves. The pertinent passages are:

> "...Member banks at present have excess reserves of $3,600,000,000, and this total may be doubled in the future. To absorb these reserves the System has the power to raise reserve requirements by $800,000,000 and to make sales out of its portfolio of United States Government obligations, which amounts to $2,560,000,000. The use of these available means of absorbing reserves, to the extent that it may be in the public interest to do so, would still leave the banks with a volume of excess reserves upon which it would be possible for an injurious credit expansion to develop.
>
> "The ability of the banks greatly to expand the volume of their credit without resort to the Federal Reserve banks would make it possible for a speculative situation to get under way that would be beyond the power of the System to check or control. The Reserve System would, therefore, be unable to discharge the responsibility placed upon it by Congress or to perform the service that the country rightly expects from it."

As an incidental remark the Council says it is unhealthy for a central monetary authority to retain as a fixed policy a large volume of Government obligations. There is no argument presented to sustain this position, which appears to the Board to be untenable. The Bank of England, which is the most respected and one of the oldest of central banks, has always kept a large proportion of its assets in the form of Government securities. The Council's

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attitude appears to the Board to arise from a lack of appreciation of the difference between purchases of Government securities by a central bank for the purpose of helping the Government finance its needs and a condition where a central bank as a part of its general credit policy acquires or holds a substantial volume of Government securities. The former course of action usually leads to inflation and is, if not an undesirable policy, certainly a reflection of an undesirable condition. It is an inflationary method for meeting Treasury deficits and has been in general the basis of all violent inflations. There is little relationship, however, between a central bank serving as a main source of a government's current funds and the policy pursued by this System, which has at no time had any reference to assisting the Treasury in its financial needs, and which has been guided entirely by the System's judgment of what would promote orderly market conditions.

There is little to be gained by discussing the Council's statement point by point, as these points have been covered in the preceding paragraphs in what appears to the Board to be a clearer statement of its policies. The rationale of the Board's policy since the beginning of the depression has been explained in this statement and clearly does not correspond to the tone of the Council's remarks, which would imply that the Board was primarily interested in pushing money rates down to excessively low levels without consideration of other elements in the situation.

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Council's recommendations

In making recommendations for action to be taken, the Council's objective is to bring an end to the period of extreme easy money. As already pointed out, extremely low rates exist primarily in the short-term money market. In the Board's opinion an announcement of reversal of policy in order to influence these rates at a time when economic recovery is far from complete would serve no useful purpose. It is far more important to use the System's influence to obtain powers from Congress with which to prevent an injurious credit expansion which might develop when business conditions become favorable to a more complete utilization of existing credit resources.

The Council states that it has no wish to appear to enter into the field of political controversy, but the governmental measures which it lists with disapproval comprise most of the major financial undertakings of the present Administration. The Board does not think that this is an appropriate place nor that it would be feasible to discuss all of the economic and political implications of the various positions taken by the Council such as, for example, its attitude towards Government spending, changing the gold content of the dollar, the practice of sterilizing gold, the silver policy, Government credit agencies, the Johnson Act, the "cash and carry" provisions of the Neutrality Act, the power to issue greenbacks, and the undistributed profits tax. The Council does not mention the tariff, however, which has certainly been an important factor in the gold inflow. These subjects are controversial, and it is not certain that all the members of this Board would take the same view of all of them.

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The Board has made clear on a number of occasions its opinion that monetary action alone cannot bring about business recovery. As a part of its efforts to understand the workings of our economic mechanism and of the way in which its own monetary actions may be either facilitated or fostered by other Government actions, the Board is continuously studying all these problems. It feels free to take positions on these questions within the Government and has often done so, although its positions, taken in conferences, are not always a matter of record. The Board believes that it is neither desirable nor feasible for it to make pronouncement on these matters to the general public. In the absence of specific authority or direction by Congress, the issuing of statements of this kind, which might involve criticism of other branches of the Government, would be inappropriate and would tend to destroy the Board's influence in the Government's councils.

The Council also recommends a reduction in the System's portfolio at the earliest opportunity. It does not indicate the extent of the desired reduction. The Board's view on this matter is that there is no special merit in a reduction of the portfolio in and of itself. It believes that open-market operations should be used in furtherance of a general policy and that at the present time the principal objective is the maintenance of orderly conditions in the market. In the pursuit of this objective the System should be prepared to make such purchases or sales as may serve the purpose. It sees no advantage, however, in trying at all costs to reduce its holdings of Government securities. On the contrary, in the absence of more important considerations,

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it is in the public interest as well as in the interest of the System to keep a substantial portfolio. This is both because such a portfolio provides material for sale when a disorderly advance in security prices may develop and because in the meantime it provides revenue for the Federal Reserve banks. Desire for revenue should never determine System policy, but in the absence of public reasons for depleting its earning assets, the System can best serve the public by preserving its financial independence and its ability to render many valuable services without charge to the business community.

The Council's other recommendations consist largely of suggestions as to the character of advice the System should give the financial branches of the Government. As already stated, the Board and the Federal Open Market Committee frequently take part in formal and informal conferences with other branches of the Government and give such advice as the occasion may demand. The Board is glad to have the expression of the Council's views on some of the matters that may come up at future conferences.

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INTEREST RATES, 1929, 1936, AND 1939

(Annual averages; per cent per annum)

	1929	1936	1939
Open-market short-term rates:			
Prime commercial paper (4-6 mo.)	5.85	0.75	0.59
U. S. Treasury bills (new issues)	1/ 4.42	0.14	0.02
U. S. Treasury notes (3-5 yr.)	--	1.11	0.59
High-grade bond yields:			
U. S. Treasury	3.60	2.65	2.36
Municipal	4.27	3.07	2.76
Corporate (Moody's Aaa)	4.73	3.24	3.01
Bank loan rates:			
Commercial loans of city banks:			
New York City	5.76	1.72	2.07
7 Other Northern and Eastern cities	5.82	3.04	2.87
11 Southern and Western cities	5.93	3.40	3.51
Loans of country national banks:			
Northern and Eastern States	6.1	5.4	2/ 5.2
Southern and Western States	7.1	6.5	2/ 6.2
Lower-grade corporate bond yields (Moody's Baa):			
Industrial	6.02	4.07	4.25
Railroad	5.93	5.55	6.14
Public utility	5.76	4.67	4.50
Farm loan rates: 3/			
Short- and intermediate-term:			
Production credit associations	--	5.00	4.50
Banks for cooperatives	--	2.00-4.00	1.50-4.00
Commodity Credit Corporation	--	4.00	3.00
Mortgages:			
Federal land banks	5.50-6.00	3.50	3.50
Federal Farm Mortgage Corporation	--	5.00	4.00
Large life insurance companies 4/	5/ 5.63	4.84	2/ 4.65
Urban real estate mortgage rates: 3/			
HOLC (home mortgages)	--	5.00	4.50
Insured by FHA (home mortgages)	--	6/ 5.00	6/ 4.50
Large life insurance companies 4/	5/ 5.69	4.67	2/ 4.50

1/ Average yield on 3-6 month Treasury certificates.
2/ Figure for 1938. For banks, available data indicate little change in 1939.
3/ Interest rates in effect at end of year.
4/ Hearings before the Temporary National Economic Committee, 76th Cong., Third Sess., Part 10-A, Feb. 12, 1940. Average contract rate on new mortgages after deduction of any payments out of interest for commissions for acquisitions of mortgages; for farm mortgages as reported by 12 companies, and for urban real estate mortgages, by 24 companies.
5/ Figure for 1932, earlier figures not available.
6/ Maximum rate, excluding insurance premium of 1/2 of one per cent.

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