The Federal Reserve System as Related to American Business

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Published by
FEDERAL RESERVE BANK *of* PHILADELPHIA

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before the

Washington Chamber of Commerce

December 13, 1921

Published by

FEDERAL RESERVE BANK
OF PHILADELPHIA

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The Federal Reserve System As Related to American Business

Although more than seven years have elapsed since the establishment of the Federal Reserve Banks, there is still a surprising lack of knowledge of what they really are and of what their proper functions are, not only on the part of the public at large but among business men and bankers as well. Much has been said and written regarding the Federal Reserve System, which is calculated to create entirely false impressions, and in order to present the subject in a fair and proper light, an effort will be made to describe concisely the fundamental character and some of the distinctive functions of the Federal Reserve Banks and the Federal Reserve System.

The Federal Reserve Act, which is responsible for the existence of the Federal Reserve Board and the Federal Reserve banks, was approved on December 23, 1913, and has, at various times since, been amended by Congress. The amendments, for the most part, have been the result of suggestions made by the Federal Reserve Board and were designed to render the Act more effective.

The general purposes of the Act are outlined in its caption or short title, which is as follows:

> "An Act to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

The need for a more efficient banking system in the United States had been felt for many years. Ever since the year 1890 the subject was one which was discussed frequently at bankers' conventions and at

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gatherings of commercial bodies, but the event which gave great impetus to the movement for banking reform along constructive lines was the panic of 1907. The following year Congress created a Monetary Commission, which after a long and thorough study of the banking systems of the world submitted an exhaustive report. During the years 1911 and 1912 a committee of the House of Representatives, commonly known as the "Pujo Committee," investigated banking methods in this country and submitted a report.

With this wealth of information in hand, Congress early in the year 1913 took up the matter of banking reform in earnest and the Federal Reserve Act was put upon the statute books before the close of the year.

This Act is very generally admitted to be a great constructive piece of legislation and is praised both by friends and critics of the Federal Reserve System; frequently by those who do not understand the Act, as well as by those who do. It is because so many have no real conception of the purposes or meaning of the Act that much of the criticism which has been directed against its administration has been given a consideration entirely unwarranted by the actual facts.

The Federal Reserve Act did not establish a central bank. On the contrary, it made possible the establishment of as many as twelve Federal Reserve banks, each almost wholly independent of the others in operation, as well as in local policies. From a legal standpoint these banks are private corporations, organized under a special act of Congress, namely, the Federal Reserve Act. They are not in the strict sense of the word Government banks, but are only quasi-Government institutions, in that they are under the general

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supervision of the Federal Reserve Board and have on their boards of directors three men, representing the public, who are appointed by the Federal Reserve Board.

Each bank has nine directors and the other six are chosen by the member banks, which are the sole stockholders of the Federal Reserve bank. The law does not contemplate active competition by the Federal Reserve banks for business with each other or with national banks, state banks, trust companies and savings banks. Federal Reserve banks are not allowed to receive deposits from the public and can accept deposits only from their member banks, from the United States Government and, solely for the purposes of exchange or collection, from non-member banks or trust companies. They are not allowed to make loans or advances direct to the public, but can lend only to the United States, to their member banks and, subject to certain conditions, for periods not exceeding six months, in anticipation of the collection of taxes or the receipt of assured revenues, to states, counties, municipalities and other political subdivisions in the United States.

The Federal Reserve banks are not permitted by law to make loans direct to individuals, firms and corporations, and while they can, under certain restrictions, purchase bills of exchange and bankers acceptances in the open market, their dealings with the public in the matter of loans are limited to the discounting of notes, drafts, and bills of exchange for member banks, all such paper to be indorsed by the member bank offering it. In lending in this way to their member banks, the Federal Reserve banks are not authorized by law to use the same discretion and freedom of action that are allowed national banks, state banks and trust companies, but they must

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observe the limitations prescribed by law as to the character and maturity of the notes offered them by member banks for discount; except as to notes, drafts and bills drawn or issued for agricultural purposes or based on live stock, which a Federal Reserve bank may discount for a member bank if the maturity does not exceed six months, a Federal Reserve bank cannot discount any paper for a member bank which has longer than three months to run, exclusive of days of grace.

The law puts a limitation also upon the character of a note which a Federal Reserve bank may discount for a member bank. A Federal Reserve bank may make advances to its member banks on their promissory notes for a period not exceeding fifteen days, provided, such promissory notes are secured by the deposit or pledge of bonds or notes of the United States, or by notes, drafts and bills of exchange or bankers' acceptances which are themselves eligible for rediscount or purchase by a Federal Reserve bank. To be technically eligible for rediscount a note must be endorsed by a member bank, its maturity must be within the time limit prescribed by law and it must have been issued or drawn for agricultural, industrial or commercial purposes, and it must also be shown that the proceeds of the note have been used or are to be used for such purposes.

As Federal Reserve banks are not permitted by law to rediscount any paper which does not bear the endorsement of a member bank, it is clear that in order for a Federal Reserve bank to render financial assistance to those engaged in commerce and industry, in agriculture or in the raising of live stock, the loans must first be negotiated with member banks. There are many loans, however, which member banks may legally and properly make which cannot be redis-

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counted with Federal Reserve banks for the reason that the law does not admit of the classification of such paper as eligible. A Federal Reserve bank, therefore, cannot discount any paper, however good it may be, which is not technically eligible under the terms of the Federal Reserve Act; and, on the other hand, it is entirely within its right in declining to discount notes which, even though technically eligible, are not satisfactory from a credit standpoint.

Federal Reserve banks are forbidden by law from discounting notes, drafts or bills, covering merely investments, or issued or drawn for the purpose of carrying or trading in stocks, bonds or other investment securities, except bonds and notes of the Government of the United States.

The Federal Reserve Act, as amended, has changed both the amount and character of the reserves which all national banks and state member banks must carry against their deposit liabilities. For a long period of years, it has been the practice of American banks to carry as a reserve in cash and on deposit with other banks, a certain proportion of their deposits. Before the passage of the Federal Reserve Act, the national banks in the three central reserve cities were required to keep in their own vaults as reserve in gold or lawful money an amount equal to 25% of their net deposits, and in other cities and towns they were required to keep a part of their required reserves in cash in their own vaults and a part on deposit with other banks. The laws regarding the reserves of state banks varied in the different states. Under the Federal Reserve Act the percentage of reserve required has been substantially reduced, and as amended, no national bank and no state member bank is required to keep any definite amount of cash in its own vaults and whatever

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amount of cash is kept on hand by the member banks, as deemed necessary by the judgment and experience of their officers, does not count as part of the banks' lawful reserve.

The entire legal reserves of all member banks must be kept on deposit with the Federal Reserve banks. As a consequence, the cash resources of the Federal Reserve banks are necessarily very large and their holdings of gold, in particular, constitute a very large proportion of all the gold in the country. The gold held by the Federal Reserve banks is equal substantially to all the gold that might have been held by all the banks throughout the country if there had been no Federal Reserve banks established.

As the Federal Reserve banks are made the sole custodians of the legal reserves of all member banks, the object of Congress in throwing safeguards and limitations around their loan transactions is evident. It is necessary that Federal Reserve banks should keep themselves in a "liquid" position, that is, their bills discounted must be of short maturity and should be readily collectible. The strength of the entire banking system of the United States is directly related to the strength of the Federal Reserve banks. If the Federal Reserve banks should allow themselves to get into a weak, over-extended and unsafe position, all member and non-member banks would be seriously affected.

While Congress has placed upon the Federal Reserve Board the responsibility of defining eligible paper, within the meaning of the Federal Reserve Act, it has entrusted the management of the Federal Reserve banks, under the general supervision of the Federal Reserve Board, to their own directors. Each Federal Reserve bank has power to appoint, by its board of directors, such officers and employees

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as are not otherwise provided for in the Federal Reserve Act and to define their duties, to prescribe by-laws, not inconsistent with the law, regulating the manner in which its general business may be conducted, and to exercise, by its board of directors, or duly authorized officers or agents, all powers specifically granted by law and such incidental powers as may be necessary to carry on the business of banking within the limitations prescribed by law.

Each Federal Reserve bank is conducted under the supervision and control of its board of directors, who are charged by law to perform the duties usually appertaining to the office of directors of banking associations and to administer the affairs of the bank fairly and impartially and without discrimination in favor of or against any member bank or banks 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.

The Federal Reserve Board is not authorized by law to pass upon the paper which is offered for discount to Federal Reserve banks. This is a function which must be exercised by the directors of the Federal Reserve bank or by their duly authorized officers or agents. While the law does not prescribe any fixed limit as to the amount of loans that a Federal Reserve bank may make to a member bank, it does require that due regard must be given to the claims and demands of other member banks, that is, to their possible needs for credit accommodation. It also provides that a Federal Reserve bank must extend to each member bank such discounts and accommodations as may be "safely and reasonably made."

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This means that the directors of a Federal Reserve bank and the officers appointed by them must exercise their best judgment in granting discount accommodations. They must assure themselves that the discounts are such as can be safely made, and reasonably made, with due regard to the possible requirements of other member banks which may ask for accommodations later on.

The lending power is not vested in the Federal Reserve Board and the reason for this is probably two-fold. First: the Federal Reserve System is not a central bank. It is a regional system comprising twelve banks. Congress did not intend that there should be a centralized control of credits. Second: in a country embracing so vast an area as the United States, it would be a very difficult task, if not an impossibility, for a central Board to pass intelligently upon the security of the paper offered for discount, which must necessarily come from all sections of the country.

While the Federal Reserve Act was intended to strengthen the banking system of the United States and to provide ready means of rediscounting certain classes of paper, it is also the evident intention of the Act to disturb as little as possible the business of the member and non-member banks, or their dealings with their customers. There is nothing in the Federal Reserve Act which gives either the Federal Reserve Board or a Federal Reserve bank any control over the loan policy of any member bank. A Federal Reserve bank cannot compel a member bank to make a loan which it does not desire to make, nor restrain it from making a loan which it wishes to make even though it is forbidden by law.

A Federal Reserve bank cannot lend directly to the customers of a member bank, nor does it, in fact,

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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.

There is a very general popular misconception regarding this and it may be that some of the member banks are responsible for this misunderstanding without being actuated, however, by sinister motives. Banks, as a rule, do not like to admit to customers that they are short of loanable funds nor do they wish to arouse enmity in declining to make loans or in asking for a reduction of a loan already made.

There are some bank officers who are able frankly to decline an application for a loan in a way which leaves no sting, but which on the contrary gives the applicant the impression that the rejection of his application is a favor to him. But not all bank officers have such tact. Some are frank enough, but their bluntness hurts the feelings of the would-be borrower. It is not unusual, therefore, for bank officers in declining loans to look for a buffer, or some one to whom they can "pass the buck." In the old days, the board of directors was made useful in this capacity.

Nowadays, however, bank officers find in the Federal Reserve Board or the Federal Reserve bank a much more satisfactory buffer than a local board of directors. In many cases, in agricultural sections particularly, banks have found it very convenient to "pass the buck," to the Federal Reserve bank or the Federal Reserve Board, and have stated to a borrower or would-be borrower that they would like to grant

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the extension asked for or make the loan desired, but the Federal Reserve would not permit it. Such a procedure has a tendency to relieve the situation as far as the local bank is concerned but it is certainly unfair to the Federal Reserve System. This evasion of responsibility has subjected the Federal Reserve banks to a great amount of unjust criticism and has given the public a wrong impression of the authority and attitude of the Federal Reserve banks and the Federal Reserve Board. It has aroused indignation which is entirely natural in the circumstances and has caused much correspondence with the Federal Reserve Board direct and with Congressmen and United States senators, whose ire has been aroused because of these alleged arbitrary methods.

It is entirely true that a Federal Reserve bank, mindful of its responsibility under the law and acting in accordance with the dictates of ordinary banking prudence, may have had occasion to call the attention of some of its larger borrowing banks to their large discount lines, which have run in some cases over a period of years, without being reduced, and have called the attention of the borrowing banks to the necessity of working themselves into a stronger position. But in no case within the knowledge of the Federal Reserve Board has any Federal Reserve bank undertaken to say to a member bank what particular loans it should call or ask to have reduced.

I will give you a concrete example. In a southern state, there is a national bank which has for a long time been a large and continuous borrower at the Federal Reserve bank, the amount of its rediscounts being several times greater than its capital stock and its fair proportion of the loanable funds of the Reserve bank. It seems that this bank has made frequent promises to reduce its discount line to a more

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reasonable sum, but as it collected notes it would constantly send in others for rediscount.

Here is a notice that this bank appears to have been sending to some of its borrowing customers, which reads as follows:

"Your note for $————falls due————————.

"Our *Federal Reserve Bank* owns this note, having rediscounted it for us. As it has been renewed several times, they are *insisting on a payment* of $——— or more. It is *absolutely necessary* to arrange this note on the day of its maturity. Yours truly ————Cashier."

When the Federal Reserve bank was informed that these notices were being sent out, it immediately called the attention of the member bank to the fact that it had not insisted upon the payment of any particular note and directed that this form of notice be discontinued. The Federal Reserve Board has received many complaints growing out of incidents of this kind.

It is gratifying, however, to know that the general sentiment toward the Federal Reserve System is not moulded by ignorant or prejudiced critics, but that there is throughout the country a high appreciation of the splendid service it has rendered during the trying times through which we have passed. I wish to avail myself of this opportunity to say a word of commendation of the manner in which the officers and directors of the twelve Federal Reserve banks have performed their arduous duties and of their skill and courage in dealing with the many grave and complex problems, some local, others national in scope, with which they have been confronted during the acute world crisis, which happily is now a thing of the past as far as this country is concerned.

It is my sober conviction that basic financial condi-

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tions in this country are very much better than they were twelve months ago. There are many surface indications which bear out this statement and those who know the general situation appreciate this fact.

Business has passed through the primary stage, the acute period of reaction, but we have not yet reached "normalcy" for the readjustment has not been uniform and there is not yet established a natural and equitable basis for the exchange of goods for goods or goods for services. For example, farm products in many cases are now below the pre-war level and in some instances below the cost of production. Prices of some manufactured goods have declined sharply, while others have not, and the general price index and the cost of living are still much above the 1913 level. Manufacturers and merchants are vitally interested in conditions in the agricultural sections. The farmer is the great consumer of manufactured goods. His purchasing power at present is much impaired, partly because of the lower exchange value of his products and partly because of unliquidated indebtedness. Until the purchasing power of the farmer improves it will, of course, be idle to look for any rapid or substantial improvement in domestic trade.

I think, however, that the outlook for the farmers is more hopeful. They have, no doubt, been benefited through the activities of the War Finance Corporation which, although it cannot make direct loans to individuals, is rediscounting paper for banks which because of long maturity is not eligible for rediscount with the Federal Reserve banks. While the agricultural situation is a most important factor in our domestic trade, there are other things which must be taken into account. The decline in prices of manufactured goods has not been as great as the shrinkage in value

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of raw materials, and the retail price index does not show a drop corresponding to that of the wholesale price index. This indicates that manufacturing costs have not declined in proportion to primary production costs and that the costs of distribution and of doing business are disproportionately high.

The remuneration of farm labor depends mainly upon the price of farm products, but in manufacturing industries labor costs are not always immediately related to the cost of the raw material used in these industries nor, indeed, to the price of the finished product. Other important elements of cost are taxes, freight rates, rents and fuel. The Federal Government must necessarily raise large revenues in order to meet obligations incurred as a result of the war and our system of taxation is designed to levy the highest rates on large incomes.

This taxation can be escaped altogether or in part by investing in State and municipal bonds, which are exempt from the income tax, and the ability of municipalities to sell their obligations more readily because of this fact has had a tendency to increase the volume of their indebtedness. Consequently local taxation has increased materially, and unless the issue of tax exempt obligations is checked, the ultimate results are likely to be serious.

Operating costs of the railroads are much above normal and transportation rates have been increased as an offset.

Rents are high because of increased taxes, higher up-keep costs and the inadequate supply of houses occasioned by the reduced building operations during the past four or five years.

Fuel is high, due partly to increased taxes, higher costs of production and increased costs of transportation and distribution.

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The restoration of normal conditions in agriculture, commerce and industry depends to a great extent upon the reduction of these essential items of expense.

Much depends also upon the results of the Conference for Limitation of Armaments now being held in this city. This Conference is the most important which has ever been held in this country and if the program submitted by the Secretary of State is adopted it will have a profound effect upon the finances of the world. In fact the proceedings of the Conference up to this time and the proposed treaty between the four great powers which control the Pacific are accepted as harbingers of peace and have had already a stabilizing effect. The notable advance in sterling exchange, which began with the assembling of the Conference, is not a mere coincidence.

When great nations enter into competition with each other in the extension of huge naval and military establishments, the large sums necessary for these additions and maintenance must be met by taxation in some form or other. Money expended for armament is devoted to non-productive and destructive purposes. These sums released for constructive or productive use in the creation of new wealth will stimulate the revival of business activity.

The position of the United States with respect to world affairs has entirely changed since 1914. Up to that time we were a debtor nation. When the war broke out in Europe the United States was a debtor on the world's balance sheet to the extent of probably four billion dollars, representing amounts due on current account plus foreign investments in this country. Now we are a creditor nation in a large amount. Besides the sum of ten billion dollars advanced by the United States to nations associated

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with us in the war, there is a large balance due this country as a result of private trade transactions, which has been variously estimated from a billion and a half to three and one-half billion dollars.

Agriculture, industry and commerce in the United States all have a vital interest in foreign trade. We produce a large exportable surplus of farm products and of manufactured goods and any curtailment in the foreign demand for these products is immediately reflected in our domestic trade.

During the past year we have received large additions to our stock of gold by reason of importations from foreign countries. These importations do not represent sums for account of central banks, which have as a rule increased their gold holdings since the outbreak of the war, but they represent widely scattered holdings from practically all countries which have been sent here in payment of pressing obligations or for the purchase of supplies urgently needed.

It is evident, however, that a normal volume of foreign trade can not be supported by shipments of gold from abroad. In ordinary circumstances international trade is based upon the exchange of goods and services, actual transfers of gold representing only a very small proportion of the total volume of business and being made merely for the purpose of stabilizing the exchanges.

Most of the business troubles through which we have passed and which still confront us today can be attributed either to the war or to the course of events during the year 1919. It was realized that the signing of the Armistice which ended the war from a military standpoint did not end it in a financial sense and during the early months of the year 1919 there was a lull and much hesitation in business. The successful flotation, however, of the Victory Loan in May of

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that year was regarded as the end of the war in a financial sense and a period of great activity set in.

It was evident that four years of war had greatly impaired the productive capacity of Europe and had reduced, almost to the vanishing point, stocks of goods and supplies of all kinds. There was a general impression that there was a world-wide shortage of goods and that Europe in replenishing her supplies must continue to draw heavily upon the productive capacity of the United States, just as had been the case ever since the year 1915. This impression was deeply engrafted upon the minds of the public and for a time European needs were so urgent that they had to be supplied at any sacrifice. At the same time a substantial part of the sum which during the war the United States had agreed to advance to foreign nations was still unexpended and these funds were used during the year 1919, in payment of goods exported to Europe.

Many shrewd business men looked forward confidently to several years of commercial and industrial activity and made their plans upon the assumption that prices would either advance or remain stable and that a return to the pre-war level or a serious decline in the immediate future was most improbable. Farmers incurred obligations for additional land at a valuation based upon the commodity prices then existing, merchants extended their business and manufacturers prepared to increase their productive capacity by making additions to their plants, regardless of the fact that such additions could be made only at costs much higher than normal.

The consensus of public opinion was that we had entered into an era of high prices and that there would be for some time a serious shortage of goods. Many jobbers called in their salesmen and were obliged to

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scale down the orders which poured in by every mail. Prices advanced week by week and many producers and merchants were reluctant to sell, for advancing prices were accompanied by higher wages and greater production costs.

Credit was freely used, not only in production at high cost but in withholding goods from the market, and inventories and bank statements everywhere showed an expanded condition which would have been regarded as unthinkable a few years before.

Looking backward it is easy to point out the essential fallacy in the position which was taken and to explain the logical and inevitable reaction which took place, a reaction, however, which many did not foresee until too late. This fallacy lay in the incorrect estimate of the shortage of goods. The normal relationship between production and consumption was accepted at a time when conditions were anything but normal. There was, indeed, no question as to the desperate need of Europe for American goods and supplies but proper consideration was not given to the flexibility of consumptive requirements. What a man cannot get at all he must do without, and when he cannot obtain all that he needs he must be satisfied with a moiety. The mere need for goods, however urgent, does not create an economic demand. There must be an ability on the part of those needing goods to satisfy the need, either by exchanging other goods, by rendering service, by paying cash or by tendering some acceptable form of credit obligation.

Millions of people in Europe were obliged to deny themselves a part of their accustomed food supply, to forego purchases of clothing and other things which ordinarily would be regarded as absolutely necessary. Luxuries were impossible and in many

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cases articles so classed were sacrificed in order to provide necessities.

The effect of high prices in this country was reflected finally in reduced consumption and in the latter part of March, 1920 those who had dreams of a long continuance of the conditions which had existed up to that time were rudely awakened by the collapse of the silk market in Japan. Public opinion began to undergo a change and public opinion is a powerful force, more potent than banking boards, than legislative bodies and Government itself. The curtailment of buying became more and more noticeable. What has since been referred to as the "buyers' strike" manifested itself throughout the country and in quick succession the drastic reactions in commodity prices began to take place. Many who had been eager to buy withdrew from the market and many who had been reluctant to sell became anxious to dispose of their goods.

Banks began to find that loans which they had thought could be repaid at any time desired could not be collected in the new circumstances and must be carried along. Recourse was had in increasing degree to the Federal Reserve System, which responded to all legitimate demands and which should be credited with preventing what would otherwise have developed into a most disastrous money panic.

During the year 1920, when these drastic changes in price levels were taking place, the total earning assets of the Federal Reserve banks, which include rediscounts for member banks, increased from $3,039,000,000 at the end of January to $3,396,000,000 at the end of October. At the same time there was not only no contraction in Federal Reserve note currency, but on the contrary there was an almost continuous increase in the volume of Federal Reserve

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notes in circulation, the amount increasing from $2,844,000,000 on January 23rd to $3,404,000,000 on December 23rd, 1920, a record high mark.

These figures should be impressed upon the minds of the public, for the reckless and unwarranted statement is often made that the Federal Reserve authorities deliberately set out to bring about deflation and to accomplish this purpose caused sharp curtailment of credit and drastic contraction of the currency.

The events of the past two years have demonstrated the fact that there is no unalterable relationship between commodity prices and the volume of credit and currency. It is not the function of the Federal Reserve System nor of any banking system to attempt to fix or control prices and Federal Reserve discount rates have never been established with that idea in view. Banks should be concerned with prices only in so far as the security of their loans may be involved and they are interested more in the stability of prices and their margin of collateral than in the price level itself. Banks do not create general conditions, but they must adjust themselves to changing conditions, which, in recent eventful months, have been brought about by unseen and irresistible forces throughout the world.

Early in September there was much rejoicing throughout the Southern States because of the marked advance in the price of cotton. This advance is not due to any increase in the loans of the Federal Reserve banks nor to any expansion of the currency. As a matter of fact the amount of Federal Reserve notes in circulation on September 15, when cotton was selling at about 21 cents a pound, was about $500,000,000 less than when cotton was selling at 11 cents a pound early last Spring. The advance in the price of cotton was due to economic causes and to the oper-

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ation of the inevitable law of supply and demand. After the report of the Department of Agriculture early in September, the world awakened to the fact that the present cotton crop is abnormally small, and it was thought at one time that less than seven million bales would be produced. As the ginners' reports were made, it became evident that the Department of Agriculture had under-estimated the size of the present crop of cotton and the price declined four or five cents a pound.

This decline took place notwithstanding the reduction which was made about the same time in the discount rates of all Federal Reserve banks, including those in the South. The fact should be emphasized that the net advance which has taken place in the price of cotton has been due not to credit or currency expansion but rather to the deflation of the anticipated supply of cotton and to the probability of increased consumption.

There is perhaps even greater confusion in the public mind regarding the issue of Federal Reserve notes than there is regarding the rediscounting functions of the Federal Reserve banks. There are some who appear to have an impression that the Federal Reserve Board has power to expand or contract the currency of the country at will and that it has exercised this power in a reckless and arbitrary manner. While the law prescribes that the Federal Reserve Board shall have the right, acting through the Federal Reserve Agent, to grant in whole or in part or to reject entirely the application of any Federal Reserve bank for Federal Reserve notes, it has never exercised this right. On the contrary, it has always approved promptly every application which has been made for the issue of Federal Reserve notes. One of the purposes of the Federal Reserve Act, as

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stated in its caption, is to furnish an elastic currency, but there are many whose idea of elasticity is continuous stretching.

Currency to be really elastic must be susceptible of expansion or the reverse, as the needs of industry and commerce may require. Many believe that there was a preordained contraction of the currency during the year 1920, determined upon in order to reduce prices. The expansion of nearly $600,000,000 in Federal Reserve note circulation which actually took place during that year shows that the impression is absolutely unwarranted.

An increase or decrease in the volume of Federal Reserve notes outstanding is not the result of any preordained policy or premeditated design, for the volume of Federal Reserve notes in circulation depends entirely upon the activity of business or upon the kind of activity which calls for currency rather than book credits.

Federal Reserve notes can be issued only against collateral in an amount equal to the sum of the Federal Reserve notes applied for, which collateral security must be notes and bills discounted or acquired by the banks or gold or gold certificates. The law requires each Federal Reserve bank to maintain a reserve of 40 per cent in gold against its Federal Reserve notes in actual circulation.

During the present year the loans of the Federal Reserve banks to their member banks have decreased by about $1,550,000,000 and as the notes discounted with Federal Reserve banks have been paid off Federal Reserve note currency has come back to the banks and in the absence of a demand for it, has not been reissued. Upon payment of commercial paper which has been deposited to secure Federal Reserve notes, there necessarily results either an immediate

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return of an equivalent 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 for credit or for redemption to the Federal Reserve banks or to the Treasury at Washington. Thus, there cannot be at any time more Federal Reserve notes in circulation than the needs of the country at the prevailing level of prices and wages require, and as the demand abates the volume of notes outstanding will be correspondingly reduced through redemption. The increased volume of Federal Reserve notes in circulation from 1917 to the end of the year 1920 was, in so far as it was not the result of direct exchanges for gold and gold certificates, the effect of advancing wages and prices and not their cause, just as the reduction which has taken place during the present year is the result of lower prices and smaller volume of business, rather than their cause.

Under the Federal Reserve System, as business expands, as labor is more fully employed and as production increases and distribution becomes more active, there follows a demand for greater discount accommodations and a need for more currency, and the increased volume of discounts furnishes a means of providing the increased volume of currency required.

The Federal Reserve banks hold today a gold reserve of about $2,850,000,000 and a combined reserve against member banks' deposits and note issues of slightly more than 73 per cent. Or if the legal minimum reserve of 35 per cent be set up against deposits, there would remain a gold reserve of slightly

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more than 100 per cent against Federal Reserve notes outstanding.

For some months past there has been a marked easing in domestic rates of interest. Notwithstanding unfavorable features in our revenue laws, the investment market is now absorbing securities at reasonable rates which could not have been considered a few months ago. Market quotations of Liberty Bonds have steadily advanced until they are now approaching par. Good railroad and industrial bonds have also appreciated and there have been some noticeable advances in standard stocks.

In his annual report just sent to Congress, the Secretary of the Treasury remarks that the advance in the price of Liberty Bonds and Victory Notes is in part a reflection of easier credit conditions and lower interest rates, though increased buying on the part of investors and better distribution of the public debt doubtless account for much of the improvement. High commodity prices and great business activity usually mean lower prices for bonds and other securities yielding a fixed income, while reduced commodity prices and lower money rates bring higher market prices for bonds.

The question is often asked—why in view of our enormous stock of gold American bankers do not avail themselves of the opportunity of making the United States the world's banker. There is no question that our present gold supply is far beyond our domestic requirements, nor is there any doubt that a great stimulus would be given to our foreign trade were it practicable for American bankers to engage in world finance in a large way.

As high grade American securities yield a lower income rate, the attention of investors will be directed more toward European securities. Investments in

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foreign properties and securities and long time loans abroad will improve foreign exchange conditions, but before such investments or loans will be made in very large volume it will be necessary to inspire American investors with confidence in the political and economic stability of Europe.

A successful outcome of the Conference for the Limitation of Armaments should do much to inspire confidence in the political stability of the world and when the governments of the various countries in Europe balance their budgets by limiting the amount of their expenditures to the revenues received from taxation and other sources, and discontinue the emission of new issues of uncovered paper money, there should follow a restoration of confidence in the economic and financial condition of Europe. Judging from our own history after the Civil War, many years will doubtless elapse before some European countries can restore the normal value of their currencies, but if the violent fluctuations in exchange which have marked the past two years can be prevented in future and a stabilization on some basis accomplished, it will be possible to engage in commercial and financial transactions with Europe on a much larger scale than at present. If we wish to sell our surplus products abroad, it is evident that we must continue to exchange commodities with foreign countries, for where we sell we must buy. A curtailment of production to meet merely American requirements would involve wide-spread unemployment and would invite disaster. On the other hand, because of the great depreciation in the currencies of many foreign countries their labor costs are much less than ours and partly because of this fact and partly because of the high premium on dollar exchange, they are able to undersell us in our own markets. One of the great

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problems of our national legislators today is to frame a tariff which will prevent the dumping upon our markets of foreign goods, without at the same time erecting a tariff wall so high that our exports will be greatly reduced because of the inability of foreign nations to trade with us.

In conclusion, a word more may be added concerning the Federal Reserve System. A Federal Reserve bank is what its name implies. It is a reserve bank. It holds on deposit the entire legal reserve of its member banks. It is not authorized by law to receive deposits from the public, nor to lend directly to individuals, firms or corporations. It can rediscount paper of short maturity for member banks with their endorsement, that is, notes, drafts and bills of exchange issued or drawn for agricultural, industrial or commercial purposes, or the proceeds of which have been used or are to be used for such purposes. Based in part on the security of such paper, it can put in circulation Federal Reserve notes in sufficient volume to meet the requirements of ordinary business transactions or of an acute emergency.

But the Federal Reserve System should not be expected to accomplish the impossible. It is not a panacea for all economic and financial ills and it cannot, however skillful its administration may be, prevent periods of depression in the future, although it can do much to modify them. Other nations, such as Great Britain and France, with their great central banking institutions, have always had their years of prosperity and their periods of depression, although they have been free from the money panics which we formerly had in this country as a result of our inadequate banking system and which we would, no doubt, have had in the most aggravated degree a year or so ago but for the efficiency and stabilizing influence of the Federal Reserve System.

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There are well defined cycles in business. We have the short and frequently recurring cycles incident to the changes of the seasons and all history shows that there are longer swings or periods of prosperity and depression, the rotation being about as follows: (1) Business activity and increasing production, (2) Excessive expansion and speculation, followed hitherto by panic and forced liquidation, (3) A long period of slow liquidation, business depression and stagnation, and (4) Revival.

There are many indications that the beginning of revival is not far distant. When it does definitely set in, it will be followed in due course by a new era of prosperity. While the losses during the past two years have been great, much experience has been gained and while experience is not transferable, except perhaps to a limited extent, the present generation of business men has several years of business activity ahead of it.

In the light of this experience, we should remember, when we again enter into a period of full prosperity, that a reaction will follow sooner or later and if the flow of the incoming tide can be controlled so that the crest may not be reached too rapidly nor rise too high, the subsequent reaction will be less severe and the next period of industrial and commercial activity and general prosperity will be marked by saner methods, greater achievement along constructive lines and by a longer duration than any which we have had before. We should not forget that the ebb of the tide is always equal to the flow and that the ebb in the Bay of Fundy, where the tide rises highest, is far greater than in safer harbors where the tidal fluctuations are more moderate.

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