FEDERAL RESERVE BANK
OF DALLAS

February 26, 1924.

USE OF CREDIT IN 1924

To the Bank Addressed:

In view of the fact that member banks are now confronted with the problem of determining what lines of credit they will extend to their customers during the coming year, the thought has occurred to us that an exchange of views between the Federal Reserve Bank and its member banks upon the general subject of the use of bank credit in 1924 would prove mutually helpful in shaping the policies that are to control, respectively, the primary and secondary distribution of credit in this district during the coming year, the former being exclusively within the hands of member banks and other commercial banks, the latter being to a large extent within the province of our rediscount facilities.

In order that our own views upon this subject may be placed before our member banks in the proper light, I desire to preface them with the statement that they are submitted solely upon the strength of whatever appeal they may carry to the independent judgment of our member banks, and in full recognition of the fact that we are vested with no supervisory authority over our members. Frankly, we should like for the views set forth in this letter to receive consideration only in the light of whatever merit they may possess by reason of being the product of our exceptional opportunities to study the credit problems of over eight hundred member banks as they come to our attention almost daily in connection with their rediscounting operations and other transactions with us.

On account of the dominant position which agriculture occupies in this section, as well as the fact that conditions affecting most of the other occupations have now become fairly stable and normal, the more serious problems that press for solution at this time are those that confront the banks engaged in the important task of financing the agricultural producers.

The present situation in the Southwestern Cotton Belt is strikingly similar to the situation that existed in the Spring of 1920. While the parallel does not altogether extend to the world supply of and demand for cotton that existed then, the present situation offers our agricultural producers practically the same temptations to allow themselves to be drawn into the evils of extravagance, speculation and over-production of a single commodity as were responsible for the greater part of the disastrous consequences that attended their yielding to these temptations in 1920.

The trying experiences of 1920 and 1921, still fresh in the minds of all of us, taught us some lessons that will not soon be forgotten, one of the most obvious of which is the fact that when bank credit is diverted from its fundamental function (financing seasonal needs incident to the normal production and distribution of commodities) to purely capital purposes, disaster generally follows. And yet during the very period in which the banks of this district were learning this lesson a radical though almost unnoticed change was occurring in our farm credit system which, unless closely watched, will tend to bring about another era of capital loans. The change referred to is the tendency on the part of merchants and landlords to permit the entire burden of financing the farmer to be assumed by the local banker, who is now, to a greater extent than ever before, carrying this burden alone. How this change in the farm credit system tends to create an increased demand for bank credit for capital purposes is readily apparent.

Those merchants and landlords who are now freed from the need of bank credit to finance the farmer, are tempted to use their line of credit with the bank for capital purposes, such as enlarging their operations and financing permanent improvements. The farmers who are no longer dependent upon merchants and landlords for provisions and supplies look solely to the banks for credit accommodations, and in order to liquidate their enlarged obligations to the banks, seek to increase their production by renting or buying more land, employing more labor, and enlarging their "cash crop" acreage. Thus the banks are confronted with a constantly increasing demand for capital loans; and, unfortunately, during the past few months the temptation to make such loans has grown apace with the demand. The heavy accumulation of deposits as a result of an exceptionally profitable cotton crop in 1923 has made the task of profitably employing these funds a serious problem.

Under such circumstances it becomes easy for the banks in an agricultural community to confuse community credit needs with community capital needs. Perhaps upon no other phase of banking has there been quite as much loose thought and mistaken conceptions as upon the question of a bank's duty to its community. Some of the most distressing situations with which the Federal Reserve Bank of Dallas has had to deal in recent years, in connection with over-extended or insolvent member banks, have been directly traceable to the inability of the bank to distinguish the line of demarcation between its duty to the community and its duty to its depositors and other creditors, while in many of these cases the bank had focussed its attention so exclusively upon what it conceived to be its duty to the community that it had entirely overlooked—and allowed its customers to overlook—the vitally important question of the **community's duty to the bank.** In such circumstances it is a too common practice both for the bank and the community to turn to the rediscount facilities of the Federal Reserve System as the panacea for all their ills. The interminable pouring of bank credit into capital channels, which in the first instance was the cause of the predicament in which the bank and the community found themselves, is the remedy they would prescribe for the disease, the only change involved in the process being the introduction of the Federal Reserve Bank, in lieu of the local bank, as the reservoir of unlimited credit. In such a situation our rediscount facilities and our genuine desire to be of helpful service are debarred from functioning by the fact that the member bank, by the misuse of its own lending power, rendered itself an unsafe and incompetent channel for the flow of credit from our rediscount facility to the community in distress.

In the light of past experience and of the trend of present conditions it is our belief that the use of bank credit for farm purposes in 1924 should be controlled by policies based upon the following definite principles:

1. Any effort to increase the production of cotton in this district should take into account not only the hazards of over-production but also the fact that the cost of production increases in direct ratio to the acreage increase.
2. The line of credit extended to each farmer should be based upon his prospective minimum crop returns.
3. Bank credit is never a justifiable substitute for capital, which, in the farmer's case, consists of soil fertility maintained by fertilizers and crop rotation; home-grown provisions for his family and workstock; and that residue of cash returns from the sale of his products which is needed to maintain himself from one harvest season to another, and which would otherwise be available for the acquisition of the comforts and conveniences of a higher standard of living.
4. From a community standpoint, lines of credit extended to landlords cannot be safely determined without taking into consideration the terms of their contracts with tenant farmers and the extent to which, under such contracts, it is possible for the tenant farmers to properly diversify and rotate their crops. It is to the interest of the landlords, as well as the community, for them to collect their rentals from the actual sale of cotton, corn and other farm products, etc., but it is often the case that the rentals are being paid from what is in reality the sale of the humus and fertility of their lands.

Our reason for calling attention at this time to these old and familiar principles is that under present conditions they are likely to be obscured and lost sight of in the face of the cheap and plentiful supply of credit that now exists in a large area of the district as the result of producing an exceptionally profitable cotton crop. Our plea is for a sane use of the credit supply, without restricting in any way the making of loans that are justified by a wide and comprehensive view of the future and supported by the time-tested principles that not only make for increased profits for our agricultural producers but also embody the inherent elements of self-liquidation.

An expression of your views in this connection will be appreciated.

Yours very truly,

Lynn P. Talley

Federal Reserve Agent.