Confidential

October 7, 1940

ADVISORY COUNCIL STATEMENT ON EASY MONEY

The statement submitted to the Board on May 20, 1940 by the Federal Advisory Council on the subject of easy money can be considered in connection with the answers to four different questions:

(1) What is easy money?

(2) What have been the causes of easy money and how important has been the policy of the Board?

(3) What are the consequences of easy money?

(4) What should be done about easy money?

"What Is Easy Money?"

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 overabundance of money and by excessively low interest rates. These three points of view overlap and are not always clearly distinguished.

The Council in its statement has been concerned almost solely with the second of these points -- low interest rates -- with particular reference to the effect of such rates on lenders and investors. A review of the Board's annual reports shows clearly that the Board's usage of 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. The Board has also been concerned about the problems created by a large volume of excess reserves, and the possibility of injurious credit expansion. The quotation in the Council's statement from the 1938 Annual 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 pointed out thedangers of possible uncontrolled credit expansion on the basis of existing reserves.

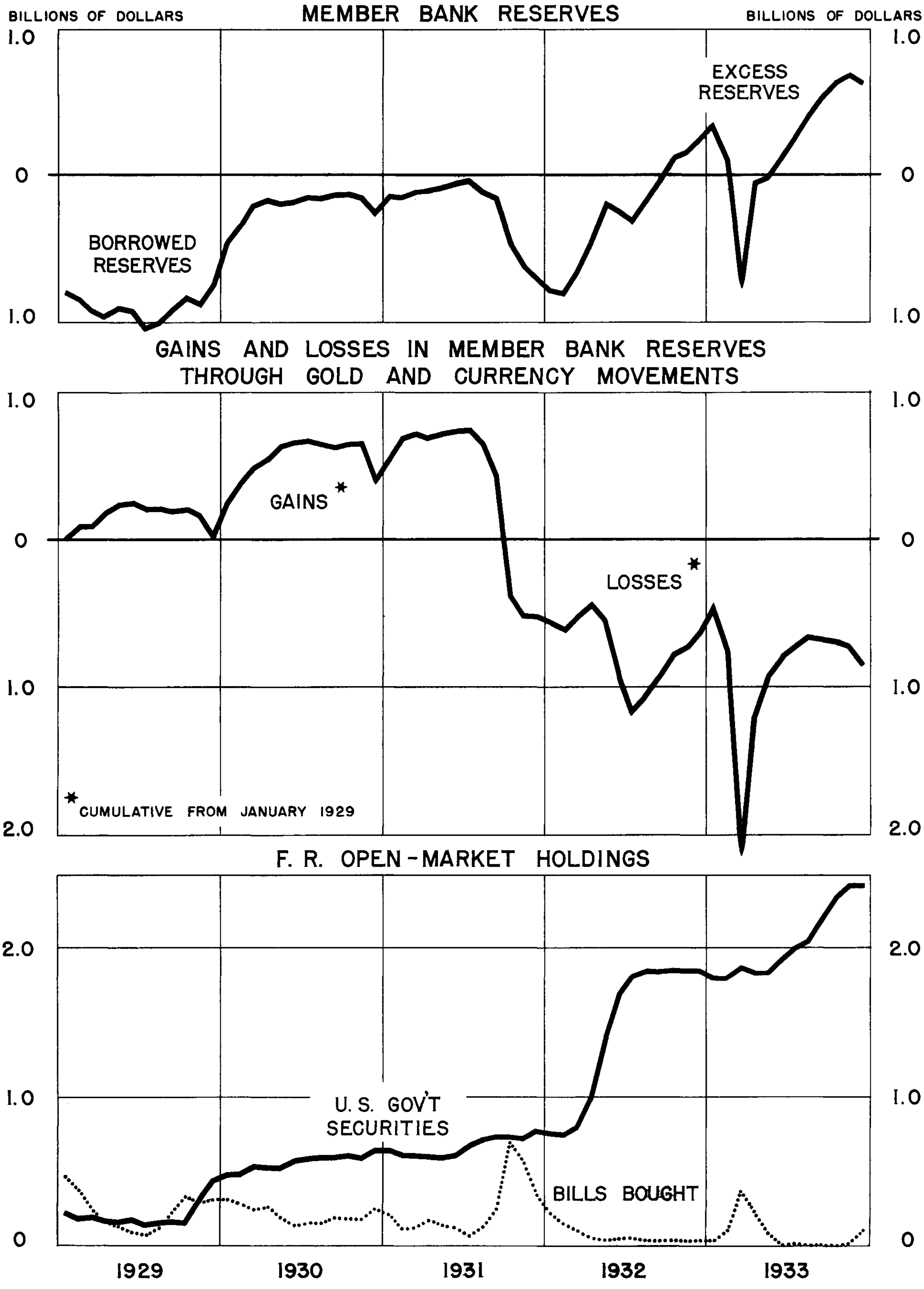
Causes Of Easy Money

The Council's statement implies that Federal Reserve policy has been primarily responsible for easy money. Neither the record of the System nor an analysis of economic events in the period supports the Council's position. Causes of easy money may be considered from two aspects: (a) abundance of loanable funds and (b) low money rates.

Abundance of loanable funds. - The Reserve System supplied funds to the market through substantial open-market purchases in the autumn of 1929, in 1932, and in 1933. The first occasion was to enable New York banks during the stock market crash to take over a large volume of security loans previously made by nonbanking lenders. In 1932 the operations were for the purpose of enabling banks to meet 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. In 1933 the policy was to enable banks to reduce indebtedness and to supply them with reserves for the purpose of facilitating the financing of business recovery and to ease the continued pressure of liquidation. Chart I shows that up to the autumn of 1933 a large part of the Reserve System's 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. By the autumn of 1933 the banks had accumulated what was then a substantial volume of excess reserves, amounting to about $800,000,000.

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 in Chart II. The Federal Reserve System took the position prior to 1936 that in view of the incompleteness of recovery and in the absence of speculative activity or credit expansion reserves created by the inflow of gold from abroad constituted no immediate danger to the economy.

CHART I



MEMBER BANK RESERVES

GAINS AND LOSSES IN MEMBER BANK RESERVES THROUGH GOLD AND CURRENCY MOVEMENTS

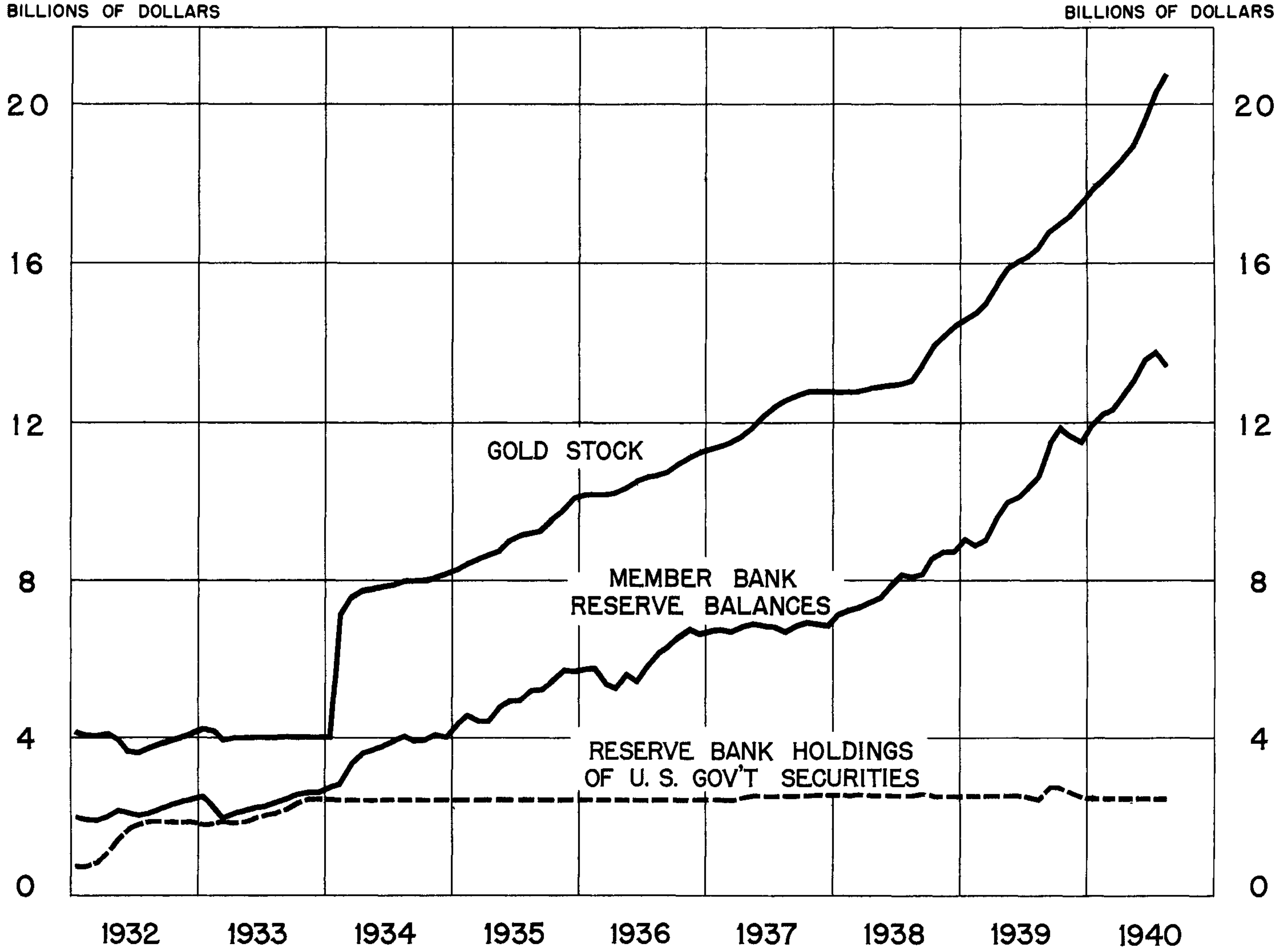
F. R. OPEN-MARKET HOLDINGS

MONTHLY AVERAGES OF DAILY FIGURES.

CHART II

SOURCES OF MEMBER BANK RESERVES

MONTHLY AVERAGES OF DAILY FIGURES



In 1936 and 1937 the Board raised reserve requirements and thus absorbed a large portion of then-existing excess reserves. 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. The System was sympathetic with the objectives of the policy of the Treasury of "sterilizing" gold, inaugurated in December 1936 and discontinued in April 1938. 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 represented the System's participation in a general Administration policy of trying to arrest a deflationary movement. In view of the business situation at the time there was little likelihood of the additional funds being used, and the System retained the power of raising reserve requirements again in case undesirable expansion threatened or developed.

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 exert its influence in the direction of a stable market and should 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. During 1939 the System sold its entire holdings of Treasury bills amounting to $480,000,000 and since the late autumn of 1939 it has sold $155,000,000 of other Government securities. Sales by the System have been arranged with regard for market conditions and it has not reduced its portfolio at times when sales were being made by the Treasury from its accounts. It may be noted that as a net result of all the System's operations since early 1939, including the liquidation of Treasury bills, purchases of bonds and notes during the war crisis, and the subsequent sales of some of these securities, the System portfolio is now $120,000,000 lower than at the beginning of last year.

It is apparent from this brief 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.

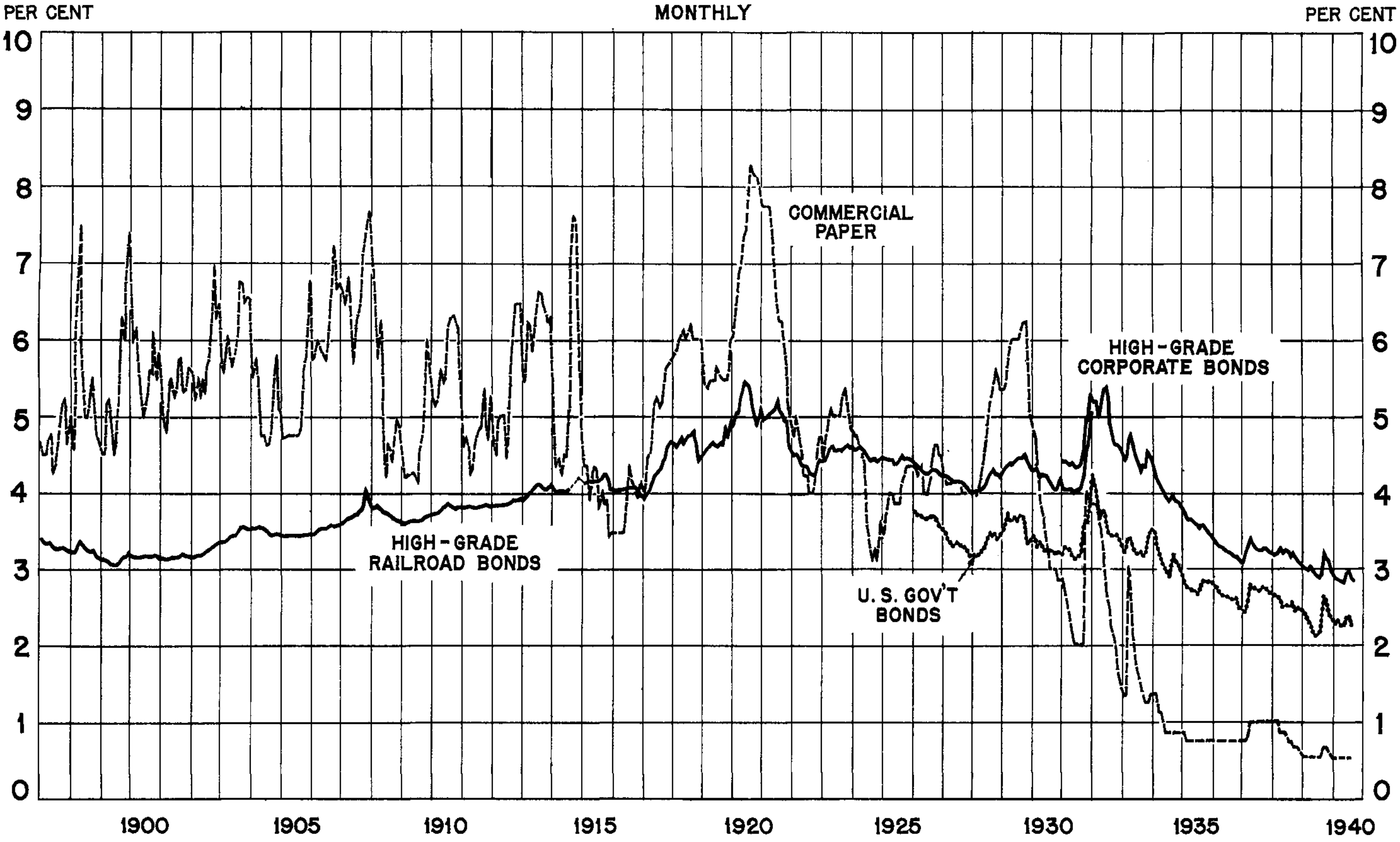
The Council gives no indication of the magnitude of this gold problem which, it believes, the authorities should have offset in some manner. As a matter of fact, the total additions to our gold supply, which amounted to about $13,000,000,000 over the past six years, are far in excess of the banks' excess 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.

Causes of low money rates. - The decline in rates has been an incidental effect of various developments during the period, of which Federal Reserve policy wa s not the most importqnt. There are several aspects of the decline in money rates that should be noted.

(a) The decline has not been continuous. That there has been little further decline in rates since 1936 is a fact that is generally overlooked or ignored. It is evident that short-term money rates can hardly decline lower. Even for high-grade long-term bonds yields are now at a level only slightly below the low reached nearly four years ago. This is illustrated in Chart III which shows the course of money rates over a long period of time.

CHART III

MONEY RATES



(b) Not all money rates can be said to be excessively low. Rates on the general run of business loans, outside of those by large banks to best customers, and rates on mortgages are not low and rates on high grade long-term bonds are little lower than in the period around the turn of the century. The table at the end of this statement shows different types of interest rates for 1929, 1936 and 1940.

(c) There has been a downward tendency in long-term rates in this country since 1920, with interruptions due to special factors. It is to be expected that long-term rates should decline as a result of the readjustment of the country to the transition from a debtor to a creditor economy and from a scarcity of capital in relation to the demand to an overabundance of savings and investment funds.

(d) It is characteristic of any depression period for money rates to decline. This is due primarily to a decrease in the demand for borrowing.

(e) In periods of decline short-term money rates and open-market rates decline further than long-term rates or than rates on the ordinary run of customers' loans. The decline in money rates in the Thirties, particularly in short-term rates, was far greater than in any previous period and also the extremely low level of rates has continued much longer during the recovery period than has been usual in the past.

The continuation of an exceedingly low level of short-term open-market rates is unusual and probably cannot be expected to continue. It is due primarily to the concentration of excess reserves in the hands of banks along with a limited demand for short-term credit on the part of borrowers. In accordance with the standards under which banks operate, established either by law and regulation or by custom and tradition, banks prefer to employ their funds in short-term uses. When banks, therefore, have funds available for investment far in excess of the supply of short-term paper in the market, the level of short-term money rates must inevitably decline. Our whole banking and money market mechanism, with its emphasis on liquidity and its system of correspondent balances, works toward this end. It cannot be changed without fundamental revisions in our banking structure.

The Board would agree with the Council that short-term open-market money rates are unduly low. If economic recovery is attained, however, there should be an increasing demand for funds and a consequent rise in money rates. Those who want higher money rates, therefore, have more to gain by permitting the course of economic recovery to continue than by arbitrary action, which while increasing money rates might in other ways check business recovery.

The Board does not feel that rates on business loans and long-term rates, especially on mortgage money, are excessively low, except perhaps to a small extent rates on the highest grade long-term bonds. Other agencies of the Government, such as the Farm Credit Administration, the Home Owners' Loan Corporation, and the Federal Housing Administration, have been instrumental in relieving the burden of debt on farmers and urban home owners and in bringing about a lower level of rates on mortgages. 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, banks and others, from loss of principal. In this field, the Board, after the emergency in the mortgage market had been relieved, expressed its views that further expansion of direct 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.

The Council implies in its statement that the spending program of the Federal Government has been one of the causes of easy money. The reason it gives for this view is that, because of the necessity to borrow, Federal authorities have been induced to exercise their influence in the direction of keeping interest rates at a minimum. It is true that low money rates have been encouraged by official policy as a means of reducing interest costs, particularly on mortgages and on business borrowing, with the hope that economic recovery might thereby be stimulated. The Treasury has been enabled as a result of easy money conditions to maintain a relatively low interest rate on its growing volume of debt but it has always followed the practice of borrowing at market rates. There is no evidence that the Treasury or the Reserve System has taken action deliberately designed to bring about low money rates for the special benefit of Treasury borrowing. Reserve System policy in this connection, as pointed out, has been directed toward maintaining stability in the Government bond market, but this policy has been followed because of its effect on the general business and credit situation.

Deficit financing has actually operated in the direction of higher rather than lower rates. This has been in part because the Treasury has provided a demand for money which might not otherwise have existed and partly because it has borrowed in money market centers where there has been the greatest plethora of funds and distributed the funds to persons who would spend the money rather than to lenders and investors.

Consequences of Easy Money

Both the Council and the Board have expressed concern about the results of easy money. The Council seems to be concerned primarily with the effect of low money rates upon the income of lenders and investors--banks, insurance companies, endowed institutions, and individual savers. The Board is aware that problems are raised by a lower level of investment earnings and agrees that short-term open-market rates are excessively low. It believes that these rates should rise with improvement in business conditions and an increase in the demand for loanable funds. The lower level of long-term rates, however, as previously pointed out, probably represents a fundamental readjustment in the capital position of the country.

The Council states that the easy money policy has not been effective in stimulating increased borrowing and in bringing about substantial business recovery. The Board is aware that low money rates in themselves cannot bring about business recovery but it recognizes the dangers involved in the adoption of policies designed to bring about a high level of money rates at a time when we have not attained full economic recovery.

A possible consequence of the large volume of excess reserves is the eventual development of an injurious credit expansion. This is a phase of easy money policy to which the Board has continuously paid attention, but is one to which the Council devoted little attention in its statement.

What Should Be Done About Easy Money?

The Board was instrumental in suggesting to Congress the necessity of adequate power to increase reserve requirements of member banks as a means of controlling excessive credit expansion. This power, incorporated in previous legislation in an unworkable form, was perfected and simplified by the Banking Act of 1935 but, because of limits placed upon its use, was not sufficient to absorb the subsequent growth in bank reserves. As is well known, the Board exercised its power by raising reserve requirements in 1936 and 1937.

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

In its Annual Report for 1938 the Board presented to Congress the problem raised by the large volume of bank reserves, including the factors outside its control, and by its limitations on its powers to absorb reserves. It suggested that Congress consider legislation to deal with this situation.

The specific actions suggested by the Council would not solve the problem of excess reserves. In the Board's opinion an announcement of reversal of policy in order to influence the level of money rates at a time when economic recovery is far from complete would be undesirable.

If the System used its remaining powers to absorb reserves -- $1,000,000,000 by increasing reserve requirements to the maximum limit and $2,400,000,000 by selling all the securities in the System portfolio -- excess reserves would be reduced only from $7,000,000,000 to about $3,600,000,000. Banks would still hold more excess reserves than before the first increase in reserve requirements in 1936. This volume will subsequently expand further and the System will be powerless to restrict their use by the banks.

The Board has exerted and will continue to exert its influence with the Treasury and with Congress against increases in reserves from the use of "seigniorage" profits and other funds by the Treasury or from the use by the Treasury of other powers, such as the issue of greenbacks. Essentially, however, these are problems which can be remedied adequately only by action of Congress.

The Council has no specific suggestions which go to the root of the problem of incoming gold. It suggests that plans be considered "on a long-range basis", including "readopting sterilization", "alteration of reserve requirements", and "use of the existing legal powers". In the meantime imports of gold are resulting in steady additions to bank reserves.

In the present world emergency, it is difficult to stop taking gold. We have a favorable trade balance and unless we reduce tariffs and take goods in lieu of gold, the gold imports will continue. At this time with war conditions and with special demands for our products from abroad and curtailment of foreign supplies of many types of products, a tariff reduction would not be particularly effective in changing our trade position.

Nor is it feasible for the Treasury to resume sterilization of gold, as the Council would suggest. Such action would entail increasing the public debt by as many billions as there are excess reserves to be absorbed by this means. It is improbable that Congress, reluctant to increase the debt limit even for the emergency of national defense, would agree to increasing it in order to accomplish what could be done without cost to the Government by the simpler and more familiar process of increasing reserve requirements.

The other alternative which the Board has suggested — that Congress give the Board additional authority to absorb excess reserves by further increases in reserve requirements or some other method — is not mentioned in the Council's statement.

The Council merely suggests that the Board use its existing powers to reduce reserves -- sell its portfolio of securities and increase reserve requirements by the remaining amount permitted by law. As already pointed out such action would not solve the problem of excess reserves. The System, however, is utilizing its opportunities to reduce its portfolio when market conditions justify such action.

In the absence of more important considerations, it is in the public interest as well as in the interest of the System to keep a substantial portfolio. This is primarily because such a portfolio provides material for sale when a disorderly advance in security prices may develop. In the meantime it provides revenue for the Federal Reserve Banks. 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.

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's other recommendations consist largely of suggestions as to the character of advice the System should give the financial branches of the Government. 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 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 public record. In the absence of specific authority or direction by Congress, the issuing of public pronouncements, 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.

It may be said in conclusion that, on the basis of the Council's statement and of the Board's record, the Board and the Council have a common objective -- to remedy a banking situation which has resulted from an extraordinary inflow of gold. The Council describes this situation in terms of an excessively low level of money rates and the Board in terms of a volume of bank reserves far in excess of the country's needs for credit expansion and far in excess of the Board's powers of control. To correct the problem as the Board views it should eventually result in a rise in money rates, the end desired by the Council.

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 mortgagos 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.