Inflation the Result, not the Cause, of High Prices.

W. P. G. Harding

FEDERAL RESERVE BANK
OF CLEVELAND

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August 12, 1919.

To the Bank addressed:

It is believed by many that one of the prime reasons of high prices is the amount of money in circulation. As a result of a resolution recently passed by the Senate directing that an investigation be made as to the advisability of enacting legislation to provide for a gradual reduction of the amount of money in circulation, a letter was addressed by the Chairman of the Committee on Banking and Currency to the Federal Reserve Board asking for its expression.

Governor Harding's reply is so comprehensive and convincing a statement of the amounts and kinds of currency in circulation, and its relation to high prices, that I am placing a copy in the hands of every banker in this District.

I trust that his reply will receive your very careful reading.

Respectfully,

E R Fancher

Governor.

August 8, 1919.

Dear Sir:

The Federal Reserve Board acknowledges receipt of your letter of the 5th instant asking for an expression of its views as to the advisability of legislation providing for the gradual reduction of the currency in circulation as proposed by Senate Resolution 142.

The Board would suggest that in determining whether or not legislation is necessary or desirable to regulate the volume of currency in circulation, consideration be given to the various forms of money which make up the sum total of our volume of currency. A distinction should also be drawn between the stock of money in the country and the amount actually in circulation.

With respect to gold coin, gold certificates, standard silver dollars, silver certificates, subsidiary silver and Treasury Notes of 1890, the Board assumes that it is recognized that no legislation is necessary.

The United States notes, or legal tenders, which have remained at the fixed amount of $346,681,016, since March 31, 1878, have not been a disturbing factor since the passage of the act of March 14, 1900. An adequate gold reserve of more than 45% is now held against these notes, most of which are in the form of small bills of $1, $2, and $5 denominations. Notes of these denominations are needed in the daily transactions of the public, and were the United States notes to be retired, the issue of an equal volume of small bills in some other form of currency would be necessary. To effect the retirement of the United States notes, funds would have to be withdrawn from the Treasury to be supplied either by taxation or by the sale of interest-bearing obligations. The Board does not believe that any legislation with respect to United States notes is necessary or desirable at this time.

The national bank notes outstanding on August 1, 1919, amounted to $658,118,555, a reduction of nearly $60,000,000 since July 1, 1914. The greater part of these notes is secured by United States 2% bonds, and provision has already been made in Section 18 of the Federal Reserve Act for their gradual retirement.

Federal Reserve bank notes, which are secured by United States obligations and are taxed just as national bank notes are, have been issued only to replace in part national bank notes retired, and standard silver dollars melted or broken up and sold as bullion under authority of the act of April 23, 1918, known as the Pitman Act. The issue of these notes has, therefore, brought about no increase in the circulating medium.

The amount of Federal Reserve notes outstanding has increased from $357,239,000 on April 1, 1917, to $2,504,753,000 on August 1, 1919. It appears, therefore, that those who see in the larger volume of circulation in the United States the prime cause of increased costs of living and who seek a remedy by a forced contraction of the currency must have in mind the Federal Reserve note and Section 16 of the Federal Reserve Act as amended June 21, 1917, which provides for its issue and redemption.

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In analyzing our present monetary situation, and in considering the causes which have led to the expansion of credits and note issues during the war, we should not lose sight of some of the developments of the pre-war period and of their effect upon credits and prices. Very heavy purchases of supplies of all kinds were made in this country by European beligerents during the years 1915 and 1916, payment for which involved the shipment to us of large amounts of gold. The stock of gold in the United States on July 1, 1914, was $1,890,678,304. This amount increased steadily until April, 1917, the date of our own entry into the war, when it reached $3,088,904,808, an increase of about $1,200,000,000. Bank deposits likewise show a large increase, the net deposits of national banks having risen from $7,495,149,000 on June 30, 1914, to $10,489,217,000 on March 5, 1917, while the net deposits of all banks in the United States increased from $17,966,150,000 in June, 1914, to $24,891,218,000 in June, 1917. Net deposits of national banks had further increased up to May 12, 1919, to $11,718,095,000, and those of all banks in June, 1918 (the latest date for which figures are available) to $26,769,546,000. Shortly after April 6, 1917, when the Congress declared war, the Treasury began to sell bonds, notes and certificates in large amounts, resulting in a net increase in the public debt to August 1, 1919, of $24,518,064,840.

On July 1, 1914, the total stock of money in the United States, exclusive of that held by the United States Treasury, was $3,419,168,368. On April 1, 1917, the stock of money, estimated on the same basis, was, $4,702,130,941, an increase of $1,282,962,573, of which increase $883,481,028 was in gold.

On July 1, 1914, there were no Federal Reserve notes in existence, while on April 1, 1917, there were outstanding $357,239,000.

The amendment to the Federal Reserve Act approved June 21, 1917, changed substantially the original reserve requirements for member banks and provided that their entire lawful reserve should be carried with the Federal Reserve banks. The same amendment authorized the Federal Reserve banks to exchange Federal Reserve notes for gold. The result of these two changes in the law was to transfer immediately large sums of gold from the vaults of the member and non-member banks and from general circulation to the Federal Reserve banks, and this caused a change in the methods of accounting for gold by the Federal Reserve banks and Federal Reserve agents.

In order to avoid confusion in determining the volume of money in actual circulation, it is necessary to distinguish between tables showing the total stock of money in the country, and tables showing the circulation outside of the Treasury and Federal Reserve agents' vaults, and to limit our view to amounts held by member and non-member banks and the public, which are exclusive of amounts on hand at Federal Reserve banks, held by Federal Reserve agents, and held in the Treasury.

The reserve money held by or for the Federal Reserve banks serves, of course, as a basis for credit, but it forms no part of the currency in circulation. Upon this basis, the amount of money in circulation on July 1, 1914 (there being no Federal Reserve banks in operation at that time) was $3,419,168,368, made up as follows: Gold coin and certificates $1,649,775,803; silver dollars and silver certificates, including Treasury notes of 1890, $552,203,610; all other currency $1,217,188,955, being circulation per capita $34.53.

The corresponding amounts of money in circulation on April 1, 1917, December 1, 1918, and August 1, 1919, are shown in the following table:

Amount of Money Outside the Treasury and Federal Reserve Banks

	April 1, 1917	December 1, 1918	August 1, 1919
Gold coin and certificates	$1,989,152,000	$861,245,000	$728,046,000
Silver dollars and silver certificates (including Treasury notes of 1890)	532,700,000	372,489,000	241,505,000
Federal Reserve notes	357,239,000	2,607,445,000	2,504,753,000
Federal Reserve bank notes	3,170,000	87,737,000	166,289,000
All other currency	1,218,715,000	1,201,069,000	1,156,297,000
Total	$4,100,976,000	$5,129,985,000	$4,796,890,000
Amount per capita outside the Treasury and the Federal Reserve Banks	$37.88	$48.13	$45.16

Assuming that the date December 1, 1918, marks the beginning of the post-war period, the table shows changes during this period up to August 1, 1919, as follows: Gold coin and certificates in circulation decreased $133,199,000; silver dollars and silver certificates, including Treasury notes of 1890, decreased $130,984,000; Federal Reserve notes decreased $102,692,000; Federal Reserve bank notes increased $78,552,000; all other currency decreased $44,772,000, being a net decrease in circulation for the post-war period of $333,095,000, or $2.97 per capita.

In considering the question of currency in circulation, there should be taken into account the various factors which have entered into the demand for currency, among which are: The gradual enlargement of payrolls, both as to the number of workers and amount paid to each; the effect of higher wages upon deposits in banks and upon the amounts of money carried by shopkeepers in their tills and by individuals in their pockets; the amounts of money locked up or carried on their persons by workmen who have been receiving high wages, and who, especially in the case of ignorant foreigners, are unwilling to deposit their savings in banks or to invest in Government bonds; the amount of money carried away by workmen returning to their homes in foreign countries; and the fact that the circulating media of the Philippine Islands, Hawaii, Cuba, Porto Rico, Santa Domingo, Haiti, Honduras, Panama, and, in part, Mexico, includes United States paper currency and subsidiary silver. The amounts required in these countries, most of which are very prosperous, have greatly increased in the last few years.

The total foreign circulation of United States currency cannot be stated accurately, but is estimated to be at least one hundred and fifty million dollars.

The difficulty, indeed the impossibility, of keeping in circulation an excessive volume of Federal Reserve notes should be understood. The issue of these notes has been carefully safeguarded by the Federal Reserve Act, and ample provision has been made for their redemption. Federal Reserve notes are redeemable in gold; they cannot be forced into circulation in payment of the expenses of the Government, or for any other purpose, as they can be issued only in exchange for gold or against a deposit of negotiable paper growing out of a legitimate commercial transaction, plus the required gold reserve of not less than 40 per centum. Upon payment of commercial paper which has been deposited to secure Federal Reserve notes, there results either an immediate return of an equal amount of notes to the bank, or an automatic increase in the percentage of gold reserve available for their redemption. Federal Reserve notes are not legal tender, nor do they count as reserve money for member banks. They are issued only as a need for them develops, and as they become redundant in any locality they are returned to the Treasury at Washington, or to a Federal Reserve bank for redemption. Thus there cannot at any time be more Federal Reserve notes in circulation than the needs of the country at the present level of prices require, and as the need abates the volume of notes outstanding will be correspondingly reduced through redemption. The increased volume of Federal Reserve notes in circulation during the past three years, in so far as it is not the result of direct exchanges for gold and gold certificates which have been withdrawn from circulation, is the effect of advancing wages and prices, and not their cause.

There has undoubtedly taken place during the last two years a certain amount of credit expansion which, under the circumstances connected with our war financing, was inevitable, but this will be corrected as the securities issued by the United States Government for war purposes are gradually absorbed by investors. This credit expansion is equal to the difference between the total of the war expenditures of the Government on the one hand, and on the other, the total amounts raised by the Government through taxation and by the sale of its obligations so far as paid for out of savings. No reliable estimate can be made of this difference, which must be gradually absorbed through future savings for the reason that banks are lending and will always lend freely on Government bonds as collateral.

The principal cause of the advance of prices before and during the war was the urgent need of the governments of the allied world for goods of all kinds for quick delivery in large volume, and the competition of this buying by governments with purchases by private individuals who failed to contract their expenditures at a rate commensurate with the growing expenditures of these governments. In the post-war period, through which we are now passing, the country has experienced rising prices owing, in part, to a general relaxation of the war time regime of personal economy, resulting in an increased demand for commodities by individuals who restricted their purchases during the war, but who are now buying in competition with export demand. In addition, accrued incomes and increased wages have led to heavy demands for commodities not of prime necessity, which have resulted in diverting labor and material from essentials to non-essentials.

The Federal Reserve Board believes that any currency legislation at this time is unnecessary and undesirable, and would suggest that whether viewed from an economic or financial standpoint, the remedy for the present situation is the same, namely to work and to save; to work regularly and efficiently in order to produce and distribute the largest possible volume of commodities; and to exercise reasonable economies in order that money, goods, and services may be devoted primarily to the liquidation of debt and to the satisfaction of the demand for necessities, rather than to indulgence in extravagances or the gratification of a desire for luxuries. The war is over,—in a military sense—and while the bills have been settled by loans to the Government, these obligations, so far as they are carried by the banks, must be absorbed before the war chapter of the financial history of the country can be closed.

Very truly yours,

W. P. G. HARDING,

Governor.

Hon. Geo. P. McLean, Chairman,
Committee on Banking and Currency,
United States Senate,
Washington, D. C.