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The Federal Reserve System and the Control of Credit

Remarks of W. P. G. Harding, Governor of the Federal Reserve Bank of Boston, at the Dinner of the Economic Club of New York, Hotel Astor, Monday Evening, March 18, 1929

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I appreciate very much the honor of participating in this discussion but would like to have it understood that what I shall say will be merely an expression of my own personal views and must not be regarded as an authoritative reflection of the opinions of the Federal Reserve Board or of any Federal reserve bank.

The problems connected with the control of credit by the Federal Reserve System, while not so simple as they may appear to some, are not so difficult as to render them incapable of solution. In considering this question, let us first understand what the Federal Reserve System is, and where lies the responsibility for its policies. It is composed of the Federal Reserve Board at Washington and the twelve Federal reserve banks. The members of the Board are government officials, appointed by the President and confirmed by the Senate. Two-thirds of the directors of the Federal reserve banks are chosen by the member banks and one-third, designated as Class C Directors, are appointed by the Federal Reserve Board, although the capital stock of the Federal reserve banks is owned entirely by the member banks.

The operations of the System are conducted by the Federal reserve banks, for the Board at Washington is not an operating body. The Federal Reserve Board has, however, plenary powers as far as system policies are concerned. In the matter of discount rates, no question has ever been raised as to the necessity of the Board's concurrence before any rate established by the board of directors of a Federal reserve bank can become effective; nor has the Board itself, since the Chicago episode of eighteen months ago, ever disavowed the right which it claimed at that time to change the rate of any Federal reserve bank under its power of review and determination, without the co-operation of the directors of the bank concerned.

"ORDERS OF THE FEDERAL RESERVE BOARD"

The directors of a Federal reserve bank are required by law to administer the affairs of the bank fairly and impartially and without discrimination in favor of or against any member bank or banks and shall, subject to the provisions of law and the orders of the Federal Reserve Board, 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 directors of Federal reserve banks are, naturally enough, inclined to be jealous of their prerogatives and have not been prone to emphasize the phrase "the orders of the Federal Reserve Board" in connection with their dealings through their appointed officers or agents with member banks, while the Federal Reserve Board, appreciating the desirability of being tactful in its dealings with Federal reserve banks, has never in specific terms called attention to this phrase. It is recognized by all that the Federal Reserve Board has the right to determine or define the character of paper eligible for discount within the meaning of the Act, but the Federal Reserve Board has conceded to the directors, through their appointed officers or agents, the right to pass upon the desirability and soundness of the paper offered for discount, and has never undertaken to compel a bank to take paper which its officers regarded as undesirable even though technically eligible. The law describes the security which must be offered for Federal reserve notes and gives the Board the right at any time to call upon a Federal reserve bank for additional security to protect Federal reserve notes issued to it and also gives the Federal Reserve

Board the right to grant in whole or in part, or to reject entirely, the application of any Federal reserve bank for Federal reserve notes.

One of the three directors appointed by the Federal Reserve Board must, under the law, be designated by the Board as Chairman of the board of directors of the Federal reserve bank to which he is accredited as Federal Reserve Agent, and in addition to his duties as Chairman of the Board of Directors of the Federal reserve bank, he is required to maintain, under regulations to be issued by the Federal Reserve Board, a local office of the Board on the premises of the Federal Reserve Bank. The law requires that another of the directors of Class C shall be appointed by the Federal Reserve Board as Deputy Chairman to exercise the powers of the Chairman of the Board when necessary, and prescribes that in case of the absence of the Chairman and Deputy Chairman, the third Class C director shall preside at meetings of the Board.

OTHER POWERS OF THE BOARD

The law permits Federal reserve banks to establish accounts with each other for exchange purposes and provides that with the consent or upon the order and direction of the Federal Reserve Board, and under regulations to be prescribed by said Board, they may open and maintain accounts in foreign countries.

State banks and trust companies desiring to become members of the Federal Reserve System are required to make application to the Federal Reserve Board, which body, under such conditions as it may prescribe, may permit the applying bank to become a stockholder in the Federal reserve bank of its district.

The Federal Reserve Board is authorized to permit, or on the affirmative vote of at least five members to require, Federal reserve banks to rediscount paper for other Federal reserve banks at rates of interest to be fixed by the Federal Reserve Board.

The Board is also authorized and empowered to examine at its discretion the accounts, books and affairs of each Federal reserve bank and of each member bank, and to require such statements and reports as may be necessary.

The Board has power to suspend or remove any officer or director of any Federal reserve bank, but the cause of such removal shall be forthwith communicated by the Federal Reserve Board to the removed officer or director and to the Federal reserve bank concerned.

The Board is authorized also to suspend for the violation of any of the provisions of the Federal Reserve Act, the operations of any Federal reserve bank, to take possession thereof, administer the same during the period of suspension and when deemed advisable, to liquidate or reorganize such bank.

Any compensation which may be provided by the Board of Directors of Federal reserve banks for directors, officers or employees shall be subject to the approval of the Federal Reserve Board, which body is authorized and empowered also to exercise general supervision over the Federal reserve banks.

RESPONSIBILITY AND WARNINGS

It appears, therefore, that the Board's authority over the twelve Federal reserve banks is far greater than that of the Comptroller of the Currency over National Banks, or of the State Superintendent of Banks over state banks and trust companies. These broad powers, some of which have never been exercised and probably never will be, which are given to the Federal Reserve Board necessarily impose upon the Board a great responsibility which, from the very beginning, the Board has appreciated and of which it has been constantly reminded by critics. It is this sense of responsibility which has doubtless impelled the Board, from time to time, to issue statements which contain a note of warning intended not only for the banks but for the general public. Occasionally these warnings were effective, but more generally they have been merely a prelude to more substantial action. One of the earliest warnings issued by the Board for the consideration of banks and investors was in October, 1916, following an announcement by a prominent international banking house that it proposed to sell indeterminate amounts of British treasury bills over its counter. This particular statement was very carefully considered and, because of its bearing upon the international situation, was not issued until it had received the approval of the President of the United States. It proved effective, for the proposed offering was immediately withdrawn.

During the period when the United States was involved in the World War, admonitions or warnings by the Board were as a rule heeded without much adverse criticism because of the general patriotic impulses which prevailed. After the armistice, however, admonitory statements which the Board on several occasions deemed it advisable to make were not so well received, and a number of Federal reserve banks reported that it would be necessary, in order to regain an effective control in their respective districts, to resort to means which up to this time have always proved effective, namely, to establish higher rates of discount which would conform more closely to current market rates. The Board, for what seemed to be valid reasons, was reluctant for some time to permit the establishment of higher rates, and the Federal reserve banks were advised to try the policy of direct action which involved closer scrutiny in accepting paper for rediscount and an appeal to member banks to use more discrimination in giving accommodation to their customers. Several months of valuable time were lost in this way, and it seems probable that had higher rates been established in the late summer of 1919 instead of in January, 1920, some of the economic tragedies of the so-called deflation period might have been averted. The depression which began in the summer of 1920 and extended during the year 1921 was however, of much shorter duration than that which had followed any other serious financial crisis in the country's history, and was followed by a period of unparalleled activity in many lines and by a prolonged season of low interest rates.

WHY LOW RATES IN 1927

The rediscount rate of the Federal Reserve Bank of New York, which in the autumn of 1920 had been 7%, stood, after successive reductions, at 3% in the late summer and fall of 1924. Late in February, 1925, the rate was advanced to 3½% and in January, 1926, to 4%, where it remained until August 5, 1927, when it was reduced to 3½%. At the time this last reduction was made, it was the policy of the Federal Reserve System to use its influence in favor of easier money conditions. This policy was initiated by the Federal Reserve Bank of New York and was approved, as was necessary to enable it to be carried out, by the Federal Reserve Board. The principal reasons as pointed out by the Undersecretary of the Treasury, Mr. Mills, in a magazine article not long ago, were (1) European exchanges were weak and it was believed that unless money rates were kept easy here, there might be a movement of funds to this country and a consequent necessity of raising rates abroad, to the disadvantage of world trade and prices, and particularly to the disadvantage of American agriculture. (2) Business in the United States at the moment showed a tendency to decline and some industrial unemployment was foreseen which in fact developed during the winter. It was believed that easier money might ameliorate those conditions.

The policy was effective in just those particulars which the Federal Reserve System had in mind when it was adopted. At the same time, it is undeniable that it served as an encouragement to speculation, and no one could foresee the extent to which the speculative movement would reach. The movement of gold abroad had begun in May, 1927, and the reduction in the discount rate accelerated this movement. In order to offset the effects of these gold exports on the money market, purchases of government securities were made for a time by the Open Market Investment Committee for the Federal reserve banks, but as soon as it became evident that the object of the policy adopted had been accomplished and that speculation was growing, this policy was reversed. After the middle of November the reserve banks discontinued offsetting gold exports by the purchase of securities and allowed such exports to work their usual effects on the credit situation. In January, 1928, in order to offset the return flow of currency to the financial centers, something over one hundred million dollars of government securities were sold by the Federal reserve banks and during January and February the discount rates of all Federal reserve banks were raised from 3½% to 4%. Loss of gold and the sale of securities forced the banks to increase their borrowings from the Federal reserve banks.

WHY HIGHER RATES IN 1928

The action taken was not effective, however, and when it became clear that repeated increases in credit were taking place for speculative purposes, the Federal Reserve System resumed its sale of securities and during the spring all of the Federal reserve banks advanced their discount rate to 4½%, and by July and August eight of them had advanced the rate to 5%. The periodic purchase and sale of government securities by Federal reserve banks had been going on for several years and was for a time thought to be an effective means of stabilizing credit without resorting to substantial changes in the discount rate. The experience of the early months of the year 1928, however, proved that this method of stabilization cannot always be depended upon to be effective. The securities sold by the System last year involved a considerable loss and many of them found their way back into the portfolios of the reserve banks as security for member banks' 15-day collateral notes. It appears also that it was a mistake to advance the discount rate by only ½ of 1%, and that it would have been better to have adopted the time-honored policy of the Bank of England and advance the rate a full 1%. Whenever it becomes necessary to administer to a speculative market the medicine of a rate advance, homeopathic doses should be avoided.

LOANS FOR "OTHERS"

The Federal Reserve System is handicapped at the present time in its efforts to exercise an effective credit control because there are so many lenders both domestic and foreign not connected with the System, who have been attracted by the abnormally high rates which have been paid for many months past for funds to be used in stock market operations. During the easy money period, many corporations took advantage of conditions then existing to anticipate their future cash requirements by selling additional stock or new securities. Ordinarily the money resulting from such operations would have been permitted to remain in banks at reasonable rates of interest, but the high rates obtainable on Stock Exchange loans attracted large amounts which reduced in corresponding degree the deposits of the banks. At the present time it appears that at least one-half of the amount of brokers' loans as shown in the weekly statements are represented by funds belonging to individuals, firms and corporations whose primary business is not that of money-lending, who feel no responsibility whatever as to market stability, and who have no hesitation in calling their loans whenever individual necessity or convenience may impel them to do so. During the latter part of last December such loans were called to so great an extent that in order to prevent a serious reaction banks in New York City felt called upon to increase their lendings to brokers by about four hundred million dollars. This necessitated their borrowing perhaps one-half of this amount from the Federal reserve bank.

I have seen some references in the newspapers to an alleged contest that is going on between the Federal

Reserve System and the stock exchange. I do not believe that there is any hostility between Federal reserve authorities and the members of the stock exchange. Certainly the exchanges are necessary in carrying on the business of the country. We have a vivid recollection of the chaos which followed the closing of the exchanges at the outbreak of the World War in 1914, and we recall how quickly conditions improved after the exchanges were reopened. Neither do I see any occasion to find fault with the methods of brokers generally, both on the curb and on the big board. They have not hesitated to increase their margin requirements from time to time, and the occasional reactions which have occurred have brought about no failures, yet, as Mr. Warburg recently pointed out in his notable address to the stockholders of his bank, dangerous tendencies are developing.

TIME FOR CORRECTION

These tendencies ought to be corrected and the sooner the better. A review lately issued by one of the large banks points out that during the past twelve months there has been an expansion of credit of about 8%, while at the same time there has been an expansion of production and distribution of only 3% or 4%. This difference represents inflation. The best time to check inflation is during the period of its incipiency. The longer the postponement the more serious the inevitable result will be when inflation is checked, as was clearly demonstrated in 1920. In the February, 1929, issue of the Federal Reserve Bulletin, the Federal Reserve Board stated its views very frankly and released the statement to the press in advance of its publication in the Bulletin. The immediate effect of this release was a temporary break in the stock market and the Board has been greatly censured in some quarters for making the statement.

The Board stated: "The Federal Reserve Act does not, in the opinion of the Federal Reserve Board, contemplate the use of the resources of the Federal reserve banks for the creation or extension of speculative credit. A member bank is not within its reasonable claims for rediscount facilities at its Federal reserve bank when it borrows either for the purpose of making speculative loans or for the purpose of maintaining speculative loans. The Board has no disposition to assume authority to interfere with the loan practices of member banks so long as they do not involve the Federal reserve banks. It has, however, a grave responsibility whenever there is evidence that member banks are maintaining speculative security loans with the aid of Federal reserve credit. When such is the case, the Federal reserve bank becomes either a contributing or a sustaining factor in the current volume of speculative security credit. This is not in harmony with the intent of the Federal Reserve Act nor is it conducive to the wholesome operation of the banking and credit system of the country."

In a recent magazine article, Senator Glass stated: "The fact remains too, and it ought to be emphasized in red letters, that whether dangerous for the moment or not, this sucking in of the country's resources for use in gambling in stocks and bonds, without regard to the need for money in legitimate industry, is precisely the sort of thing the Federal Reserve Act was designed to prevent, or at least to minimize." He then quotes from Section 13 of the Federal Reserve Act, the paragraph which defines what kind of paper Federal reserve banks may discount and in which the Federal Reserve Board is given the "right to determine or define the character of the paper thus eligible for discount within the meaning of this Act . . . but such definition shall not include 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." He points out that "Thus even the legitimate and necessary trading in stocks and bonds for purposes doubtless sound and productive was barred as a basis for rediscounting.

. . . Could there have been a more emphatic pronouncement of the intent of Congress to hold our capital resources down closely to the vital processes of producing and distributing actual commodities?"

The Federal Advisory Council, as you know, is composed of twelve practical bankers, one from each Federal reserve district. The Council is a statutory body (Section 12, Federal Reserve Act) and has power to "confer directly with the Federal Reserve Board on general business conditions; to make oral or written representations concerning matters within the jurisdiction of said board; to call for information and to make recommendations in regard to discount rates, rediscount business, note issues, reserve conditions in the various districts, the purchase and sale of gold or securities by reserve banks, open market operations by said banks, and the general affairs of the reserve banking system." Its members are elected by the directors of the Federal reserve banks and the Council is, therefore, entirely independent of the Federal Reserve Board.

At the last meeting of the Council held on February 15, it went on record as approving the letter of the Federal Reserve Board which instructed the Federal reserve banks to "prevent as far as possible, the diversion of Federal reserve funds for the purpose of carrying loans based on securities. The Federal Advisory Council suggests that all member banks in each district be asked directly by the Federal reserve bank of the district to co-operate in order to attain the end desired. The Council believes beneficial results can be attained in this manner."

The Federal Reserve Bank of Boston immediately sent out a letter to all its member banks asking for their co-operation. The letter was well received and the results attained have been satisfactory, although it was pointed out by some of the banks that it was difficult to decline to make loans secured by good collateral to regular customers even where it seemed probable that the proceeds would be used for speculative or investment purposes, because in many cases loss of deposits and good-will would follow a refusal.

CALL RATE NOW DOMINANT FACTOR

The paragraph in Section 14 of the Federal Reserve Act which gives the Federal reserve banks "power to establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank for each class of paper which shall be fixed with a view of accommodating commerce and business" contains a definite mandate — "the rate shall be fixed with a view of accommodating commerce and business." Generally speaking, low rates give such accommodation and high rates do not. I have always noticed a more marked disposition on the part of the Federal Reserve Board to agree to a reduction in rates than to an increase in rate. Doubtless this is because of the view that high rates do not conduce to the accommodation of commerce and business. Sometimes, however, it is necessary to look beyond the immediate effect, to take a longer view into the future. The highest rate now prevailing at any Federal reserve bank is 5%, and yet I doubt if there is any firm or corporation in the United States today which is able to borrow from its own bank at that rate. Until recently offerings of United States Treasury certificates bearing interest from 3¼ to 4½% have been heavily oversubscribed, sometimes at a ratio of more than two to one, but the offering of $475,000,000 last week at 4¾% was oversubscribed by less than $50,000,000. The Federal reserve bank rate is no longer the dominant rate. It is generally recognized both at home and abroad that the master rate in this country is the call money rate in New York which fluctuates at frequent intervals from 6 to 12%. Perhaps the Federal Reserve Board at the present time may feel the same reluctance to agreeing to an advance in rates that some members of the Board felt in the summer of 1919; but yet if there is to be an advance, and I may say that I have no information whatever as to the likelihood of this, the rate established would only follow and not lead the market, for market rates have already been established.

AGAINST DIVERSION INTO PROHIBITED CHANNELS

In matters of credit control, it is of course important that there should be a thorough understanding between the Federal Reserve Board and the various Federal reserve banks; they should work in harmony and not at cross purposes. The Federal reserve banks should do everything in their power to carry out the views of the Board in matters of policy and if the Board believes that appeals to member banks should be made, or statements to the public should be issued, such appeals should be made; and if it should develop, as was the case in the fall of 1919, that conversation is not effective, resort should be had to those sterner methods which have never failed to be effective. Continued high rates of interest will eventually bring about a slowing down in business and industry. Such a slowing down would inevitably affect adversely security values. While the Federal Reserve System is not engaged in any kind of economic warfare, and has no desire to destroy values, it is my belief that under the terms of the Federal Reserve Act its first duty is to the industrial, commercial and agricultural interests of the country. That there can be no dependence upon the effective discharge of this duty if the resources of the System are permitted to be diverted through indirect methods into channels expressly prohibited directly by the law, appears to me so clear as to be beyond dispute.