Speech delivered before
Richmond Chapter, American Institute of Banking
Richmond, Virginia
March 25, 1936

CREDIT CONTROL BY THE FEDERAL RESERVE SYSTEM

There are five principal means by which credit control may be exercised in the Federal Reserve System. These are:

- Discount Rates
- Open Market Operations
- Direct Action
- Reserve Requirements
- Margin Requirements

Discount Rates

Under the original terms of the Federal Reserve Act two principal instruments of credit control were used. One of these was the discount rate; the other was the rate on bills, or as they are called in the Act, "Acceptances". The Act specifically provided that each Federal Reserve bank "establish from time to time, subject to review and determination of the Board of Governors of the Federal Reserve System, 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". To this the Banking Act of 1935 added the provision that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board". This does not mean that the rates have to be changed every time, but that they must be regularly and frequently reviewed. The Reserve banks usually take the initiative in any action on rates.

The discount rates of the Federal Reserve banks are usually somewhere between bill rates, which are usually lower, and other short-term rates in the open market, which are usually higher. They are also lower than rates which banks charge their customers for loans. They differ, therefore, from the discount rate of foreign central banks, such as the Bank of England, for example, whose discount rate is higher than the market rate. Since the Federal Reserve bank discount rate is lower than the rates charged by member banks it has usually been possible for member banks to borrow from the Reserve bank and relend at a profit. It has not been the practice for them to do so, however, probably because they are averse to having borrowings show up in their published statements. Consequently, member banks as a usual thing borrow of the Reserve bank only when they have to in order to replenish their reserves and avoid the penalty for deficiencies in their reserve accounts.

Although each Federal Reserve bank's rate is determined largely with reference to local conditions, it is important, of course, not to fix rates at any one Reserve bank without reference to the conditions to which other Reserve banks are subject. The member banks in one district cannot go to the Federal Reserve bank of another district, but nevertheless if rediscount rates in one district were noticeably lower than in another it would be possible for funds to find their way through indirect channels (such as correspondent banks, for example) from the district where rates were low to the district where rates were high. Consequently, general conditions as well as local have to be taken into account in determining what the rediscount rate will be and what changes should be made.

The Federal Reserve Act formerly limited the classes of paper which Federal Reserve banks could discount for member banks, on the principle that a definite preference should be maintained for short-term credit based on self-liquidating commercial transactions. The Reserve banks were, therefore, given the power to discount only short-term self-liquidating commercial paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial, industrial and agricultural transactions, and to make advances to member banks on their promissory notes backed by paper eligible for discount or purchase or backed by United States Government obligations. It was a narrowly defined classification. Advances on a wide range of other assets which made up an important part of the total earning assets of banks were not authorized. These included advances on securities other than those of the United States Government, on real estate loans, and on other loans of considerable importance in the portfolios of banks.

As a result of many developments in our financial organization, paper which qualified for borrowing from the Reserve banks has constituted a constantly decreasing proportion of the total assets of member banks ever since the System was established. In 1929 it was only about twelve percent of total loans and investments of such banks, and in 1934 it was but eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks with assets which were good but technically ineligible for borrowing at Reserve banks, were obliged to dump them on a falling market, suffering severe loss thereby and contributing to the deflation in values, or to close their doors.

The new banking act increases the powers of the Federal Reserve banks so that they may meet this situation. It authorizes the Reserve banks to make advances to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank, at a rate of interest at least one-half of one percent above the highest discount rate in effect at the particular Reserve bank. This amendment modifies and makes permanent the emergency legislation which was passed in 1932.

In addition to the foregoing general powers of discount and purchase the Federal Reserve banks have special powers with respect to loans to commerce and industry for working capital purposes. These powers are granted by Section 13b of the Act. Under this section the Reserve banks are authorized to discount loans made by member banks and other financing institutions to established industrial and commercial businesses for the purpose of supplying working capital.

These changes made by recent legislation enlarge very greatly the kind of credit which the Federal Reserve banks may deal in directly, and give the Reserve banks greater freedom of action in meeting requirements of the money market.

Open Market Operations

In addition to the discount rate and the bill rate, two other important means of credit control have been developed from Reserve System experience, although they were not specifically contemplated in the original Federal Reserve Act. These are open market operations and direct action. Open market operations consist of the purchase and sale by Reserve banks of certain classes of securities, chiefly Government obligations. They have the effect of increasing or decreasing the supply of credit available in the money market as a whole. They do not leave control of the money market dependent upon the voluntary action of member banks in seeking funds for the replenishment of their reserves, but give to the Federal Reserve banks the initiative in influencing the market. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available. By purchasing securities they put funds into the market and tend to ease credit conditions. If securities are sold they must be paid for, and in the process of paying for them the reserves of member banks are diminished, for every payment means a debit sooner or later to some member bank's reserve account. If the program is carried far enough the member banks will be forced to restrict their extensions of credit or dispose of some of their assets to the Federal Reserve banks either by sale or rediscount in order to replenish their reserves. When this happens, the member banks have been forced by the initiative of the Reserve banks to take action which they would otherwise not have had to take. If, on the contrary, market conditions are such that member banks have gone into debt to the Federal Reserve banks in order to replenish depleted reserves, the Federal Reserve banks may relieve the situation and the tightness which exists in the money market generally by buying securities on a large scale. The funds which they release in payment for the securities which they buy flow one way or another into the reserve accounts of the member banks and enable the latter to pay off their obligations. If the purchases continue beyond this point, they create excess reserves which it is likely the member banks will try to put to some use.

By selling securities, therefore, the Federal Reserve banks may enable themselves to give an effectiveness to a discount rate which it would not have otherwise until such time as market conditions had stiffened and individual banks were forced by those conditions to go to the Reserve banks for funds. Open market operations, therefore, enable the Reserve banks to accelerate corrective action. They are especially useful in view of the tradition which makes banks refrain as much as possible from borrowing from the Federal Reserve banks. If member banks felt no inhibitions about being in debt, and built up their reserves by borrowings so that they might make more loans, they would more generally be amenable to control through the discount rate. As it is, however, the discount rate must depend for much of its effectiveness upon open market operations.

The powers of the Reserve banks to buy and sell securities in the open market were granted in general terms in the original Federal Reserve Act, but at the time were not generally considered to be of very great importance. It was not until 1922 that open market operations were conducted on a large enough scale to affect the money market. The first operations were carried on by the Federal Reserve banks independently of one another, but it was soon found that action had to be coordinated, for otherwise the banks would be buying or selling in competition with one another and following different, and perhaps conflicting, policies. Consequently, a committee representing several of the reserve banks was formed for the purpose of coordinating their operations. About the same time the purpose of the operations was clarified. For some time there had been a tendency to allow purchases and sales to be influenced by the objective of profit, but it was eventually realized that such an objective was in conflict with that of moderating a given condition of the money market, and must, therefore, be subordinated or even abandoned. This is in line with the general policy of central banks in conducting open market operations; they do so quite definitely with the idea of correcting credit conditions and not for the purpose of making earnings.

The Banking Act of 1933 gave specific recognition to open market operations and established a Federal Open Market Committee of twelve members, one representing each Federal Reserve bank, to take the place of the former non-statutory committee. At the same time the law adopted substantially the statement of purpose which had already governed open market operations. The statute provides that open market operations "shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made further change by providing that the Federal Open Market Committee should comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen by the twelve Federal Reserve banks. The law also makes the decisions of this committee obligatory upon the Federal Reserve banks and provides that the record of the committee's actions shall be included in the annual report of the Board submitted to Congress. Thus an activity which was barely recognized in the original Federal Reserve Act, and which was gradually developed in the process of administration of the System, has come to be emphasized in the law as one of the System's most important activities.

<u>Direct Action</u>

I also mentioned direct action as a means of credit control. Direct action means individual effort by the Federal Reserve banks to discourage credit policies of given member banks in given circumstances. For the correction of specific conditions, it is to be regularly resorted to by the Reserve banks in their relations with member banks. Opportunity for it occurs on various occasions, but particularly when the member bank is being examined, and when it is seeking to rediscount some of its paper. In this sense, direct action is largely an individual matter and the form taken by it in any case may have little or no reference to general credit conditions. It may also have reference either to regional or country wide conditions, however, and may then be resorted to for the purpose of enforcing general credit policy. The power to exercise direct action against member banks lies partly with the Federal Reserve banks and partly with the Board of Governors.

The effectiveness of direct action was specifically strengthened by the Banking Act of 1933 in several particulars. When it appears that undue use of bank credit is being made for the purpose of speculation in securities, real estate, or commodities, or for any other purpose inconsistent with sound credit conditions, the facts should be reported by the Federal Reserve banks to the Board of Governors of the

Federal Reserve System. The Board may in its discretion suspend any member bank making such use of credit from recourse to credit facilities of the System. Furthermore, authority has been given to the Board to remove from office any officer or director of a member bank who has violated the law governing the bank's operation or who has persisted in unsafe and unsound practices in conducting the bank's business. The Board also has power to limit for each Federal Reserve district the individual bank capital and surplus which may be represented by loans secured by stock or bond collateral.

It is to be presumed that these special powers will not often have to be used, in view of other broad powers designed for control of credit conditions, but in principle they are nevertheless significant, for they indicate that the law definitely contemplates the exercise of considerable responsibility by the Federal Reserve banks and the Board.

Power to Change Reserve Requirements

Recent legislation has also established two other new forms of general credit control which previously did not exist. The first of these is the power given the Board to change the reserve requirements imposed upon member banks by the statute. For most banks the requirement is and has been for years that they have reserves on deposit with the Federal Reserve bank equal to at least 7 percent of their demand deposits, and 3 percent of their time deposits. The power to alter these reserve requirements was first given the Board by an amendment to the Federal Reserve Act May 12, 1933, but under limitations which were later removed by the Banking Act of 1935. The Board is now authorized to change the reserve requirements "in order to prevent injurious credit expansion or contraction", but it is not permitted to lower them below the present requirements nor increase them to more than twice the present requirements. The effect of raising them, which is the only action that could now be taken, because the reserves are now at the point of legal requirement, would be to decrease the lending power of member banks and consequently the available credit. The effect of subsequently lowering them would be, of course, to enlarge the lending power and the amount of available credit. This means of credit control is one of the most powerful and direct that the law has bestowed.

Margin Requirements

The second new form of general credit control recently authorized pertains to margin accounts and loans made for the purpose of purchasing or carrying listed securities. Authority for the Board to issue regulations in this field was granted by the Securities Exchange Act of 1934. This grant of authority was in line with various provisions of the Federal Reserve Act, such as I have already referred to, aimed at restricting the use of credit for speculative purposes. In the language of the Securities Exchange Act, the authority it bestows is to be exercised with the object of preventing "the excessive use of credit for the purchase or carrying of securities". The standard established in the Act and adopted by the Board as an initial regulation limits the loans which a broker or dealer may make on a security to whichever is higher of the two following ratios:

(a) Fifty-five percent of the current market price of the security, or

(b) One hundred percent of the lowest market price of the security since July 1, 1933, but not more than seventy-five percent of the current market price.

This standard permitted the extension of credit up to seventy-five per cent of current market value on securities that had made little or no advance from the lows of recent years, and up to fifty-five percent on securities that had made considerable advance. The Board, however, was given authority to alter this initial standard, making it either higher or lower as conditions might warrant, and it has recently changed the fifty-five per cent limitation to forty-five per cent. The reason for this action was realization of the possibility that recent increases of stock market values might lead to such excesses as the law sought to prevent.

The determination of margin requirements is designed to exert a restraining influence on speculative trading. By imposing higher margin requirements on securities that have had a rapid rise, credit is made less freely available for trading in speculative stocks. A limitation is also imposed on the extent to which speculative profits on securities can be used as margins for further speculation, a practice that is known as pyramiding.

The power of the Board to raise margin requirements provides an instrument for controlling the demand for credit from speculators in the stock market without restricting the supply available for other borrowers. It differs from other means of credit control in that it affects directly the demand for credit rather than the available supply or cost. Through the use of this instrument it may be possible for the Board to exert a restraining influence on the use of credit for speculation in the stock market before it has reached a stage at which the general business and credit situation is unfavorably affected. The use of the instrument exercises a restraint on speculation without limiting the supply or raising the cost of credit to agriculture, trade, and industry.

The Securities Exchange Act specifically exempts from its provisions all obligations of the United States Government, of any state, municipal, or other political subdivision, and of agencies or instrumentalities of a State or local government. Additional exemptions of a similar nature are provided for.

Brokers and securities dealers subject to the Act are not permitted by the Act to borrow from banks which are not members of the Federal Reserve System, unless such banks agree to comply with the same conditions relating to the use of credit to finance transactions in securities as are imposed on member banks.

The foregoing provisions governing the credit activities of brokers and dealers are covered in Regulation T of the Board of Governors.

Insofar as banks are concerned, the Board's authority relates to loans made for the purpose of purchasing or carrying securities registered on national securities exchanges. It does not apply, therefore, to loans made solely for industrial, agricultural, or commercial purposes, regardless of the question whether these loans are secured or unsecured, and, if secured, regardless of the character of the collateral. The determining factor is the purpose of the loan and not the nature of the security offered. If a loan is made for the purpose of purchasing or carrying securities registered on a national securities exchange, it comes under this section of the act; if it is made for any other purpose -- industrial, agricultural, or commercial -- then it is exempt. It is also exempt if it is secured by certain types of collateral other than stocks, such as bonds and government obligations. In general, the law, insofar as it applies to control over banks, is intended to prevent the banks from being used for the purpose of circumventing the margin requirements prescribed for loans extended by brokers to their customers, and to prevent undue expansion of bank credit in the securities markets.

The law imposes upon the Board no duties in connection with supervision of stock exchanges or prevention of undesirable practices among members of such exchanges. Responsibility for these matters rests upon the Securities and Exchange Commission.

Conclusion - Limitation on Means of Credit Control

Although the five means I have discussed by which credit control may be exercised - discount rates, open market operations, direct action, reserve requirements, and margin requirements - appear to be very comprehensive and powerful, it would be a mistake to convey the impression that a perfect control of credit will be effected through them. In the first place, their application cannot be mechanical nor governed by simple unvarying rules. Credit and economic relationships are extremely intricate, and the circumstances under which the need for action arises are always to some extent different and special. Let me mention a few things that complicate the task of credit control.

In the first place, if there were a clear connection between given extensions of credit and the uses to which the credit is ultimately put, the control of credit would be simplified. This connection was formerly assumed to exist and to afford an important means of control. The thought was that the Reserve bank could shut off speculation by refusing to discount the notes of speculators. That, of course, is far from the facts. A bank may borrow from the reserve bank on bills of lading covering the sale of merchandise and at the same moment it may buy the mortgage of a man who is speculating in industrial stocks. The extension of credit on bills of lading was specifically favored by the original Federal Reserve Act, yet in such an instance as I mention, it might make possible a speculative activity directly opposed to the purposes of the Act.

Another important fact is that more than half the banks of the United States are not members of the Federal Reserve System. The system has consequently only a partial and indirect influence on their credit activities.

For another thing, there is always the important consideration that United States Treasury activities must be taken into account.

These have to do in part with the operations of the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve such large sums and so intimately affect the banking and credit situation that Federal Reserve policy and Treasury policy must always be coordinated with one another.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold to the United States from abroad - a movement that in the last two-years has added over three billion dollars to the reserves of member banks.

These factors, among others, necessarily limit and modify the exercise of credit control.