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NEW ENGLAND BANKERS' ASSOCIATION

NEW LONDON, CONN.

BY

EDMUND PLATT, VICE GOVERNOR, FEDERAL RESERVE BOARD.

Since the decision to publish the so-called "street loans" or broker's loans made in New York as a part of the regular weekly statement of condition of reporting member banks there has not been very much in the functioning of the Federal Reserve System to attract attention. Apart from the revamping of the criticisms of 1920-21 in the Iowa primary campaign the System has been generally free from political attack, and I think may almost be said to be in more danger today from the extravagant encomiums of its friends than from attacks of its enemies. The charters of the Federal reserve banks have been extended 50 years by the McFadden banking bill, almost without opposition - in fact without any expressed opposition at all in the Senate, which was rather surprising.

The decision to publish brokers' loans was the result of mature consideration, and had been discussed informally in the Federal Reserve Board and in the Federal Reserve Bank of New York for more than a year. The New York Reserve bank had been receiving reports from a group of the leading banks of the city showing their loans to brokers on demand and on time, both for their own account and for the account of correspondents. This gave some indication of the amount of credit absorbed by the stock market, and it appeared that most of the banks furnishing these reports were willing to have the totals made public. The governors of the Stock Exchange, when consulted were also favorable to publication and as you know decided to obtain the figures from the borrowing brokers and publish them,

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so that the public would have the information as coming both from the chief lenders and from the borrowers who are members of the Exchange.

The publication of these loans to brokers was well received, though the size of the fund was evidently a surprise to many people. It isn't the business of the Federal Reserve System to regulate the market for securities, but it is a part of its business to know how and where credit is being used. During the latter part of last year the Federal Reserve Board and the directors of many of the Federal reserve banks looked with some apprehension upon the gathering force of speculation in securities and in real estate. Rates were raised in four of the Reserve districts, as you know, beginning with this district, the Boston district, one half of one percent, followed by an increase in the New York district soon after the first of January. The Boston increase in November was hailed as a turning point by some of the speculators in the Stock Market, and though insignificant in itself was used as a signal for a sharp break in the price of securities. I may say here in New England that the directors of the Boston Federal Reserve Bank voted that increase of one half per cent in September and it might have been better if it had been approved and put into effect then. There was more or less criticism of the delay in the increase of some of these rates, but that criticism, if valid at all, does not hold against the Federal Reserve Bank of Boston.

It appeared that Federal reserve funds were indirectly used in the call loan market and the spread between call loan rates and Federal Reserve rates at 3-1/2 per cent was clearly, in my opinion, too great. The slight increases of rates, however, did not prevent the prices of securities from recovering rapidly and from reaching new high levels early in the year only to be followed some two months later by a severe period of readjustment. Just how much Federal Reserve policies have had to do with all this it is

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difficult to say, though it has given the financial writers ample opportunity for expressing their opinions and has doubtless stimulated study of the statements of the Reserve banks published from week to week.

It seems now to be the consensus of opinion that the break in securities in March did not foreshadow any very serious decline in the business of the country which has maintained itself at a rather surprisingly high level ever since, while the outstanding volume of Federal Reserve credit has been continuously higher than at the same periods a year ago, and was on June 10th about $64,000,000 more than at the same time last year.

The Federal Reserve Board and the Federal Reserve System have been criticised for many things and have been praised for many things, and I sometimes think that the praise received is likely to do it quite as much harm as the adverse criticism. Foreign economists have credited the Federal Reserve Board with accomplishments little short of miraculous. They have credited us with preventing the great gold importations from producing another inflation of prices and declared that we practically control the destinies of the world in the matter of prices as well as credit.

I do not know how much the rank and file of bankers who are members of such an organization as the New England Bankers Association may have read about the hearings on the bill introduced by Representative Strong of Kansas directing the Federal Reserve banks and Board to use all their powers to promote a stable price level, but from a Federal Reserve point of view these hearings have been rather the most interesting thing that has taken place in Washington during the past session of Congress, much more interesting in fact than the hearings and debates on the McFadden bill and on the branch banking controversy.

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The idea of a stable price level is a captivating one which has been given widespread interest by the Stable Money Association at the head of which is Professor Irving Fisher of Yale University. It was in fact Professor Fisher and Mr. Lombard of this Association who seized upon the Strong bill as a means of spreading their ideas that gave the hearings a standing. So far as I know none of these hearings, although they started in March and proceeded through April and for a week or two in May, have yet been printed, but the testimony has been so voluminous that it will probably be a good while before all of it can be revised and published.

In the course of their testimony expounding their theories, Professor Fisher and other economists who hold substantially the same views, declared that the Strong bill merely gave to the Federal Reserve Board and Banks the direction to continue doing what they had already been doing. These economists declared that the Federal Reserve System was and is promoting a stable price level as shown by the comparative stability of prices since 1922, and they cited charts and statements from the reports of the Federal Reserve Board and from the Federal Reserve Bulletins in support of this belief. They called upon the operating officials of the Federal reserve banks, notably Mr. Benjamin Strong, Governor of the Federal Reserve Bank of New York, and Mr. Norris of the Federal Reserve Bank of Philadelphia. Governor Strong was kept before the Committee day after day/for something like two weeks and the Committee took occasion to question him not only as to the operations of a bank that might perhaps have had an effect upon the price level, but as to every detail of operation. The Committee wanted to know not only all the considerations which move the directors

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in advancing or lowering discount rates, and the purchase of government securities or acceptances through open market operations, but they wanted to know how acceptances are drawn, just how they finance the movement of goods in import and export and in domestic transactions, how they get into the hands of dealers and how they come into possession of Federal reserve banks.

Governor Strong was flanked by Deputy Governor Harrison, Mr. Burgess and some of the other officials of the Federal Reserve Bank of New York and went very patiently into details of all these operations. He explained fully how the acceptance market was built up, stating that it had to be built up from the bottom and showing that it was necessary to have dealers in the financial centers carrying portfolios of bills to be distributed to member banks or corporations having surplus funds to invest. Such dealers or brokers have for many years existed in London and in fact the Bank of England almost invariably deals with them and not directly with the Joint Stock Banks which carry their reserves in the central bank.

The Federal Reserve Act provides for member banks carrying reserves in the Federal reserve banks and provides that member banks only may rediscount their paper with Federal reserve banks, but it also gives Federal reserve banks the authority to make contracts and authorizes the purchase of government securities, drafts and bills of exchange in the open market. Under this authority the Federal Reserve Bank of New York and occasionally other Federal reserve banks take short term government securities and acceptances from dealers on repurchase agreements at times when money rates make it impossible for the dealers to carry their portfolios on call money without serious loss. Governor Strong and others

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who have studied the bill market carefully consider this service absolutely essential to the continued operations of the dealers and the dealers themselves are, of course, essential to the building up in this country of an acceptance or bill market. Some of the members of the House Banking and Currency Committee questioned the legality of these operations but appeared to be satisfied as the hearings progressed that they are not only essential but legal. It would seem that it could not have been the intention of Congress to prohibit operations with the dealers in bills of exchange and acceptances which are the very backbone of such central bank operations as have been carried on by the Bank of England for generations.

I may say in passing that the questions asked of Governor Strong and other representatives of the Federal Reserve Bank of New York amounted almost to a searching investigation not only of its operations but of its expenses in every direction, and Governor Strong submitted charts showing the organization of the Bank and the functioning of every department together with much of the detail of its expenses. When these things are published they may be of interest to some of you. Those of us who have watched its operations from week to week, from month to month and from year to year are satisfied that the Federal Reserve Bank of New York as well as the Federal Reserve Bank of Boston and the other banks in the System are well organized and officered by men of high type, who conduct them with an eye single to the public welfare.

Besides Governor Norris and Governor Strong Mr. Adolph C. Miller, Member of the Federal Reserve Board, has testified at considerable length before the House Committee with relation to the Strong bill and has explained

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by means of charts and otherwise the technique built up by the Federal Reserve Board to enable it to form some judgment with relation to credit and business conditions, and the desirability from time to time of changes in policy whether in rates or in open market matters. The open market operations of the Federal Reserve Board were first explained in some detail in the Board's annual report of 1923, a report which attracted an unusual amount of attention from economists and financial writers. Some of them jumped to the conclusion that open market operations were of far more importance than discount rates and that here lay the secret of the Board's success in maintaining, as some of them believed, a fairly stable price level. I think it may be said, nevertheless, that the open market policy of the Board was not instituted with any idea of promoting a stable price level though price indexes are of course among the evidences of business conditions consulted.

Federal reserve banks on their own initiative in 1921 and 1922 began to purchase short term government securities with the idea of maintaining their earning assets at a time when their rediscounts were rapidly running off. The Federal Reserve Board at first contented itself by pointing out to them that by purchasing these short term governments in considerable amounts they were not really adding to their earning assets but were merely transferring them from rediscount to investments as they were actually furnishing the money to the market with which the rediscounts were paid off. The total volume of these government securities held by the Federal reserve banks approached $600,000,000 in the summer of 1922 and it seemed time to call a halt, as the Reserve banks were absorbing so large a volume of these securities as to give them an artificial market. The fund was then gradually

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liquidated in large measure and in April 1923 an Open Market Committee was formed under supervision of the Federal Reserve Board with the statement that its operations were to be governed with primary regard "to the accommodation of commerce and business and to the effect of such purchases in the general credit situation."

In general I think it may be said that this expressed purpose has been well carried out. Several meetings of the Open Market Committee are held every year and with particular regard to the effect of purchase and sales of securities in connection with the quarterly Treasury operations that come at the time income taxes are paid. At these periods the operations of the Open Market Committee have certainly served to prevent extreme fluctuations of money rates in the leading financial markets. How this is done was well explained in the Federal Reserve Bulletin for April last with reference to the March 15th Treasury operations. On that date the Treasury was called upon to pay out over $700,000,000 for the redemption of maturing security issues and for interest on the public debt, and during the following week it purchased over $100,000,000 of Third Liberty bonds for account of the sinking fund. At the same time the Treasury received more than $400,000,000 in income taxes and about $500,000,000 in the proceeds of the new refunding issue of United States Bonds.

Doubtless many of you remember the extreme fluctuations in call money rates that used to take place around these tax payment dates. The Treasury would disburse a large amount of money on the 15th of the month but the checks in payment of income taxes could not all be collected promptly on that date and consequently money rates for a few days would be extremely easy followed by a gradual tightening up. The Treasury has obtained

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its funds for payments on the 15th of each month in part from overdrafts at the Federal reserve banks covered by the sale tothe Federal reserve banks of special certificates of indebtedness. In New York on the 15th of last March it amounted to $190,000,000 with $19,000,000 additional to the Federal Reserve Bank of Chicago. These certificates were cut down each day following as the proceeds from income tax payments were brought in and the last portion was taken up by the Treasury on March 19th. Treasury outlays exceeded receipts for a day or so by about $130,000,000 and to offset this in part the New York Reserve Bank on March 13th and 15th sold government securities under repurchase agreements to the banks in the city, thus preventing any violent fluctuations in money rates.

Undoubtedly this is a valuable service, as such fluctuations in the money rates are always misunderstood by some people and may cause them to make commitments which they otherwise would not make. This is a simple case of the use of open market facilities in steadying short time interest rates. Something can be done and has been done along the same line over longer periods but it is easy to exaggerate the effects of such operations and it is not easy always to bring into the picture other contributing factors which those who are watching the thing from day to day cannot in fact always see until afterwards. That the open market operations of the Federal reserve banks have had some effect in the direction of steadying the general price level is probably true, but to infer from this that interest rates can be so manipulated through open market operations as to promote continuously a stable price level is an inference which seems to me unwarranted.

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The theory itself upon which the proposal for Federal Reserve action to stabilize prices is based is not by any means universally accepted, and among the economists who were called before the Banking and Currency Committee Professor O. M. W. Sprague of Harvard and Dr. Walter W. Stewart, who for several years was Chief of the Division of Analysis and Research of the Federal Reserve Board, called it seriously into question. Professor Sprague, I suppose, will be generally admitted to be the leading authority on the economics of banking in the United States. He said in his testimony before the Committee "I am very certain in my own mind that it is not possible to handle the ordinary oscillations of prices effectively by means of Reserve bank operations". He stated that he thought a marked inflation developing into a seller's market could be checked in some measure by Federal Reserve operations, but he did not believe that moderate variations in price "such as we find at the present time" could be directly attacked by Federal Reserve policies to any advantage. Citing the fact that there had been a decline in the general price level of about 7 points in the last few months he asked how anyone could tell what would be the effect of injecting arbitrarily additional credit into the situation. Open market operations he stated would merely put additional money in/to the New York market and there was no good reason for supposing, for instance, that this would have the effect of advancing the prices of the commodities that are lowest. It would be more likely, if it had any effect upon prices, to advance the prices of the commodities that had at the time the strongest tone in the market. "No central bank" said he "so far as I know has ever assumed the responsibility for the stabilization of prices."

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Both Professor Sprague and Dr. Stewart attacked the statements of Professor Fisher and other economists who had declared the comparative stability of the price level from 1922 to the present time was due to the policies of the Federal Reserve System. Professor Sprague said "I do not believe that that degree of stability is to be in the main attributed to the management of the Federal reserve banks. I consider it primarily due to the attitude of the business community which continued to recall the losses which it had experienced in 1920-21. The business community has been in the state of mind ready to take in sail at very short notice indeed." He disagreed strongly with the opinion which had been expressed to the effect that the upward movement of prices which culminated in the spring of 1923 was checked primarily by Federal Reserve policies and declared that agricultural prices were at that time out of line with industrial prices and stated that he knew "of no instance of a decided inflationary condition developing which did not start with a fairly sound situation as regards prices between agriculture and industry, and a fairly complete liquidation in agricultural regions of the wreckage from the previous period of inflation."

Dr. Stewart referred in more detail to the situation in the spring of 1923. Prominent economists at a meeting in Chicago toward the closing of the year 1923 had declared that there would be an increase of prices during 1923 amounting to something like 25 per cent. When this predicted increase did not take place they declared it was due to the action of the Federal Reserve Bank of New York in increasing its discount rate and in reducing open market holdings. Dr. Stewart declared that "with Europe out of the picture in 1923 so far as being an active purchaser of goods in this

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market was concerned, the foreign buying power being at a very low level, we did not have a business situation which could have given rise to any marked inflation no matter how abundant the volume of credit was", and he expressed the opinion that the turn of commodity prices in 1923 was not due to a change in credit conditions but to the fact that the level of output in industry "had been carried to a point where it was not possible to sell at the prevailing level of prices", and he called attention to the fact that after prices had begun to recede the volume of credit continued to increase. Dr. Stewart showed that for the periods of which he had made particular study an increase in the volume of credit did not precede price increases. The order was, first, production, then prices, then credit. When prices were advancing and when prices were declining in 1924 the order was the same. Increased credit frequently is granted to take care of inflated inventories which result from declining prices. This would seem to a layman to be a reversal of the procedure indicated by the theory that prices are always stimulated by increase of credit.

Now to turn to another subject. Just before I left Washington word came that the Conferees had agreed on the McFadden bill and it seemed likely to pass in substantially the form in which it was passed in the Senate, i.e., with the so-called Hull amendments eliminated. I do not know how largely New England bankers allowed themselves to be used in support of these Hull amendments, but it seemed to me that they were utterly illogical and probably would not have done anything towards accomplishing what their proponents professed to expect. It is a little hard to understand anyway why the storm center of opposition to any kind of branch banking should be

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centered in the city of Chicago. New York and Boston and Philadelphia and Baltimore and Buffalo and Cleveland and Detroit and New Orleans and Atlanta all have a certain amount of branch banking. In most of these cities it is confined to city limits, though in Cleveland it extends to immediately contiguous territory. This branch banking is wholly the result of state laws and if Illinois does not want branch banking it is the glorious privilege of her bankers to prevent it through the Illinois Legislature. There would appear to be no good reason why they should seek to control the matter through Federal legislation or why they should seek to influence State legislation by Federal legislation. The Hull amendments, as you remember, provided that if states where branch banking is not now permitted should change their laws so as to permit state banks to have branches national banks should not be given the same privilege. The theory was that national banks and state banks would not then have an inducement to go to the state legislatures and ask for a change in state laws. This theory ignores entirely the fact that the present branch banking situation has been brought about by state laws passed at the instance of state banks without any cooperation from national banks. It would certainly appear that one of the chief motives of the present state laws in states which favor branch banking was to give state banks a certain advantage over national banks. The branch banking features of the McFadden bill were drawn to correct this situation, but they would repeat it in the states which do not at present permit branch banking. Inasmuch as state banks outnumber national banks considerably more than 2 to 1 it would appear that with the Hull amendments in force the inducement to obtain an advantage in the matter of branches over national

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banks in these states would be very strong. What standing would national banks have before state legislatures in opposition to bills granting privileges to state banks? They would be told, I should think, to obtain their relief from Washington. The advantages state banks could obtain are obvious. If Missouri, for example, should change its laws in favor of branch banking while Congress was not in session state banks desiring to establish branches could obtain all the best sites in St. Louis before Congress so much as had a chance to act for the national banks.

Some of the bankers who advocate the Hull amendments seem to have no idea what they are, judging from the letters they write to Members of Congress. Senator Carter Glass paid his respects to this class of letter writers in no uncertain terms in his recent address to the stockholders of the Federal Reserve Bank of Richmond. He declared that the man who drew the Hull amendments "a little stockyards banker out in Illinois" was asked by the Senate Committee to justify the proposition, but "never came within a thousand miles of justifying it." "I have failed to find an American banker who says it is a sound proposition," said Senator Glass, and he added emphatically that the Senate will not accept the bill containing it. Now Senator Glass knows what he is talking about and unless the Hull amendments go out the bill will fail of passage. It comes up again in the Houst next Tuesday, I understand.

As I have said on several occasions I consider branch banking a country bank proposition rather than a city bank proposition, and I consider it a proposition for the agricultural West rather than for the industrial East. Unit banking works very well in the East. We have none of the very small banks that are so numerous in the West and even our smallest banks are nearly all situated in territory where they have more funds at their

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disposal than they can loan at home and where they are not under any serious temptation to loan an undue proportion of their funds to one industry. We have had a tremendous number of bank failures in this country during the past few years, so many as to constitute it seems to me a disgrace to a great nation so strong as we are in financial matters. In 1924 there were 777 failures, in 1925 there were 612, and in this year down to the 1st of June there were 183. A study of the bank failures of 1924 and 1925 made by the Federal Reserve Board shows that the great majority of these failures were in the section between the Mississippi River and the Pacific slope, a section which in my opinion, for the purpose of serving an agricultural community adequately and safely, has the worst banking system in the world. 40 per cent of all the bank failures during the past two years were in places of less than 500 population, and over 61 per cent were in places of less than 1,000 population, while only 20 per cent of the total failures occurred in towns that are defined by the Census Bureau as <u>urban communities</u>, i. e., places of 2,500 population or over. 63.4 per cent of all bank suspensions during the past two years were banks with a capital of $25,000 and under, and less than 10 per cent were banks with a capital of $100,000 and over. The average capital of suspended banks was $38,243.00 and their average deposits $281,182.00. Thousands of western banks have a capital of less than $25,000. The conclusion is inevitable, it seems to me, that they are too small to afford good management, and operate in too narrow a territory. The resources of very many of them are too small to take care of their home demands in peak seasons and they frequently have to borrow heavily. I can see no reason at all why they should not be consolidated into little systems of some size with the smaller places served by branches. It is not

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at all necessary to build up big systems, and if big systems are feared it might be a good plan to prohibit banks in reserve cities from having branches outside their limits, or it might even be provided that no cities of more than 25,000 or 50,000 inhabitants should be allowed to have branches outside. As outside branch banking has so far developed in this country most of it proceeds from cities of less than 10,000 inhabitants and the banks scarcely average 2 branches to a bank. Such little systems are very common in the South and appear to have done something to strengthen the banking situation.

The McFadden bill discriminates against these little country branch banking institutions most of which are not members of the Federal Reserve System. Their branches are as a rule all outside of so-called city limits for the very good reason that they are not in cities and have nothing to do with cities. The largest of them, in number of branches, is the Eastern Shore Trust Company of Cambridge, Maryland. I wonder if any of you ever heard of this Cambridge. Another, almost as large, has its headquarters at Decatur, Alabama, and another at Grenada, Mississippi. The McFadden bill, as it passed the House, would have barred these little country branch banking institutions from the Federal Reserve System. In the Senate form it will admit them with their present branches. They take on new branches only occasionally, but they seem to value the branch banking privilege, and now and then they prevent bank failures by consolidations that could not be made without the branch banking privilege. There appears to be no reason whatever for refusing them admission to the Reserve System with the privileges given them under State laws, and my belief is that they will in time demand the removal of the discrimination against them. The McFadden bill

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does not settle the branch banking controversy. It can only be settled by giving to national banks the same privileges with respect to branches that are given to State banks, thus leaving the matter of branches wholly to the States.

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