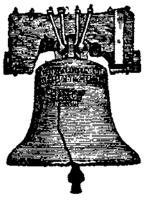
The Functions of the Federal Reserve System

HON. EDMUND PLATT, *Vice-Governor*
FEDERAL RESERVE BOARD



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Following a brief introduction relating to banking conditions in West Virginia, Mr. Platt spoke as follows:

WITHOUT the Federal reserve system, or some similar central banking system, I think we shall all agree, the war could not have been financed on a gold basis, and the system has very properly been described as a wonderful success. It has been ably administered, but we must not forget that the system is still on trial. It has never yet had a chance to function normally and has only within the past year begun to be a determining influence in the stabilization or regulation of credit. The war thrust upon it enormous business, of a kind not contemplated when the Act was passed —a business based not upon self-liquidating commercial paper but upon government bonds, and at rates abnormally low considering the demand. As the Board's last report says "In order that the member banks might carry the burden of undigested Government securities they were obliged to rediscount with the Federal reserve banks and in order that such rediscounting should not involve them in heavy loss it was essential that as long as the banks were lending to bond subscribers at coupon rates the rediscount rate should be related to the bond rates. The rediscount rates of the Federal reserve banks, therefore, instead of being *higher* than the market rates, as in theory and normal practice they should have been, were made *lower* than the market rates." This enforced departure from sound banking principles necessarily led to enormous expansion of credit—or inflation, if you prefer that term, and the problem has been ever since how to get away from it. Of course it is entirely contrary to the principles on which the Federal Reserve Act was founded to make loans on bonds, even if government bonds, at lower rates than on commercial paper, yet in some districts we are still doing it. And indirectly we are issuing currency based upon these bonds, though that was one of the very things the Federal Reserve Act was expected to put a stop to. As much was said in Congress and out, while the Federal reserve bills were under discussion, about providing an elastic currency which would expand and contract in accordance with the demands of business as about any other feature of the bill, and the currency contemplated in the Act was to be issued only upon the rediscounting of short-time paper growing out of actual business transactions, paper that was expected to be self-liquidating when the transactions were completed by the sale of goods. The whole scheme was upset by the flood of government securities, and furthermore central banking principles and practice being unfamiliar to most of our business men and bankers, a great many people got the idea that Federal reserve bank rates should be permanently lower than market rates, so as to make rediscounting attractive and profitable to the member banks and so as to make the borrowing of money for any and all purposes easier, and many also got the idea that Liberty bonds should be carried indefinitely at the coupon rates. It is not necessary for me to say to an audience of bankers that if the Federal reserve system should be conducted in accordance with such ideas the final result would be a crash such as we have never had before in the history of the country. The system contains the possibilities of enormous expansion of credit, as the war financing has demonstrated. It remains to be seen whether it can be brought back to sound normal conditions gradually and without producing any serious hardship.

We are now almost at the peak of the demand for credit and currency caused by the movement of crops, and it is easy to see that the situation might have been serious had there not been a general increase of reserve bank rates beginning about a year ago. There was some grumbling over the increase of rates on "war paper," but it had to be made and in due time should go further, in my opinion, so that there should be at least no preference shown to bond secured paper. The great issues of Liberty bonds are gradually being digested, going into the hands of investors who intend to hold them, and there has been a gradual reduction of loans on "war paper." Apparently about $16,000,000,000 of Liberty bonds and Victory notes have been actually paid for and are out of the banks—a really stupendous achievement, which we would not have thought possible a few years ago. The Comptroller brought this fact out in an address before the Maine Banker's Association in June. According to his figures there remained less than two billions of these securities in the national banks, counting bonds on which the banks were making loans and bonds owned by the banks, and he estimated about an equal amount in the state banks and trust companies. Splendid as the showing of saving and absorption of Liberty bonds has been, however, it must be realized that the four billions left in the banks, together with the Treasury certificates, still cause a very serious displacement of credit, which can only be made good by continued steady saving and investment on the part of the people. The high record of bills discounted based on Government obligations by the 800 reporting member banks was made in June, 1919, $1,438,000,000, and the high mark for the present year was made on January 2nd when these banks had loaned $1,289,000,000. The low mark was August 20th when these loans to individual borrowers on Government paper had declined to $959,000,000, a decrease for this year of $330,000,000. If all banks were included I suppose the decrease would probably be twice that figure, or about $600,000,000, showing what seems to me very gratifying progress in the payment for bonds. Some part of the decline must be due to the reduction of the outstanding Treasury certificates but certificates were largely held by the banks themselves until their interest rates were raised, and have not entered very largely into collateral for loans to individual borrowers from the banks. Federal reserve rediscounts based on war paper reached their high mark on May 16, 1919, at $1,863,476,000 during the Victory Loan campaign. On June 18, 1920, these war paper rediscounts had been reduced to $1,231,841,000 or $631,000,000 less. Since June 18th there has been some natural increase due doubtless to the increased demand for credit as the harvest progressed and the crop moving season advanced. The remarkable thing is that the reduction in war loans has been *very much more than made up in increased loans on commercial paper.* A year ago September 5th, the reserve bank rediscounts on commercial paper were only $212,185,000, about one-eighth of the loans on war paper, which then stood at $1,635,233,000. On September 3, 1920, the commercial paper rediscounts had advanced to $1,412,035,000, or nearly seven times as large as last year at this time, and more than $79,000,000 greater than the rediscounts on war paper, though the latter had increased more than $100,000,000 from the low mark of $1,231,841,000 of June 18th to $1,332,892,000. Commercial paper rediscounts passed the war paper bills in the reserve banks for the first time on July 30th when they reached $1,250,613,000, against $1,241,-017,000 war paper bills. They seesawed afterwards for a few weeks but the commercial bills seem now to have taken the lead permanently. It should be added that the recent increase of a hundred million in war paper loans is probably also to be considered chiefly commercial—bonds merely being used as a convenient collateral.

Although some increase of commercial loans was expected and some increase in the rates of interest was predicted, I do not recall that any banker or financial writer during the year following the conclusion of the war predicted a continuous expansion of credit that would much more than take up the slack created by the payment made to the banks for Government bonds. It was generally expected that rediscounts with the Federal reserve banks would diminish almost if not quite as fast as the bonds and notes of the Government were absorbed by investors.

On the whole, however, the policies of the Federal Reserve Board and of the Federal reserve banks seem to be working well. In the face of an enormous and unprecedented demand for commercial credit the reserves have held pretty steady with only slight declines week by week. There appears to be credit enough for all legitimate demands without encroaching on the legal reserves, but no surplus for speculation, or for profiteering, or for holding any *unusual amount of harvested crops from the market.* Though the percentage of decrease of reserves each week has been in tenths there *has been a steady decrease* each week since July 23rd. It should be remembered that the reserve banks of the crop moving sections are being sustained today chiefly by help from the Boston and Cleveland reserve banks. New York has helped until recently, and Philadelphia and San Francisco still are helping some through purchases of acceptances from the west and south. The Boston reserve bank is charging its own member banks 7 per cent for rediscounts of commercial paper and is loaning its surplus to western and southern reserve banks, which make most of their rediscounts to member banks at 6 per cent. That doesn't seem quite right. In accordance with strict business principles, or with economic principles, if you like that term, the rates ought to be highest where the demand is greatest. Boston's surplus of credit comes partly from dull business, textile plants closed down, etc., and there is naturally some grumbling at its high rediscount rate maintained at present largely for the benefit of the rest of the country. It should not be forgotten that the regional reserve system is not exactly the same as a central reserve bank with branches. When considering the present situation, furthermore, it is well to bear in mind that as a result of the high (7 per cent) reserve bank rate in New York and of curtailment of loans for speculation the stock market is absorbing *a billion dollars* less credit than last fall, and that billion dollars is now in use financing the movement of crops, and financing production generally. Securities, including Liberty bonds, are at a very low point—the only things in the country that are really cheap, judged by prewar standards.

Falling Prices

As I have said, some of the surplus of credit in Boston which is now helping Federal reserve banks in the west and south results from dull business in manufacturing lines, and the same is true of Cleveland and Philadelphia, and to some degree also of other districts where there is much manufacturing. There is evidence that we have entered upon a period of readjustment of values. The people have rebelled against the ever mounting prices and have so diminished demand for many articles, particularly clothing and shoes, that some factories have been compelled to close or run on part time for lack of orders for the time being. This has been charged as due to restriction of credit, but I think there is ample evidence that the movement is deeper and more wide-spread. There has been a decrease of prices all over the world to some extent. It began, I think, with the collapse of the silk market in Japan in the winter and early spring. The big drop in raw silk was naturally followed by a drop in wool and in leather, and the movement spread from one thing to another. Cotton, though a somewhat shorter crop than usual, naturally came in line for a drop following wool and we hear cries from the rubber and automobile industries and from some others. Sugar and coffee have gone down, and the pressure on the breakfast table has perceptibly relaxed. All this I believe is in accordance with economic laws. How far the price recession will go remains to be seen. A lower range of prices will ease up the credit situation considerably, but will at the same time perhaps increase grumbling and criticism. We have all complained of high prices and of the high cost of living and have charged inflation, profiteering, etc., but we all like to see somebody else's prices go down. When the prices of things we ourselves sell or produce also go down—why that's all wrong. We can't sell them below the cost of production, you know! People like to find a "goat" somewhere to blame when things go against them, and some of them, perhaps naturally enough, turn their criticisms against the Federal Reserve Board or the Federal reserve banks. The war taught people to look to the Government for everything and now-a-days when a man can't "hock" his last winter's overcoat for as much as he thinks it ought to bring he writes to the Federal Reserve Board and says it is outrageous that money is so tight.

Criticisms of the Federal Reserve Board

There are several classes of critics of the Federal Reserve Board, some of whom know something about banking and about economic laws and some of whom do not. Perhaps they may be divided roughly into three classes. One class wants lower rates—cheap money—regardless of economic laws, or the reserve requirements of the Federal Reserve Act; another class declares that rates were not advanced quickly enough after the war financing was finished, and are not yet high enough to control credit fully; a third class just criticises on general principles, perhaps mostly for political effect.

This third class is not troubled by any particular regard for consistency or for laws of any kind. The same persons have declared that enormous inflation has been promoted by the Board and has been the cause of high prices—pointing to the great volume of outstanding Federal reserve notes—and then when prices began to fall they declared that the Board was stifling business by refusing credit for production and causing deflation. The chief stock in trade, however, of the third class of critics is the charge of "profiteering." They point to the fact that the net earnings of the Federal reserve banks, the excess of earnings over current expenses, for the half year ended June 30th totaled $68,583,111 or at the yearly rate of 151.2 per cent on an average paid-in capital of $91,-165,000, and that they made 92 per cent in the corresponding period last year. Well, if you can "profiteer" by having your rates or your prices *too low*, and when practically all your profits go to the Government as a franchise tax, there may be something in the charge. The reserve banks before the war were not making their dividends, as a rule, and one member bank up in my old Congressional District charged off its reserve bank stock to profit and loss, and said it was no good as an investment. Profits were *forced on the reserve banks* by the war, and have been made at rates lower than good banking practice would have dictated—rates which attracted business instead of stabilizing credit.

It is proper in this connection that I should call attention to the very extraordinary nature of the Federal reserve banks considered as corporations. The stockholders are the member banks, but those member banks not only subscribed the capital, on which the reserve banks began operations, but furnish all the deposits from which loans are made. Suppose the stockholders of one of your banks were the only depositors, how would you reckon the profits of the institution? The Richmond reserve bank during the first half of the fiscal year made a profit of $2,610,000 or 113.6 per cent based on its paid-in capital alone—which averaged $4,622,000 during the six months ending June 30th. Based on capital and surplus, $12,689,000, it's current net earnings were at the rate of 41.4 per cent. Based on its capital and reserve balances—and these reserve balances were all furnished by the stockholders—the earnings were at the rate of only 8.1 per cent, or based on combined paid-in capital, surplus and reserve balances the rate was 7.2 per cent—not such a very impressive figure, but higher than the average rate for the whole 12 reserve banks, which was 6.4 per cent. On either of the last two bases of reckoning the highest percentages were made by the Philadelphia and Atlanta reserve banks.

You will perhaps say that if the Richmond reserve bank makes 8.1 per cent on its capital and reserve balances—which you furnish—you ought to have a larger return than 6 per cent on the capital, but this brings up a question which I shall not discuss today. I introduced a bill in the last session of Congress that would have allowed extra dividends of not to exceed three per cent from reserve banks that had accumulated the full 100 per cent reserve, but I should add that my position as a member of Congress on such measures must not be understood as necessarily indicating my position as a member of the Federal Reserve Board. You remember that Salmon P. Chase as Secretary of the Treasury issued greenbacks which later as Chief Justice of the Supreme Court he declared unconstitutional. It is very important that there should be no motive for running the reserve banks for the *purpose* of making a profit. An extra dividend bill if passed should be carefully safeguarded. Lower rates than those at present prevailing would probably bring larger profits by attracting more business, but the reserve banks have the custody of your reserves—of the reserves of the banks of the country, and those reserves must be conserved if the system is to be managed with safety. There must be no inducement for the expansion of credit merely for the sake of profit.

The first class of critics of the Federal Reserve Board mentioned above deserve some attention as well as the last class—the class that wants cheap money, regardless of laws, economic or statutory. A very well known United States Senator has recently contributed an article to an industrial journal, published in Baltimore, in which he urges that the reserve bank rates should be lowered to where they were before the war, or at least during the war. In one part of the article he says that the policy of the Board has had the effect of "breaking down the price of securities"—which is tantamount to saying that speculation in Wall Street has been checked—in another place he says that "there is no sense whatever in retiring credits which are employed in production." Well, obviously if you should open the flood gates of credit for speculation the price of securities would advance, but such an advance at this time would absorb credit needed in moving the crops and in productive enterprises. The policy of the Board has been throughout to conserve credit for production and orderly marketing. Reserve bank rates must be fixed with the purpose of maintaining safe reserves—the reserves required by law—otherwise we should have such inflation and speculation as could end only in disaster. The Senator urges Chambers of Commerce throughout the country to pass resolutions in favor of lower rates. Chambers of Commerce are composed of business men and bankers and it will be interesting to see what response they make. They are not as a rule inflationists and I shall be surprised if they do not recognize the necessity of the application of sound principles—of maintaining sound conditions of credit. They know that the banks have been meeting all demands for credit for sound productive enterprise, and have been curtailing credit only for speculation or for non-essentials. They know that with reserves lower than they should be, and with loans outstanding far greater than ever before in the history of the country there has been no "retirement of credits which are employed in production," where conditions were sound.

Personally, I can't help having some doubt whether all has been done that could be done to curtail speculative and other unnecessary credits. The enormous expansion of all bank loans since the end of the war and the fact, already stated, that Federal reserve bank loans on commercial paper have increased nearly seven fold in a year, or about $1,300,000,000, makes it hard to believe that all that additional credit can possibly be used in useful productive enterprise. Certainly there is no evidence of restriction, in these figures, but strong evidence to the contrary.

The total loans of the Federal reserve banks are at their *highest* now—higher than at any time during the war, the highest in the history of the system. All previous records of "total bills on hand" were passed in the statement of August 27th, and again on September 3rd, and on September 10th. They passed *three billion dollars* for the first time on the 3rd. The figures are so high, in fact, that they seem to constitute strong prima facie evidence of undue expansion.

This brings me to some consideration of the criticisms of the second class of critics mentioned above, critics who include some of the leading students of economics and a few of the leading bankers of the country. They maintain that the rates of the reserve banks were not advanced soon enough after the war, and some of them maintain that they are not yet high enough in all districts to give the necessary check to dangerous expansion. I am personally of the opinion that these criticisms are useful. The hindsight of these college professors and bankers is often better than their foresight, and like the rest of us they frequently find it easier to point out mistakes long after they occur than at the time. Their criticisms often fail also to take into consideration practical difficulties, but on the whole, as an abstract proposition, I agree with them that conditions would probably be better today, if the check to expansion had been started by a somewhat earlier increase of rates after the war. I agree with them also that reserve bank rates should be higher than they are today in some of the districts where the demand for credit is greatest and where legal rates of interest are 7, 8, and even 10 per cent, as in the Sixth Federal Reserve District, and in several others. Practical difficulties, however, have to be considered. Some people, and some banks, got themselves pretty badly overloaded with Liberty bonds through patriotic motives, and must be given more time to work out. The habits engendered during the war can't be thrown off at once, and people must be given time to understand what the purposes of the Federal reserve system are and what the principles are which must guide it. If we can succeed in keeping the reserves of the system within safe limits without again raising rates, it may be better to do so.

One thing I want to say as a new member of the Federal Reserve Board, though I am sure it is not necessary to say it to this audience. There is absolutely *no politics* in the administration of the affairs of the Board. I was in close touch with the Board for considerably more than a year as Chairman of the Committee on Banking and Currency of the House of Representatives and in frequent consultation with Governor Harding, with regard to proposed amendments to the Federal Reserve Act. You don't need to be told that I am a Republican and that I should have scented partisanship long ago if there had been any. If the time ever comes when the Federal Reserve Board yields to partisan pressure and fixes its policies with relation to their influence on elections, rather than the security and soundness of the banking system of the country—then there will be danger ahead. I do not believe such a time ever will come. I do not believe the policies of the system today would be appreciably different if Mr. Hughes had been elected President four years ago instead of Mr. Wilson.

The Federal Reserve Act may not be 100 per cent perfect, but it works well and needs only such minor amendments as suggest themselves from its administration from time to time. No changes will be made in its main features for many years, if ever, in my opinion, unless Socialists or some other radical or destructive party should gain control of the country—which I don't expect will happen in my time or in yours.

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