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THE WORK OF THE FEDERAL RESERVE BOARD

It is quite generally agreed at the present time that the Federal Reserve Board is striving earnestly to bring to a close the era of currency and credit expansion. In the opinion of some it is endeavoring to secure some small measure of deflation. But whatever measures have been adopted to realize these ends have called forth the utmost of protest on the part of many powerful agricultural and business organizations. The last month[1] has witnessed many a conference between the members of the Board and representatives of certain business interests in the endeavor of the latter to secure concessions in the way of easier and more abundant bank credit. Will the pressure of these groups become too strong to be resisted? It is obvious that a sufficient answer to this query will involve two lines of investigation. In the first place, as a proper background for an understanding of its present credit attitude, there must be a study of the Board's past deeds and expressions of opinion and the industrial circumstances under which these were formulated. In the second place, there must be a consideration of future difficulties in the endeavor to learn whether a fitting solution is possible to its most urgent problems of credit and banking. It is the endeavor of the writer to furnish a mite of aid in the making of such an investigation.

In many circles it has been felt that in the past the Board has been much more influenced by the requirements of the entrepreneur than by the interests of the general body of consumers. But so far as the opinions of the Board have been expressed in the *Federal Reserve Bulletin* there seems no doubt that in the months following the signing of the armistice a considerable drop in the price level was sincerely desired. The lot of the recipient of a fixed income seems to have been fully recognized. As typical of many pronouncements on this matter we read the following in the *Bulletin* of March, 1919:

The era of inflated prices maintained by aid of legislation or by government administrative action thus draws to a close, and the aim to be sought is

[1] This article was prepared in October, 1920.

not that of perpetuating war conditions but that of returning to a stable footing upon terms and conditions that would be just and fair to all concerned. There is much agreement with the Secretary of the Treasury in his statement that the readjustment must begin with a reduction in the cost of living to the consumer, sorely tried as the latter has been by the great inflation of prices and the additions made to his living costs in many directions. [1]

Largely as a result, however, of an observation of price movements in past periods of post-war finance it was felt generally that such a reduction in prices was inevitable. It seems at least to have been believed by the Board that no definite policy of credit control was required in order to effect such a change. If, then, such a decline was bound to occur the credit problem became one of lessening, so far as possible, the duration of the period in which industry must be disturbed by the fall in prices. A shortening of this period would minimize the difficulties of reconstruction, while at the same time good results would be accomplished for the general consumer. Accordingly, in the early months of 1919 account was frequently taken of the efforts initiated by certain governmental agencies to effect as speedily as possible the transition to the "rock-bottom" level of prices.

In the first few months of 1919 pronounced price breaks were experienced in various lines of industry and some justification was afforded the belief that the familiar cycle was being repeated. There seems no doubt, however, that these price drops were much fewer and of lesser extent than generally anticipated. Undoubtedly a very large majority of observers were amazed at the rapidity with which industry absorbed the labor returning from the field and camp and war industry factory. In the writer's opinion there has not been one-tenth as much discussion over the reconstruction problem as most economists expected. In the May, 1919, *Bulletin* attention was called to the fact that the recessions were not proceeding with the anticipated rapidity. Prices of certain commodities previously held down by price-fixing activities of governmental agencies began to move upward; others maintained themselves because of the influence of world conditions. Accordingly the Board seemed to assume a more resigned and

[1] *Federal Reserve Bulletin*, March, 1919, p. 191.

passive attitude. Thus in the *Bulletin* of the same issue we find the following:

> What is now happening seems to indicate that business will, after a period of initial readjustment in prices, proceed upon a level not far removed from that established during the war, leaving the question as to the ultimate level of prices to the future and to more slowly acting forces.[1]

Following this statement there occurs an account of the difficulties any considerable reduction in prices might create in international trade. Foreign countries with rising money prices could not hope to find extensive markets in the land of lower production costs. And the ability of foreign countries to buy from us must depend finally upon their ability to sell to us.

As thus interpreted, the events of the early part of 1919 seemed to bring to a close that part of the reconstruction period in which industry was compelled to adjust itself to a lower level of prices. By the month of May industrial activity burst forth in renewed volume and a firm trend toward higher prices was noted. Thereafter the Board's policy must be directed toward the problems resulting from a rise rather than from a decline in prices.

In anticipation of such difficulties the Board early called attention to what it deemed an abuse of the rediscounting privileges. The occasion was the inclusion in the New York clearing-house's weekly statement, in the account bills payable, acceptances and other liabilities, of an item which covered rediscounts at Federal Reserve banks. In the opinion of the Board this seemed to point toward member banks' regarding the rediscount privilege as a normal and customary operation. The Board was quick to point out that this was not its conception. Thus:

> Already some well-managed member banks are showing in their statements the extent to which they are in debt to Federal Reserve banks. It has been the opinion of the Board that the borrowing of member banks at Federal Reserve banks might very easily be carried to excess, the loans being placed there primarily for the purpose of profit and not for any more general public or fundamental object. In a general letter to banks issued on November (1918) and referred to in the *Federal Reserve Bulletin* for December the Board took occasion to caution member banks which it was thought were in some danger

[1] *Ibid.*, May, 1919, p. 411.

of overdoing their rediscounting, that the purpose of such rediscount operations was not primarily that of assisting the member institutions which placed the rediscount to obtain the funds for further profitable operations but was rather to be determined upon the basis of general banking advantage or upon that of relief for banks which found themselves hard pressed or were suffering from reductions in reserve account.[1]

If, then, the Board saw clearly by the spring of 1919 that future difficulties were to be those occasioned by an increase rather than by a decline in commodity prices, why did it not move at once to place a check upon further credit expansion? It is now common knowledge that far from limiting the volume of rediscounts it permitted advances to member banks to proceed to dizzy heights. Not until November, 1919, was there any considerable increase in rediscount rates: the average monthly reserve ratio fell in this period from 50.4 per cent in July, 1919 to 46.6 per cent in November;[2] total gross deposits increased from $2,436,757,000, on June 27, to $2,807,688,000, on November 7;[3] Federal Reserve notes rose in the same period from $2,499,180,000 to $2,806,759,000;[4] and in the pages of the *Bulletin* we read the following regarding the growth of earning assets:

> The advance in the total of earning assets from about the beginning of March, a date roughly corresponding to the opening of the great growth in industrial speculative operations throughout the country, to the beginning of November, at the time of the first application of the higher rate policy, amounted to the difference between $2,348,000,000 on March 7, and $2,923,000,000 on November 7, or about $575,000,000 in round numbers.[5]

This was fabulously rapid expansion; why was it permitted? On the basis of present knowledge the following may be offered by way of explanation: first, the Board felt constrained to modify its rediscount operations in the interests of the requirements of the federal treasury and of the holders of war bonds; second, it adopted no consistent price theory which compelled it to place the responsibility for rising prices on its own liberal rediscount policy; third, it was somewhat doubtful as to what would be the effects of

[1] *Federal Reserve Bulletin*, April, 1919, p. 311.

[2] *Ibid.*, July, 1920, p. 663.

[3] *Ibid.*, p. 664. [4] *Ibid.*, p. 665. [5] *Ibid.*

higher rediscount rates upon the loaning power of member banks. Let us first of all turn our attention to the matter of governmental finance.

Difficulties in regard to war paper may be classified under two heads: first, those which had to do with the long-time or funded debt; second, those which had to do with the current operations of the Treasury. It will be recalled that the Victory Loan was floated in the spring of 1919, and at that time the portfolios of banks were overflowing with the notes of the buyers of these bonds. The war bond issues were made successful only by means of the "buy and borrow" plea. If member banks could not rediscount paper collateraled by war bonds the banks could not carry the buyers of these bonds. In order that the bond buyers might be carried on a low interest charge it was necessary that rediscount rates be made low also. Having ignored the market in the period of bond issues the money market must be made to conform to the rates borne by the bonds. This necessitated continued inflation.

Higher rates of rediscount might have been, and as a matter of fact were, exacted on non-war-paper security. But this only meant that in the great bulk of their applications member banks picked out the war paper for their collateral. In June, 1919, discounts secured by government war obligations totaled $6,036,000,000. Otherwise secured rediscounts totaled only $292,000,000.[1] The portfolios of member banks were full of war paper. The rates borne by the war bonds controlled the situation unless it should be decided to ignore the rights of those who had subscribed largely through motives of patriotism.

It may be remarked here that further analysis would have demonstrated that in no possible manner could the interests of the bond holder have been fully protected. Only on terms of inflation could the money value of the bonds be upheld. But inflation meant the decline in the purchasing power of the dollars yielded as interest or as the proceeds of the sale of the principal. Undoubtedly, however, the wisest policy from the standpoint of avoiding popular discontent was to think first of the money prices of these securities. Accordingly the Board felt itself obliged for the

[1] *Ibid.*, August, 1920, p. 867.

time being to confine its efforts to imploring the public to do its part in eliminating war-loan paper from the portfolios of the banks.[1]

Although the difficulties experienced in accommodating the Treasury in its current borrowing operations were much the same, it seems to the writer undeniable that a mistake was made in continuing to ignore the market. Undoubtedly continued inflation created evils which far offset any advantage to the public in the reduction of interest charges on the short-time debt. But this opinion did not prevail in the minds of the members of the Board. Thus in the *Federal Reserve Bulletin* for March, 1920:

> In such circumstances it was of course unavoidable that discount rates should be largely controlled by rates established primarily with a view to public borrowing.[2]

And in the words of Secretary Houston: "it was consequently impossible for the Federal Reserve Board to exert any effective control over rates."[3]

It was thus assumed, so far as the public was aware, virtually without debate, that federal reserve policy must be subordinated to the needs of the Treasury. The writer is not at all certain that this is the proper conception of the function of the reserve system. But space is lacking for an adequate discussion of this matter.

The peak of the war debt was not reached until August 31, 1919; nevertheless much progress had been made in the elimination of war paper from the banks. Accordingly in November the first of a series of rate increases was established by the Board. At the present time these difficulties have been so greatly reduced that the hands of the Board are no longer so firmly tied because of the Treasury's requirements. On July 25, 1920, the following figures were presented by the Secretary of the Treasury: between June 30, 1919, and June 30, 1920, the floating debt was reduced from \$3,267,875,500 to \$2,485,552,500 and the total gross debt from \$25,484,506,160 to \$24,299,321,467. And the absorption by the public of the war paper proceeded much faster than the reduction in the total of the debt.

[1] *Federal Reserve Bulletin*, April, 1919, p. 310.

[2] *Ibid.*, March, 1920, p. 213.

[3] *Ibid.*

In an address before the Maine Bankers' Association in June the Comptroller of the Currency presented some interesting figures regarding the extent to which the war securities have become lodged in the hands of permanent holders.[1]

According to his estimates about sixteen billions of these securities are out of the banks and only about $2,000,000,000 remain in the hands of the national banks. A similar amount was estimated to be in the vaults of state banks and trust companies.

Record of bills discounted by reserve banks tell much the same story. In June, 1919, discounts secured by government war obligations totaled $6,036,000,000.[2] By June, 1920, this had shrunk to $4,545,000,000. Otherwise secured rediscounts increased in this period from $292,000,000 to $1,791,000,000. This represents an enormous shifting in the quality of collateral from the war paper to the classes comprising commercial paper. As regards member banks the high record of bills discounted during the current year to individuals on the security of government war obligations for 800 reporting member banks was reached on January 2 with a figure of $1,289,000,000. On August 2 this had shrunk to $959,000,000.

These figures indicate that the reserve banks are rapidly getting into shape to adopt a rediscount policy independent of considerations pertaining to public finance.

But was this all? Can we find any other explanation of the Board's liberal rediscount policy? All who have read the pages of the *Federal Reserve Bulletin* may well be in doubt as to whether credit and note issue expansion would not have proceeded to dizzy heights even had there been no difficulty connected with the public debt. For, not consistently to be true, but frequently nevertheless, a price theory has been enunciated which would seem to support the position that liberal credit could not be held responsible for any subsequent rise in prices. It will be well to learn the statement of this theory and the circumstances under which it was formulated for only in this way can we gain a clue as to the Board's future

[1] Cf. Hon. Edmund Platt, "The Policies and the Administration of the Federal Reserve Board," *Economic World*, September 25, 1920, pp. 437 ff.

[2] *Federal Reserve Bulletin*, August, 1920, p. 867.

attitude in the matter of the relation of the volume of currency and credit to the level of prices.

It will be recalled that by the end of July, 1919, and largely as a result of the demands of the Railway Brotherhood leaders, the cost of living discussion aroused the full attention of certain of our governmental departments. On August 8 the President delivered an address to Congress in which he declared that "the prices the people of this country are paying for everything that it is necessary for them to use in order to live are not justified by a shortage in supply in the present or prospective." In the subsequent discussion it was inevitable that a prominent place should be given to the operations of the banks and particularly those of the federal reserve banks.

On August 8, 1919, in a letter replying to certain queries propounded by the chairman of the Committee of Banking and Currency of the United States Senate, Governor Harding expressed his views regarding the relation of the increasing note issues to the level of prices. Thus:

> The difficulty, indeed the impossibility of keeping in circulation an excessive volume of Federal Reserve notes should be understood. They are issued only as need for them develops and as they become redundant in any locality they are returned to the Treasury at Washington or to a Federal Reserve bank for redemption. Thus there cannot be at any time more Federal Reserve notes in circulation than the needs of the country at the present level of prices require.[1]

This was in line with a previous statement of the Board:

> The increase in the circulation of the Federal Reserve notes has been in the main in response to actual needs, and that whatever inflation of prices may be said to exist cannot properly be said to have been induced by overissue of Federal Reserve notes.

In the September number of the 1919 *Bulletin* appears the following:

> While it is technically a true statement to say that the Federal Reserve note when issued is issued by the Federal Reserve bank, the greater truth in understanding our present monetary machinery is missed unless it is perceived that the occasion of the issue of a Federal Reserve note is determined not by the bank for itself but for the bank by the community. The question

[1] *Federal Reserve Bulletin*, August, 1919, p. 699 ff.

whether or not a Federal Reserve note shall be issued is decided by the business and general community in accordance with its circulation needs. It is its needs rather than the bank's desire which determines the question of issue.[1]

It would seem to the writer that if this position is taken as regards note issues it must be also made to apply to the deposit credits granted by member banks. For the underlying theory of Federal Reserve note issues was that notes should be issued and regulated in a manner more similar to that of deposits. Notes are payable to bearer, book credits to the depositor. The note issue has a greater circulation power and is needed by banks for counter money to protect their reserve money, but so far as their effect on prices is concerned both must be regarded as a part of the general circulating medium.

This position of the Board is in the main the Laughlin theory that prices are fixed before credit or currency is called into being; that accordingly the volume of credit and bank note issues is determined by the level of prices instead of in reverse manner. Such a doctrine leaves the Board in a most comfortable position so far as its responsibility for the cost of living is concerned. For, according to the terms of this theory all the banks do is to meet the demands for whatever volume of the circulating media the existing height of prices renders necessary.

It is no doubt true that such a doctrine runs counter to the thought of most price theorists. Under certain circumstances, however, the writer would not deny its applicability. In a period when orders are behind supplies, when much labor is unemployed, when the farther back one goes toward the ultimate producers the more difficulty one finds in sellers' disposing of their stocks, liberal bank loans need not create rising prices. Rather easy credit may facilitate production, the full employment of labor, the more complete use of existing stocks, in short the bringing on to the market of goods which otherwise would not be created. To lock up credit or curtail note issues at such a period would mean the locking up with it of the country's productive resources.

But such was not the situation at the time this doctrine was enunciated in Harding's letter. The transition from war conditions seemed in the main to have been completed and everywhere

[1] *Ibid.*, September, 1919, p. 814.

entrepreneurial activity was at its height. Business failures were remarkably few; comparatively little labor was unemployed; stocks of wholesalers and retailers were, in general, low. Under these conditions easy credit meant higher money terms on which business men were to bid for the scanty supply of goods, materials, and labor. Expansion *then* must mean price inflation.

Under these circumstances would the Reserve Board continue to hold its old position? Or would it revert to a position established by itself before the cost of living discussion became so acute; a position which the writer believes to be substantially true:[1]

> The attempt of our financial system to advance credit at a rate more rapid than justified by the rate of saving would, therefore, simply mean advance in the "cost of living" to the average consumer through a further aggravation of existing conditions of inflation in banking and credit, with harm not only to ourselves but also to those who receive advances on an unreasonably high basis of valuation. The natural tendency of the present time is to attempt to accomplish too much in a short time and to go beyond the natural limits set by available resources, thus overstraining and crippling the investment mechanism of the country and opening it to the possibility of serious danger as the result.

Some evidence of a leaning toward the position just stated appeared in the October, 1919, *Bulletin* as follows:

> Credit affects prices only as it is used in the purchase and payment of things. It can affect prices, therefore, only when acting in conjunction with other favoring circumstances.[2]

May not "the other favoring circumstances" have had reference to the full employment of labor and the scanty supply of available materials?

And possibly by way of further concession:

> While credit, therefore, cannot create a situation which results in high prices, it is equally true that a situation cannot eventuate without the assistance and mediation of credit.[3]

And further:

> While it may be true as a theoretical proposition that prices at retail could not rise without an increase in the volume of currency and that refusal

[1] *Federal Reserve Bulletin*, January, 1919, pp. 524 ff.

[2] *Ibid.*, October, 1919, pp. 911–12. [3] *Ibid.*

to supply currency might impede an upward movement of retail prices, it is also true that such a method of controlling prices would be at the cost of business disaster.[1]

In the writer's mind it seems as if in these latter statements the Board is veering toward the position that an answer to the question as to whether liberal and easy credit would be followed in the main by increased production or by higher prices must be decided only on the basis of the existing situation in trade and industry. But nowhere is this clearly formulated. It seems probable, therefore, that, despite these later modifications of the position as expressed in Harding's letter, the Board cannot be expected soon to adjust its credit policy in the interests of price stability as the vigorous application of any clearly understood price theory. If there is to be such a control we must look elsewhere to find the motive. Would either of the following afford a clue regarding the Board's probable future policy?

1. Firm insistence on the preservation of the legal reserves of the reserve banks according to the terms of the Federal Reserve Act.

2. Desire to prevent the bank credit based on advances by reserve banks from being absorbed by the speculative interests and thus defeating one of the dominant purposes of the Act.

In regard to the reserves it will be recalled that the Act stipulates a minimum gold reserve of 40 per cent for Federal Reserve notes and 35 per cent for deposit advances to member banks. Provision is made, however, whereby these minima may be lowered upon the consent of the Board. The question which here arises is whether the provisions for waiving these minima will be regarded by the Board as having been established for the purpose of taking care of difficulties human judgment cannot foresee, or whether they will be regarded merely as provision for the worst of the contingencies which may be foreseen. If the latter should prove correct we may find the Board petitioning Congress in the period of emergency for an amendment lowering reserves. One amendment lessening reserve requirements for member banks was passed on June 21, 1917, and it is not impossible that another such modification applying to reserve banks might be requested. The attitude

[1] *Ibid.*, p. 913.

of the Board regarding the finality and definiteness of the reserve minima is more than a mere academic question.

The official pronouncements of the Board will not aid us much in finding an answer to this query. After diligent search through the recent pages of the *Bulletin* the writer has been unable to find any definite statement of the Board's opinion. Such a statement, moreover, would scarcely be expected. It might be regarded as tying the hands of the Board in a future emergency. We are, therefore, obliged to rely solely on inference.

In the early months of 1919 the *Bulletin* contained few reference to the reserve ratio. In these months the ratio of reserve moneys to net deposits and note issues combined remained above 50 per cent. But once the ratio had fallen as low as 47.9 per cent, as on October 31, 1919, the Board appeared to become somewhat nervous.[1]

Thereafter in its official announcements the *Bulletin* contains regular mention of the ups and downs in the reserve ratio. And conclusions in many matters of controversy are predicated upon the assumption that the ability of the banks to manufacture credit is strictly limited. It is therefore probably correct to infer that the Board has interpreted somewhat closely its responsibilities in the matter of preserving the legal reserve ratio.

But after all, dependence upon the maintenance of reserve ratios offers extremely unsatisfactory assurance to the public. If reserves become larger in the aggregate as by importations of specie from abroad or by increased production of gold at home some other protection is required to avoid the evils of excessive credit grants. The quantity of gold in the reserves is a more or less accidental thing. The Board should not permit credit expansion to get to the point where in insisting upon the rejection of any large volume of rediscount applications its only defence is to say we have already gone as far as the law permits.

Of course the writer is not asserting that the state of the reserves should receive no consideration. Neither is he arguing that the level of commodity prices should be the sole criterion in determining the permitted volume of bank deposits. Indeed he feels that a

[1] *Federal Reserve Bulletin*, November, 1919, p. 1009.

weakness of the plan for a "stabilized dollar" is that in some situations a rise or even a fall in prices is socially desirable. But scarcely ever should this rise or fall be encouraged unless such a course appears necessary to solve some perplexing problem of distribution or to make function better the productive energies of the people.

But easy credit has other effects than those discussed. It may mean the use of funds provided by the reserve institutions in a manner contrary to the terms of the Federal Reserve Act. And it is no doubt true that of all the factors influencing the Board to restrict credit advances this has been the most important. It was both a matter of observing the terms of the Act and of avoiding objections previously urged against an earlier formulated plan of centralized banking. When one recalls the vigorous denunciation of the Aldrich plan on the ground that it concentrated control of bank credit too largely in the hands of the dominant banking interests one can easily understand how anxious the reserve administration must have been to render impossible a similar accusation against its own system. And stubbornness in this matter did not depend upon the successful establishment of any difficult point of controversial theory. It could be based solely on the formal declarations of the Act.

Now that so much success has been had in reducing the volume of war paper in the hands of member banks the Board may proceed more vigorously in curbing the use of funds based on its advances in unwarranted speculation. But this is only a small part of the problem. The volume of security speculation is fanned by other winds than those of easy credits. Rising commodity prices, made possible perhaps by excessive liberality in grants of commercial credit, offer equal encouragement to the speculator. And the principal objection against the use of reserve bank funds for speculation was based upon the fear that thereby the volume of funds for assisting commerce and trade was restricted. Are not our present difficulties due to an excessive rather than to a deficient volume of commercial bank advances? It would seem that we cannot be assured of a proper control of credit solely on the basis of the insistence that speculative operations shall not be encouraged.

But may we not find in the methods employed to restrict rediscounts a better clue regarding the Board's probable future policy than in any point thus far discussed? Let us first turn our attention to the weapon traditionally regarded as the first line of defence of a centralized banking system, raising rediscount rates.

Objections in the way of controlling credit by increasing rediscount rates fall in the main under the following heads:

1. American business has been conducted on the basis of such liberal margins above costs that higher rates might not restrict seriously the demand for credit.

2. Since credits obtained by member banks through rediscounting with reserve banks count as the legal reserves of member banks effective use of this weapon must mean the imposition of absurdly high rediscount rates.

3. Increasing interest and discount rates in the market does not distinguish between legitimate and illegitimate demands for credit; it imposes the same handicap upon all, regardless of the genuineness of the demands for credit.

We shall discuss each of these in turn.

Expression was given to the first difficulty in the October, 1919, issue of the *Bulletin* as follows:

> The extent to which Federal Reserve Bank rates may normally be expected to be "effective" in the sense in which that term is used in Continental Europe still remains to be determined. Our experience under the Federal Reserve system is too brief to enable definite conclusions to be drawn with reference to this matter. It seems doubtful, however, whether, for a long time to come and taking the country as a whole, there will be any such close connection of Federal Reserve Bank rates with the volume of credit in use as was to be noted, for example, in prewar days in England, the home of central banking. Our nearest approach to an effective Federal Reserve Bank rate was reached in the closing months of the year 1916.[1]

Then follows a statement of the fact that since American business is conducted on the basis of very liberal margins above costs a slight increase in commercial discount rates might have little or no effect. In other words member banks could pass on any increase to the borrowing public without great difficulty.

[1] *Federal Reserve Bulletin*, October, 1919, p. 911.

In the matter of the Bank of England's control over the London money market much has been made of the difficulty encountered in rendering effective the "Official" rate. Often the Bank of England is forced to rely upon other weapons in the endeavor to make the market conform. With little experience to guide us in the operation of our own system it is not startling, therefore, that the Board refrained from advocating any great increase on the occasion of the first advance in November, 1919. The general increase on this date was one-half of 1 per cent, with the differential in favor of war paper maintained. And on December 11, after the autumnal demand for funds had subsided, another slight increase was authorized by the Board.

The beneficial effect of these increases was undoubtedly greater than anticipated. And the most decisive results seem to have been attained in New York City. In the four weeks ending February 13, 71 banks in the city which report weekly to the Board reduced loans by $178,000,000.[1] The 733 reporting banks elsewhere in the United States increased their loans in this period, however, to the extent of $67,000,000. But all in all, the results of what may properly be called experimenting in rate control were such that increased reliance came to be placed on this weapon. Accordingly by the late spring of 1920 rates in many districts on commercial paper were advanced to 7 per cent, thus bringing the rediscount charge into conformity with the commercial rate.

But one theory was current in a limited circle at this time, which, if true, would have rendered this weapon of no avail. It will be recalled that since the amendment of June 21, 1917, all that counts as a legal reserve of a member bank is credits with a reserve bank. Among other ways these credits may be established by rediscounting. But reserves thus established may be multiplied manifoldly in determining the volume of deposits member banks may create for their customers. If, for instance, a member bank's legal minimum is 10 per cent, it may loan ten dollars for every dollar of reserves. It could receive interest on ten dollars of discounts while paying interest on one dollar of rediscounts. Any slight advance in rediscount rates would appear therefore to be of

[1] *Ibid.*, March, 1920, pp. 221–22.

small importance. And to be really effective must not the rate be absurdly high, as for instance, 18 or 20 per cent?

Various answers were offered to this puzzling question. Some argued that it was merely a matter of the bankers not understanding the operation of the reserve system. But in most situations bankers were correct in refusing to admit the profit if the rediscount rate was higher than the discount rate. Every dollar advanced to a customer increases the extent to which checks drawn against that account will be deposited with other banks. To increase loans $1,000 might mean the increase of $1,000 debit balance at the clearing-house. Debit clearing-house balances mean the loss of cash. The process of creating these deposits would then be profitable only if the credits had been obtained from the reserve banks at a lower rate of interest.

The last difficulty, that higher rates mean the cutting down of loans to all equally, to the needy possibly on the same basis as to the extravagant borrower, proved more serious. If obliged to curtail credits member banks would in many situations begin with those accounts not regarded as necessary to advance the productive efficiency of the community. But in other situations credits which rank highest from the standpoint of advantage to the banker might not be those most essential to the community. Thus the Board states:

> There is no ready method in reserve banking by which the use of reserve facilities can be withheld from use in undesirable lines of activity without, also, being withheld from use in desirable lines.[1]

A partial answer to the problem of how to check the excessive borrower was found, so far as the borrower is a bank, in the terms of the Phelan Bill[2] which passed Congress on April 13, 1920. By the terms of this act rediscount rates may be increased by the reserve banks to those member banks whose rediscount applications exceed a specified base line to which the normal rate applies. The increase in rates for excessive borrowers as it has been worked out in two districts has resulted in some cases in the imposition of rates as

[1] *Federal Reserve Bulletin*, October, 1919, p. 911.

[2] For an explanation of the working of this act, see *Federal Reserve Bulletin*, August, 1920, p. 777.

high as 9 per cent. This should be of some assistance in limiting advances to those banks which seem likely to use the rediscount facilities.

But no ideal solution can be found solely by the working of such an indirect force as increase in rates. To supplement it a more direct method of control is required. Accordingly, by warnings and advice to the member and district banks the Board has endeavored to restrict the granting of "unessential" loans. As to the effectiveness of such advice there is a great difference of opinion. But in view of the desire of most member banks to avoid controversy with reserve banks and of the Board's power of direct control over reserve bank directorates, a power which it can exercise as it wishes, it appears to the writer that much may be accomplished in situations where the advice is supported by sound argument. It seems at least as if experience has shown that banks pay considerable heed to such warnings.

But what definition shall be given to unessential credits? The following might be employed:

1. Credits requested by industries which during the period of hostilities were regarded as unessential.

2. Credits required by industries whose services are not regarded as useful or beneficial to society.

3. Credits to be used for speculative purposes or to render possible the withholding of goods from the market.

The uselessness of the first criterion is scarcely debatable at the present time. Requirements of war time differ from those of peace. Probably not much would have been heard of this had not some industries conceived the belief that the Board's counsel meant the revival of war-time restrictions. On several occasions Governor Harding has reiterated that this was not the mind of the Board.

In regard to the second basis of distinction few would agree that the time has yet arrived when we wish the banker to sit in judgment as to the ethical character of our wants.

As to prohibiting the use of reserve bank funds to support speculation or the withholding of goods from the market, we encounter many difficulties. Now that the security speculator has had his feast the farmer feels that in this time of need his turn should come. But any liberality here may mean the taking of a class position. The consumer feels that after all these years of waiting the Board should not nullify the first favorable turn the market has yet brought him. The problem thus becomes one of granting such credits as are required to provide for the legitimate needs of the producer without taking undue advantage of the consumer.

Can such a close distinction be drawn successfully? The Reserve Board's answer is that it has endeavored and will endeavor to grant such funds as are required in the *orderly* marketing of crops. Thus we read in the *Bulletin* for December, 1919, some remarks addressed to certain cotton growers' interests:

> The Board has consistently advocated during the past five years the policy of orderly marketing of crops. Assuming that adequate warehousing facilities are available, it seems to be in the interest of the consumer as well as of the producer that staple commodities remain as far as possible in the hands of producers until sold for consumption. This policy gives the producer the benefit of an average price in that he is not required to "dump" his products upon the market in excessive volume, thereby depressing the price to the advantage of favored consumers or of speculators who do not as a rule pass the advantage on to the consumer. Owing to the great number of producers there will always be competition between them to sell which would not be the case if larger syndicates were able to acquire control of the bulk of the crop.[1]

And, in a letter addressed by Governor Harding to a counsel of the National Canners' Association we find:

> It is evident that there are certain seasons of the year when loans of a particular kind must be made in large volume and are entitled to more consideration than would be the case at other seasons, this being dependent upon the character of the industry. There is a wide difference between the granting of credit by banks for crop moving purposes at a time when crops are moving, or for canning or cold storage purposes at those seasons of the year when goods naturally pass into the hands of the canners, and the making of loans on agricultural products at periods when they should be marketed and not hoarded, or in lending on canning or cold storage products when they ought to be sold to jobbers and retailers instead of being held indefinitely for higher prices.[2]

[1] *Federal Reserve Bulletin*, December, 1919, p. 1109.

[2] This letter has been published in the *Commercial and Financial Chronicle*, July 10, 1920, pp. 137–38.

These statements of the Board's policy illustrate the extreme difficulty of the problems with which the Board is now confronted. It is no doubt true that in such demands as these lies the greatest danger in the attempt to maintain firm control of credit. If the Board surrenders in unwarranted manner to one of these interests it becomes all the more difficult to resist the demands of another. A simple and scientific manner of defining essential credits would at least prove welcome.

In the attempt to formulate such a definition some have come to stress the matter of guaranties of prompt repayment. The test of essentiality is thus reduced to that of liquidity; to the ability of the borrower to liquify his paper. In the words of the director of the Division of Analysis and Research of the Federal Reserve Board:

> If for example, it should appear that a borrower had fallen into a way of business which required the extension of a longer and longer credit to customers, or that he was drawing upon securities of which he might stand possessed in order to protect or collateral paper which he was keeping practically permanently in bank, or for which he was asking repeated renewals, the situation would be such as to raise a strong presumption against the essentiality of his borrowing.[1]

Except in certain minor instances, however, the Board has steadfastly refused to define essentiality. According to a statement by Governor Harding:

> It is not sufficiently close to the actual day-to-day requirements of business to lay down rules as to what loans are for essential purposes and what loans are not. The Federal Reserve Banks in their dealings with member banks are better situated in this respect, but ultimately the main responsibility of such decisions must rest with the commercial banks themselves, which in their dealings with customers are in a position to ascertain the purpose of each loan and to decide whether this purpose is essential or not.[2]

It is easy to understand the necessity of the Board's refusal to define essentiality so far as the member banks are concerned. For these institutions Willis' test of liquidity is undoubtedly as good as any which can be had. But for the district reserve banks

[1] H. Parker Willis, "Discrimination in Inflation," *Commercial and Financial Chronicle*, September 11, 1920, pp. 1040–41.

[2] *Federal Reserve Bulletin*, August, 1920, pp. 774–75.

it will not suffice at all. For what circumstances determine the liquidity of paper over the general field? It is obvious that one factor must be the inflation of the currency. All loans are more or less liquid in a period of rapidly rising prices.

But this does not mean that the Board should give up the attempt to define essentiality so far as the district reserve banks are concerned. For unless there is a clear formulation of the Board's belief the district banks in rejecting or accepting rediscount, applications cannot know whether they are carrying out the Board's will. There cannot thus be any policy consistently accepted the country over. Without such a policy the reserve system cannot function as intended. While liquidity may be made the test so far as each member bank is concerned, the general conditions affecting and underlying liquidity must be determined for each district by the district directorate and for the nation as a whole by the Federal Reserve Board.

The only possible basis for such a test has already been suggested. Increase in the volume of rediscounts should be permitted so long as the main effect is to enlarge the volume of production and not to raise the level of prices. Decreases in rediscounts should be enforced when it appears that the volume of business and consequently the need for credit is declining. Over a long period of time increases in rediscounts should be apportioned to the natural rate of growth in the productive capacities of the people. To express the matter in terms of the equation of exchange $(P=\frac{MV}{T})$ M should be altered when its principal effect will be borne by T and not by P.

What specific and detailed rules should be drawn up to realize these results the writer has not the necessary facilities to indicate. But before such specific regulations are formulated it is necessary that there be a clear and consistently accepted conception of the relation of increasing bank credits to the level of prices and the volume of trade. The writer's principal purpose in writing this article is to insist upon the necessity of such a formulation.

No other basis of approach can prove adequate in the proper control of commercial credit. Leaving the definition of essentiality entirely to each member bank will not do. Requiring all banks to reduce credits with equal rapidity is obviously unscientific. The state of the reserve ratio, varying as it does through the working of accidental forces, will not suffice. If the reserve bank which increases rediscounts cannot be made to defend such a course on the ground that it is necessary to unlock unused productive resources or to meet an enlarged seasonal demand; if production statistics cannot later be employed to justify the validity of the bank's pleas, there is no possibility of a scientific regulation of rediscounts. And if the desired solution cannot be found along these lines it is difficult to understand how the desire for sectional or factional advantage can prevent the employment of political power, with the danger that the whole matter of reserve bank policy shall become a football in the arena of politics. At the present time there are many evidences of such a danger. It may be that ahead of the reserve system lie times as troublous as those which witnessed the dissolution of both the First and Second United States Banks.

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