The Problem of Credit Regulation and Control

Address by
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Figures compiled by the Board's Statistical Division indicate that since June 30, 1914, there has been an expansion of banking credit in the United States, properly attributable to the war, of about $11,000,000,000. Since that date there has been an increase in money in actual circulation of about $1,900,000,000. When it is considered that our Government has during the past three years floated $26,000,000,000 of securities to meet its war requirements and its advances to governments associated with it in the war, the credit expansion which has taken place is neither excessive nor alarming when viewed from the standpoint of war necessity.

The continued expansion, however, which has occurred since the flotation of the Victory Loan last May in the face of a decreased production of essentials is one of the disquieting features of the present situation. The expansion of national bank credits was 16%, or at the rate of 10½% a year, during the nineteen months of the war. From April 1, 1919, to April 1, 1920, the increase in bank loans was approximately 25%, and during the same period the rise in commodity prices was about 26%. Assuming an index number of 100 for the year 1918 for each of the following—livestock, grain, lumber, coal, petroleum, pig iron, steel ingots, copper, and cotton and wool actually consumed—the average index number for the same articles in 1919 is 89.07. While neither of these indices can be accepted as definitive evidence of the trend of production in this country, they do indicate a falling off of at least 10% in the actual output or marketing of goods in ten important lines. While production figures for the first quarter of the present year in some leading lines, such as soft coal, steel, cotton and wool, are indicative of greater industrial effort, the difficulties in the transportation field which became acute during April are bound to affect both the production and shipment figures for the last two months.

It is this tendency of production to decline, particularly in some essential lines, which constitutes a very unsatisfactory element in the present outlook. It is evident that the country cannot continue to advance prices and wages, to curtail production, to expand credits and to attempt to enrich itself by non-productive operations and transactions without fostering discontent and radicalism, and that such a course, if persisted in, will eventually bring on a real crisis.

There is a world-wide lack of capital, and with calls upon the investment market which cannot be met, there is an unprecedented demand for bank credits. The fact must be recognized that however desirable on general principles continued expansion of trade and industry may be, such developments must accommodate themselves to the actual supply of capital and credit available.

Official bank rates now in force in the leading countries are higher than at any time during the present century, except during the war panic week at the beginning of August, 1914. Only within the last few weeks the official rate in Italy has been raised from 5 to 5½, the Bank of France rate from 5½ to 6 and the Bank of England rate from 6 to 7 per cent.

Every effort should be made to stimulate necessary production, especially of food products, and to avoid waste. Planting operations in many sections have been delayed because of adverse weather conditions, and should there be an inadequate yield of crops this year the necessity for conservation and conservatism will be accentuated. War waste and war financing result inevitably in diminished supplies of goods and increased volume of credits. The normal relationship between the volume of goods and the volume of money and credits thus unsettled can be restored in either of two ways: one, the drastic method of contraction of credit, and the other, by far the more desirable way, increased production. In the same way progress towards the restoration of the normal relationship may be made by reducing credit more rapidly than production is diminished, or by increasing production at a greater rate than credit is expanded. If it should prove impracticable in the existing circumstances to increase essential production, then we must through economy in consumption and through moderation in the use of credit check the tendency towards a further widening of the margin between goods and credit.

Our problem, therefore, is to check further expansion and to bring about a normal and healthy liquidation without curtailing essential production and without shock to industry, and, as far as possible, without disturbance of legitimate commerce and business.

As a rule there is a substantial reduction in the volume of commercial loans during the first quarter of the year. This liquidation is entirely natural and healthy and is necessary in order that the banks may be prepared to meet the demands made upon them during the crop making and harvesting seasons. There has been no such liquidation during the present year; on the contrary, commercial loans have steadily increased. Thus the public has anticipated demands for banking credit which are usually made later on in the year. The average reserves of the Federal Reserve Banks are now about 42% as against 45% at the beginning of the year and about 51% twelve months ago.

The solution of the problems confronting us will require the co-operation of all banks and the public. Whatever personal sacrifices may be necessary for the general economic good should be made. The war-time spirit to do things that are worth while must be revived, and there should be the fullest co-operation in an effort to produce more, save more, and consume less. The banks should lean less heavily upon the Federal Reserve Banks, and rely more upon their own resources. Unnecessary and habitual borrowings should be discouraged, and the liquidation of long-standing non-essential loans should proceed. Drastic steps, however, should be avoided and the methods adopted should be orderly. Gradual liquidation will result in permanent improvement, while too rapid deflation would be injurious and must be avoided.

There should be a clear understanding of the parts to be played by the Board, the Federal Reserve Banks, and by the member and non-member banks and trust companies. With respect to credits, the problems of the Federal Reserve Board, the Federal Reserve Banks, and the member banks, while inter-related, are distinctive. The Federal Reserve Board has but little direct contact with the member banks; it deals with general conditions and principles rather than with individual cases and details. The Federal Reserve Banks, on the other hand, are in daily contact with their member banks and have constant dealings with them. Between the Federal Reserve Banks and the Federal Reserve Board, as the supervisory and co-ordinating body, there is necessarily a close and intimate relationship. The member banks transact the greater part of the primary banking business of the country. They receive the deposits of the public and are the media through which ordinary commercial credits are extended.

The primary duty of the Federal Reserve

Board is to see that the Federal Reserve Banks function normally in the manner prescribed by the Federal Reserve Act. The character of business which may be engaged in by the Federal Reserve Banks is described in detail in Sections 13 and 14 of the Federal Reserve Act, and all regulations of the Board bearing upon the loans and investments of the Federal Reserve Banks must be in conformity with the provisions of the law. Regardless of the extent of its legal powers, it would be a most difficult task for the Federal Reserve Board sitting in Washington, to attempt by general rule of country-wide application to distinguish between "essential" and "non-essential" loans. During the war there was a broad underlying principle that essentials must be "necessary or contributory to the conduct of the war," but notwithstanding the sharp outline of this principle, much difficulty was experienced by the various war boards in defining essentials and non-essentials. All the more difficult would it be for the Federal Reserve Board to make such a general definition now when there is no longer that purpose as a guide.

The Federal Reserve Board is not a temporary organization. It is a permanent board, and it must be guided by the terms of the Federal Reserve Act. Section 13 in defining the eligibility of paper for discount by Federal Reserve Banks lays down the general rule that any paper maturing within the time prescribed, and issued or drawn for commercial, agricultural or industrial purposes, or the proceeds of which have been used or are to be used for such purposes, is eligible. No express condition is made regarding the essential or non-essential character of the transaction giving rise to a note which may be offered for discount, and the Federal Reserve Board is not required and properly could not be expected generally to adopt such a criterion of eligibility. It is too much a matter of local conditions and local knowledge to justify at this time any general country-wide ruling by the Board even if such a ruling were deemed helpful.

On the other hand, there is nothing in the Federal Reserve Act which *requires* a Federal Reserve Bank to make any investment or to rediscount any particular paper or class of paper. The language of both Sections 13 and 14 is permissive only. Section 4 of the Federal Reserve Act, however, requires the directors of a Federal Reserve Bank to administer its affairs "fairly and impartially and without discrimination in favor of or against any member bank," and subject to the provisions of law and the orders of the Federal Reserve Board to extend "to each member bank such discounts, advancements and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks." Thus the directors of a Federal Reserve Bank have the power to limit the volume and character of loans which in their judgment may be safely and reasonably made to any member bank.

The recent amendment to paragraph (d) of Section 14 distinctly authorizes each Federal Reserve Bank on its own account, without reference to action taken by any other Federal Reserve Bank, to establish a normal discount or credit line for each member bank, and permits the imposition of graduated rates on discount lines in excess of the normal lines. This amendment, however, does not repeal or modify Sections 4 and 13, and a Federal Reserve Bank is still free to decline to discount any paper which in its judgment does not constitute a desirable investment for it or which in its opinion would not constitute a safe and reasonable investment within the meaning of Section 4.

It is the view of the Board, however, that while Federal Reserve Banks may properly undertake in their transactions with member banks to discriminate between essential and non-essential loans, nevertheless that discrimination might much better be made at the source by the member banks themselves. The individual banker comes in direct contact with his customers; he is better qualified than anyone else to advise the customer because of his familiarity, not only with the customer's business, but with the general business conditions and needs in his immediate locality. In making loans he is bound by no general rule of law as to the character of the purpose for which a loan is being asked. He is entirely free to exercise discretion and can make one loan and decline another as his judgment may dictate. He can estimate with a fair degree of accuracy the legitimate demands for credit which are liable to be made upon him, as well as the fluctuations in the volume of his deposits. He knows what industries sustain his community, and is thus qualified to pass upon the essential or non-essential character of loans offered him. He knows, or should know, what rediscount line he may reasonably expect of his Federal Reserve Bank, and he ought not to regard this line as a permanent addition to his capital. With knowledge of the limitations or penalties put upon his borrowings from the Federal Reserve Bank the banker may be depended upon to use a more discriminating judgment in granting credit accommodations to his customers, and that judgment he must exercise if the present situation is to be remedied fundamentally.

It is true that under existing conditions the volume of credit required in any transaction is much greater than was the case in pre-war times, but it is also true that the resources of the member and non-member banks would be ample to take care of the essential business of the country and to a large extent of non-essentials as well if there were a freer flow of goods and credit. If "frozen loans" were liquefied, and if commodities which are held back either for speculative purposes or because of lack of transportation facilities should go to the markets, and if large stocks of merchandise should be reduced, the resultant release of credit would have a most beneficial effect upon the general situation. In the meantime everything must be done to expedite the release of these credits and to restrict non-essential credits in future.

While the problem of credit regulation and control is national and even international in its scope, yet in the last analysis it is merely an aggregation of individual problems, and the proper working out of the situation must depend upon the public and upon the banks which deal with the public. The public must be made to realize the necessity of economy in expenditures and in consequent demands for banking credit. The banks themselves are best able to impress the importance of this policy upon the public.

The Federal Reserve Banks may be depended upon to do their duty to the member banks and the public, but to accomplish results the banks and the public must do their part in accelerating the processes of production and distribution and in restricting waste and extravagance.

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