

St. Louis, Mo., June 22, 1920.

TO THE MEMBER BANKS OF DISTRICT No. 8:

At the request of the Federal Reserve Board, your attention is called to the following editorial which appeared in "The Dallas Morning News," of Friday, June 11, 1920.

Respectfully,

WILLIAM McC. MARTIN,
Chairman of the Board.

"THE ADVANCING COST OF BANK CREDIT"

"It seems to have become the policy of banks to advance their discount rates commensurately with the advances made in the rediscount rates of the Federal Reserve Banks. Some of them seem not to have been content to limit their advances to the advances made by the Federal Reserve Banks, but to have made the action of the Federal Reserve Banks a pretext to widen the previously existing difference between the discount and the rediscount rates. We use the word pretext for the reason that the action of a Federal Reserve Bank in increasing its rediscount rates does not necessarily warrant member banks in making any increase, whatever. The idea that it does, which idea seems to govern the policy of member banks, betrays a most surprising misconception of the purposes and functions of the Federal Reserve System.

"It was not the purpose in creating the Federal Reserve System to enable the member banks to make a profit out of their rediscount operations. Nor was it the purpose even to enlarge their opportunities for increasing their earnings in any way. The salient purpose was to create and maintain a reservoir of credit for use in times of stress. Whenever rediscount rates are advanced, therefore, it is done chiefly to husband the resources of the Federal Reserve Banks. Under normal conditions, the rates of a central bank, in countries which have long had them, are higher than the open market rates, so that banks which rediscount lose instead of gain by the operation; and properly so, since the effect is to restrict the use of credit, which is the purpose of the central bank in advancing its rediscount rates. It is obvious that if member banks are to make a profit on their rediscount operations they will be under no inducement to contract the volume of credit, and hence the purpose of the Federal Reserve Bank in advancing its rediscount rates will be somewhat balked, if not defeated.

"That there is a species of profiteering in advancing discount rates on no other warrant than the fact that the Federal Reserve Banks have advanced their rediscount rates will become apparent on a moment's reflection. For it is but a small percentage—about 12 per cent, we believe—of the loans made by member banks that are rediscounted at the Federal Reserve Banks. In other words, about 88 per cent of their loans are made from their own funds, so that when they advance their discount rates commensurately with an advance made in the rediscount rates of the Federal Reserve Banks they are merely increasing their profits on nearly 90 per cent of the loans they make at the advanced rates. Thus what they in reality do is to put a 'replacement value' on their funds, but without, however, always replacing them, so that they have even less excuse than the dealers in sugar for adopting that thrifty rule of pricing. If the member banks had all of their loanable funds outstanding, or even any very large percentage of them, it might be both just and expedient to make additional loans at the rates of the Federal Reserve Banks, or even at rates higher than those of the Federal Reserve Banks. But when they make their rates advance with those of the Federal Reserve Banks without being under the necessity of rediscounting the loans made at those advanced rates, it is evident that they are merely exploiting an opportunity which arises from an unhealthful condition of finance and industry. There is the less excuse for doing this in the fact that the Federal Reserve Act has freed for use a great deal of the money which the old law required them to keep in their vaults. Since a greater percentage of their funds is thus made available for lending, they can make their rates lower and still make their discount operations as profitable as they were before the institution of the Federal Reserve System.

"The action of the banks throughout the country in advancing their discount rates has engendered no little dissatisfaction, and that dissatisfaction vents itself in complaints against the Federal Reserve Banks. That this is an injustice to those institutions is made clear by what has been said."