September 29, 1921.

Dear Governor McKelvie:

Last Saturday I acknowledged receipt of your letter of the 22nd instant and in replying to it now at greater length I wish to invite your attention to some of the underlying principles of the Federal Reserve Act which govern the operations of the Federal reserve banks. Following that I will submit some facts relating to the operations of the Branch of the Federal Reserve Bank of Kansas City at Omaha, in which you and your people are particularly interested.

(1) - The law does not permit Federal reserve banks to compete for business with each other or with the national banks, state banks and trust companies of the country. They are not allowed to receive deposits from the public nor are they permitted to make loans or advances direct to individuals, firms or corporations. In their rediscount operations they are limited to notes and bills defined as "eligible" which bear the endorsement of a member bank. It follows, therefore, that Federal reserve banks cannot extend any discount accommodations to the public except through the medium of a member bank, with which institutions the loans must first be negotiated. Federal reserve banks have no funds to lend the public through the instrumentality of member banks acting as brokers. A Federal reserve bank does not take the initiative in making loans to a member bank for the purpose of enabling the member bank to distribute the funds so advanced to its customers. The Federal reserve bank lends to the member bank against transactions already made for the purpose of enabling the member bank to restore its reserve to the legal requirement, after the reserve has been impaired or is about to be impaired because of increased loans and deposits.

(2) - I have already called your attention to the fact that the Federal reserve bank is given no control over the policy of its member banks with respect to loans but that it cannot compel a member bank to make a loan which it does not desire to make nor prevent it from making one which it wishes to make. Neither can a Federal reserve bank control the rate of interest charged by member banks. In case of state banks the interest rate is regulated by the laws of the respective states and in the case of national banks the Federal law permits those institutions to charge up to the maximum rates permitted in the states in which they are located.

(3) - No Federal reserve bank can rediscount paper for member banks outside of its own Federal Reserve District. Its rediscount transactions are limited to dealings with its own member banks. The Federal Reserve Act does not require rates of discount to be uniform in all districts. Each Federal reserve bank is authorized by paragraph (d) of Section 14 of the

Federal Reserve Act "to establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business and which, subject to the approval, review and determination of the Federal Reserve Board, may be graduated or progressed on the basis of the amount of the advances and discount accommodations extended by the Federal reserve bank to the borrowing bank". The last sentence of the paragraph quoted above relates to what is known as the "progressive rate", which has now been abolished in the four Federal Reserve Districts in which it was formerly effective.

One of the early drafts of the Federal Reserve Bill which was considered by Congress in 1913 provided that the Federal Reserve Board should each week fix the rates of discount to be charged by the respective Federal reserve banks and that it should notify each Federal reserve bank what its discount rates would be for the ensuing week. This provision was stricken out in a later draft of the bill and the Act as finally passed contains the language above quoted. It seems, therefore, to be the intent of Congress that the discount rates shall not ordinarily be initiated by the Federal Reserve Board but by the directors of the respective Federal reserve banks. This is consistent with the theory of the Act which does not create a central bank but a regional banking system, comprised of twelve independent units. This theory is based upon the presumption that the directors of a Federal reserve bank are more conversant with credit conditions and current rates for money in their respective districts than the Federal Reserve Board in Washington can be expected to be. While the Federal Reserve Board undoubtedly has power to direct any Federal reserve bank which persists in maintaining a discount rate which is clearly not warranted by general conditions to change that rate, the Board so far has had no occasion to initiate a rate for any Federal reserve bank.

In considering the proper level of discount rates, the directors of the Federal reserve banks have taken into consideration not only the reserve position of the bank but also current local rates for money. It is the purpose of the Federal reserve banks to afford a ready means of rediscounting paper for member banks but if artificially low rates should be established the result would probably be an unhealthy stimulation of loans by member banks, which, I understand from your letter of September 12th, is something that you do not desire, for you say in that letter "Nor would I have you believe for a moment that I would have the Federal Reserve Bank System encourage an extension of credit that would result in unwise inflation or speculation". The Board is entirely in accord with your desire to see the Federal Reserve System operate as an agency for financial relief at a time when it is most urgently needed, and in order to keep the Federal reserve banks in position to extend such relief it is necessary that a policy be adopted which will not encourage an undue expansion of loans made for the sake of the profit to be derived by rediscounting with the Federal reserve bank.

In your letter of the 22nd instant you say that you are altogether convinced that the Federal Reserve System is not functioning as it should in your district. You say that you are informed that the banks in your district are not generally patronizing the Federal Reserve System. It is true that a large majority of state banks, for reasons satisfactory to themselves, have not deemed it advisable to apply for membership in the Federal Reserve System and there are also a considerable number of member banks which have had no occasion up to this time to rediscount with the Federal reserve bank. Many of the non-member state banks, however, have borrowed money from their correspondents in Omaha, Kansas City and other cities and these banks in turn have rediscounted with the Federal reserve banks. Nor is it to be doubted that the member banks which have not rediscounted with the Federal reserve bank would hesitate to do so should occasion arise.

On August 31, 1921 there were 203 member banks in Nebraska. At that time 74 of these banks were not borrowing from the Federal Reserve Bank. 129 Nebraska member banks were at that time rediscounting to the extent of $11,263,345. On June 3, 1920, 135 Nebraska banks were borrowing from the Federal Reserve Bank $30,068,992 and on October 30, 1920, 168 Nebraska members were borrowing $38,294,175. When it is remembered that the total rediscounts and bills payable of all national banks in the United States, as shown by the official report of the Comptroller of the Currency, on August 22, 1907 amounted to $59,177,000, itwwould seem that the advances last October of over $38,000,000 by the Kansas City bank to member banks in Nebraska alone would indicate very effective functioning on the part of that bank. You will recall the severe panic which occurred in the fall of 1907, and for several weeks before the panic developed credit conditions were as stringent as they have ever been in this country.

It is true that the loans of the Federal Reserve Bank of Kansas City to member banks in Nebraska are now only about eleven and a quarter million dollars as against thirty-eight and a quarter millions last October, but it does not follow necessarily that this has been the result of harsh demands for liquidation on the part of the Federal Reserve Bank of Kansas City. Is it not possible that there has been a great deal of voluntary liquidation, made possible by sales of farm products or by increased deposits? Certainly credit conditions generally are by no means as stringent now as they were last October. While it may be true that the Federal Reserve Bank of Kansas City, mindful of its responsibility under the law and acting in accordance with the dictates of ordinary banking prudence, may have had occasion at times to call the attention of some of the larger borrowing banks to the necessity of working themselves into a stronger position, the Federal Reserve Board has yet to be shown that the Federal Reserve Bank has ever undertaken to say to a member bank what particular loans it should require to be paid or ask to have reduced.

At my request the Board's Division of Reports and Statistics has prepared two tables which relate to the discount transactions by the Omaha Branch of the Federal Reserve Bank of Kansas City during October, 1920 and August, 1921. One table shows the total amount of bills discounted for member banks during these months, the rate of interest charged the borrowing customers by the rediscounting member banks, the amount at each rate and the percentage of paper taken at each rate, to the total amount. You will understand, of course, that this relates only to the rates of interest charged by member banks on the particular notes which they in turn rediscounted with the Federal Reserve Bank Branch at Omaha. I have no information as to the rates charged by the member banks on their entire volume of loans to customers. The other table shows the number of separate notes or pieces of paper discounted by the Omaha Branch during the same months and the rate charged customers by the borrowing bank in each case.

TABLE A

BILLS DISCOUNTED FOR MEMBER BANKS BY THE
OMAHA BRANCH OF THE KANSAS CITY FEDERAL RESERVE BANK
DURING OCTOBER 1920 AND AUGUST 1921

	October 1920	August 1921
Amount of paper discounted:		
Member banks' collateral notes:	$16,058,686	$6,562,685
Customers' bills and notes: -	16,800,179	7,308,203
TOTAL -	$32,858,865	$13,870,888
Number of pieces of paper discounted:		
Member banks' collateral notes:-	442	255
Customers' bills and notes:-	3,647	1,733
TOTAL -	4,089	1,988
Number of member banks accommodated:	179	145
Average rate of discount charged member banks by Omaha Branch -	7.10%	6.0%

Amount of paper discounted by Omaha Branch on which discounting member banks charged their customers a rate of:-

	October 1920 Amount	October 1920 Per cent of total	August 1921 Amount	August 1921 Per cent of total
5¼ -	$ 19,700	.12	$ - -	- -
6 -	150,200	.89	- -	- -
6½ -	85,000	.51	546,100	7.47
6¾ -	6,100	.04	- -	- -
7 -	1,825,800	10.87	1,650,100	22.58
7½ -	2,576,600	15.34	1,977,400	27.06
8 -	9,154,100	54.49	1,870,400	25.59
8¼ -	30,000	.18	- -	- -
8½ -	528,200	3.14	400	.01
9 -	1,077,500	6.41	460,900	6.31
9½ -	130,300	.77	- -	- -
10 -	1,192,900	7.10	796,800	10.90
12 -	23,800	.14	6,100	.08
	$16,800,200	100.00%	$7,308,200	100.00%

TABLE B

NUMBER OF PIECES OF PAPER DISCOUNTED BY OMAHA BRANCH ON WHICH DISCOUNTING MEMBER BANKS CHARGEDTHEIR CUSTOMERS A RATE OF: -

RATE	October 1920 Number	October 1920 Per cent of total	August 1921 Number	August 1921 Per cent of total
$5\frac{1}{4}$	3	.08	- -	- -
6	20	.55	- -	- -
$6\frac{1}{2}$	9	.25	26	1.50
$6\frac{3}{4}$	1	.03	- -	- -
7	237	6.50	67	3.87
$7\frac{1}{2}$	229	6.28	95	5.48
8	2,022	55.44	468	27.00
$8\frac{1}{4}$	2	.05	- -	- -
$8\frac{1}{2}$	111	3.04	1	.06
9	199	5.46	152	8.77
$9\frac{1}{2}$	11	.30	- -	- -
10	800	21.94	913	52.68
12	3	.08	11	.64
Total	3,647	100.00	1,733	100.00

It should be borne in mind that due to the operation of the progressive rate last October the average rate of discount which the borrowing member banks paid the Omaha Branch during that month was 7.10%, while in August 1921, the progressive rate having been abolished, the discount rate paid in all cases was 6%.

It is interesting to note the changes in the percentages of rediscounted paper which had been taken at varying rates of interest by the borrowing member banks. In October 1920 the percentage of 7% paper discounted by the member banks was 10.87 against 22.58 in August 1921. The percentage of $7\frac{1}{2}$% paper was 15.34 against 27.06 and the percentage of 8% paper was 54.49 against 25.59. The percentage of 9% paper was 6.41 against 6.31. The percentage of 10% paper, which was 7.10 in October 1920, increased, however, to 10.90 percent in August 1921. Looking at Table "B", which relates to the number of pieces of paper discounted, you will see that in October 1920 the percentage of rediscounted paper taken by the member banks at 8% was 55.44 against 27.00 in August 1921, 9%, 5.45 against 8.77 and 10% paper 21.94 against 52.68.

Carrying the analysis further we will see that of the total of $7,308,200 which was rediscounted by the Omaha Branch for Nebraska member banks during August 1921, only $796,800 was taken by the borrowing banks from their customers at a 10% rate, but this amount was made up of 913 separate pieces of paper, more than one-half of the total number of notes taken during the month. The average amount of the rediscounted notes on which customers had been charged 10% was in October 1920 about $1,490 and in August 1921 about $870. The average amount of the rediscounted notes on which customers had been charged 8% was in October 1920 about $4,520 and in August 1921 about $4,000, and the average of 7% notes was in October 1920 about $7,700 and in August 1921 about $24,625.

All this would indicate, at least so far as the rediscounted notes are concerned, that the larger borrowers are getting a slight reduction in rate but there is nothing to show that the smaller borrowers are, for notwithstanding the reduced volume of loans the number of transactions at 10% was greater in August 1921 than in October 1920.

There is nothing in this letter or in my letter of September 15th which is intended as a reflection upon or a criticism of the banks of Nebraska. In common with the rest of the banks of the country, they have had very serious problems to contend with and they are entitled to great credit for the manner in which they have met the strain which has been imposed upon them, but I wish to call your attention to the fact that the Federal Reserve Bank of Kansas City, like all other banks has had its problems too and its rediscount facilities have certainly been of great assistance to the banking community and through the banks to the public. The Federal Reserve Board is watching the rate situation closely and is anxious to have the rates of each Federal reserve bank bear the proper relationship to current rates in the respective districts.

I inquired in my previous letter whether you thought a reduction in the discount rate of the Federal Reserve Bank of Kansas City would result in a lower level of interest rates to the public. I see nothing, however, in your letter of September 22nd which bears on this inquiry and I will now withdraw that question and ask instead whether you think conditions in your State will be improved by a reduction in the Federal Reserve Bank rate and I would appreciate a frank expression of your views.

I am informed by the Governor of the Federal Reserve Bank of Kansas City that the records of the Omaha Branch will show that no member bank has been urged to liquidate rapidly its discount line and that neither the head office nor the Branch has ever suggested to a member bank what policy it should adopt towards requiring its customers to liquidate. Between October 30, 1920 and June 30, 1921 the member banks in Nebraska have reduced their loans from the Federal Reserve Bank by about $25,000,000 but of this amount approximately $19,000,000 was liquidated by banks in Omaha and Lincoln, while the loans of all other member banks in Nebraska were reduced only by about $6,300,000.

Whatever impressions may exist to the contrary, it is a fact that the Federal Reserve Board has always been keenly desirous to have Federal reserve banks do all they could legitimately to aid the member banks in meeting the credit requirements of those engaged in agriculture and the raising of live stock. The trouble, however, lies largely in the fact that the larger operations in farming and cattle raising are carried on in sections where the deposits are seasonal and where the lending ability of the banks out of their own resources is limited. Then again, many banks do not like to lend their money for as long a term as it is needed in cattle raising and in certain farming operations

The Joint Commission of Congress of Agricultural Inquiry has been for some months past investigating thoroughly the credit situation as related to the farming and live stock industries and I am informed that its report will be made public before very long. I am sure it will be most interesting and illuminating and will no doubt contain some constructive suggestions.

I am sending you with this letter a copy of Bulletin No. 999, entitled "Prices of Farm Products in the United States", recently issued by the Department of Agriculture, which contains a great deal of information of vital interest to farmers and to all who live in agricultural states.

I wish in conclusion to thank you for the letters you have written me and to say that I have replied to them in no controversial spirit whatever. I am sure that we have a common purpose and I hope that you will have an opportunity sometime of talking with the officers and directors of the Federal Reserve Bank of Kansas City, who are more directly responsible for the policies and operations of the Federal Reserve Bank than the Federal Reserve Board is. It is difficult for the Board to admonish the officers and directors of a Federal reserve bank as to their proper policies and conduct as long as complaints are merely general in their nature. It is the earnest desire of the Federal Reserve Board that all Federal reserve banks should function as they are intended by law and if you will let me know just in what respects the Omaha Branch or the Federal Reserve Bank of Kansas City is not functioning properly, the information will be appreciated.

I have sent a copy of this letter to the Chairman of the Board of directors of the Federal Reserve Bank of Kansas City, with the request that it be read to the directors at their next meeting.

Very truly yours,

Governor.

Hon. Samuel R. McKelvie,
Governor of Nebraska,
Lincoln, Nebraska.

COPY

STATE OF NEBRASKA
EXECUTIVE OFFICE
LINCOLN

Sept. 22, 1921.
X-3217b

Hon. W.P.G.Harding,
Governor, Federal Reserve Board,
Washington, D.C.

My dear Governor Harding:-

I am greatly obliged to you for the information contained in your letter of September fifteen.

The facts which you set out are of such vital importance and suggest other leads of even equal or greater importance, that I have called a conference of the Council of the Nebraska Bankers' Association and the officials of certain Federal and private financing agencies to be held in Omaha at 7:30 P.M., September twenty-six. The purpose of this conference will be to discuss these questions in detail and to determine what may be done to effect a source of reasonable credit to the farmer at a rate of interest that he can afford to pay. I have invited Governor Miller of the Kansas City Federal Reserve Bank and Mr.Ramsay, Chairman of the Board of Directors of that bank. I wish that you might also be present.

The facts that you give regarding the rate of interest that is being charged by correspondent banks on loans that are rediscounted through the Federal Reserve Bank are intensely interesting. I am not prepared to say that these margins have given any unusual profit to the banks that have been patronizing the Federal Reserve System, but I do feel that there is something radically wrong with a system which requires such wide margins. Also, I am convinced that this and other hampering influences must be remedied before the system will be very useful to agricultural borrowers here.

I am further informed that the banks in this district are not generally patronizing the Federal Reserve System. It would seem that if the margins indicated in your letter are profitable to the correspondent banks, there would be a more general patronage of the Federal Reserve Bank. The answer to this seems to be indicated in a telegram that I have just received from a member bank at Genoa, Nebraska, as follows:

"The Farmers State Bank joined the Federal Reserve Bank two years ago and for the past six months has rediscounted 10% interest-bearing notes. Our records justify me in saying that we have made no profits owing to their changes of rules and rediscount rates."

I am also informed that certain banks in this territory have, within the last sixty days, withdrawn from membership in the Federal Reserve system.

From information that I have, I am altogether convinced that the Federal Reserve system is not functioning as it should in this district. The demands for liquidation were harsh in the extreme, in view of the fact that this is an agricultural region and the borrowers here could not easily conform to the same requirements that were imposed upon semi-agricultural or non-agricultural regions.

In conclusion I desire to suggest the desirability of a close cooperation among all of the agencies that have a controling influence over the handling of Federal Reserve funds in this district. This is not the condition that obtains now, and I am sincerely hopeful that something will be done to bring it about. May I anticipate your hearty interest in that direction?

Very truly yours,

Samuel R. McKelvie

Governor.