RECOMMENDATIONS OF THE FEDERAL ADVISORY COUNCIL TO THE FEDERAL RESERVE BOARD

February 17, 1920

TOPIC NO. 1—Special rates for the rediscount of bankers' acceptances and the policy which should be pursued by Federal Reserve banks, having such rates, in their open market purchases.

Recommendation:

The special rate established by Federal Reserve banks for the rediscount of bankers' acceptances affords member banks the legitimate opportunity of purchasing them, carrying them as a secondary reserve, and realizing on them promptly whenever they have occasion to do so. It also, however, affords them the opportunity of purchasing them at current open market rates and having them rediscounted at the preferred rate simply for the profit in the transaction if this is permitted.

It should be understood that the object of the special rate is to encourage member banks to carry lines of this class of paper as a secondary reserve, promptly convertible into legal reserve balances when such conversion becomes necessary. With such an understanding prevailing many of the member banks would no doubt adopt the policy of carrying lines of bankers' acceptances as secondary reserves and the market for them would thus be materially broadened. In some districts this has already occurred.

The policy to be pursued therefore by Federal Reserve banks should be to leave the control of the open market for such acceptances in the hands of member banks and discount houses, so long as the former use the special rediscount rate legitimately and do not abuse it. The Federal Reserve banks should not therefore normally buy acceptances in the open market below the current rates at which the member banks and discount houses are buying them. Should it become urgently necessary to curtail rediscounts at the Federal Reserve banks rates can be raised and should it be found that the preferred rate for bankers' acceptances is being abused such discrimination in their favor should be discontinued.

TOPIC NO. 2—Rates of interest on deposits paid by member banks.

Recommendation:

The Council has had under consideration the rates of interest paid on the several classes of deposits by the banks located in the large cities of each Federal Reserve District as shown in a statement prepared by the Federal Reserve agents and submitted to a conference of bankers representing the twelve districts recently held in Chicago. As the banks in the three central reserve cities and those in all other cities, where the rate of interest paid on bank deposits has been regulated by the current rate of discount at the Federal Reserve banks on ninety day commercial paper, have already taken action limiting the maximum rate of interest to be paid on net and available daily balances of banks and trust companies to 2¼% and as such action enables the Federal Reserve banks to increase their discount rate without reference to existing clearing house rules regulating the payment of interest, we are of the opinion that no further steps are necessary or advisable looking to the regulation of the rates of interest to be paid on deposits.

TOPIC NO. 3—Effectiveness of the Federal Reserve Banks' 6% Rediscount rate.

Recommendation:

It is the opinion of the Council that the Federal Reserve Banks' 6% rate for the rediscount of ninety day commercial paper has not been without its effect on the credit situation but this rate has not been long enough in operation to determine whether or not it is high enough to effect the control desired.

TOPIC NO. 4—Differential rates for loans secured by Government bonds:

Recommendation:

In the opinion of the Council the differential rates now established in favor of loans secured by the Liberty and Victory loan bonds will ultimately have to be discontinued but we do not believe that the time has yet arrived when it should be done.

TOPIC NO. 5—The Federal Reserve Board recommends to Congress that an additional power be granted it by adding to subdivision (d), Section 14, a proviso that each Federal Reserve Bank may, with the approval of the Federal Reserve Board, determine by uniform rule, applicable to all its member banks alike, the normal maximum rediscount line of each member bank and that it may submit for the review and determination of the Federal Reserve Board graduated rates on an ascending scale to apply equally and ratably to all its member banks rediscounting amounts in excess of the normal line so determined. In this way, in the opinion of the Board, it would be possible to reduce excessive borrowings of member banks and to induce them to hold their own large borrowers in check without raising basic rates.

Recommendation:

The Council approves the principle of applying regulatory rates to such banks as are making an excessive use of the facilities of the Federal Reserve Banks, but doubts the practicability of establishing a normal maximum rediscount line applicable alike to all member banks. In determining the line of discounts and loans to be granted to a member bank due regard must be given to the nature of the business of each member bank, as it is obvious that a bank serving a commercial clientele would legitimately require a larger rediscount line than one which did not serve customers who require considerable borrowing facilities, and such bank should not be penalized for performing its proper function in financing commerce and trade.

TOPIC NO 6—Rate of interest at which future government certificates of indebtedness should be issued.

Recommendation:

If such certificates are to be of short maturity, not exceeding three months, the Council believes they may be marketed if they bear a rate of 4¾%. If, however, they are issued to mature in nine or twelve months, it is the opinion of the Council that a higher rate, bearing a closer relation to the rates current in the investment market, will be necessary in order to find a market for them. In either case a more general distribution of them should be aimed at and their concentration in the Federal Reserve banks as security for loans to member banks should be discouraged. For this purpose the Federal reserve banks' rate for loans to member banks secured by them should be not less than ¼ of 1% above the rate of interest at which they are issued.

TOPIC NO. 7—Are balances due from foreign banks deductible from balances due to banks for the purpose of determining reserves.

Recommendation:

We have read the opinion of your Counsel undertaking to refute the opinions of Messrs. Sherman & Sterling, White & Case, Mayer, Meyer, Austrian & Platt, Stetson, Jennings & Russell, and Edward E. Brown, all eminent bank counsel, who agree that balances due from foreign banks can lawfully be deducted from balances due to banks for the purpose of determining reserves in the manner provided by Section 19, of the Federal Reserve Act.

We submit that the great preponderance of counsel is on the side of the opinion expressed by us to the effect that balances due from foreign banks may legally be so deducted. Wholly apart, however, from the legal question on which the lawyers seem to differ five to one, it is the opinion of this Council that the question should be considered and decided by your Board along the lines of good banking practice.

The practice has heretofore existed and we know of no good reason why it should be changed now. At the present time it makes very little difference to banks carrying foreign balances, as nearly all of them have little or no balances due them in foreign countries. In normal times, however, these balances mount up into very substantial figures and there are no balances on their books more easily and more readily convertible into legal reserve balances with the Federal Reserve Banks than they are.

In the interest of financing the foreign trade of this country, we therefore again respectfully urge a reconsideration of your ruling in this matter.

The following members of the Federal Advisory Council were present at this meeting: Messrs. James B. Forgan, President; L. L. Rue, Vice-President; Philip Stockton, W. S. Rowe, J. G. Brown, Oscar Wells, F. O. Watts, C. T. Jaffray, R. L. Ball, A. L. Mills, and Merritt H. Grim, Secretary.

RECOMMENDATIONS OF THE FEDERAL ADVISORY COUNCIL TO THE FEDERAL RESERVE BOARD

May 18, 1920

Hon. W. P. G. Harding, Governor,
Federal Reserve Board,
Washington, D. C.

My Dear Sir:

The Council has given consideration to the matters included in your communication of April 17th, and beg to reply thereto in the following manner, following the order set out by you:

TOPIC NO. 1.—"Causes of continued expansion of credits and of Federal Reserve note issues."

Answer:

There are many contributing causes of which the following may be regarded as paramount:

1. We recognize, of course, that the first cause is the Great War.
2. Great extravagance, national, municipal and individual.
3. Inefficiency and indifference of labor, resulting in lessening production.
4. A shortage of transportation facilities, thus preventing the normal movement of commodities.
5. The vicious circle of increasing wages and prices.

TOPIC NO. 2.—"How can the reserve position of the Federal Reserve banks be materially strengthened before the seasonal demand sets in next Fall without undue disturbance of the processes of production and distribution?"

Recommendation:

By urging upon member banks, through the Federal Reserve banks, the wisdom of showing borrowers the necessity of the curtailment of general credits and especially for non-essential uses, as well as continuing to discourage loans for capital and speculative purposes; by checking excessive borrowings through the application of higher rates.

TOPIC NO. 3.—"If steps cannot be taken at this time leading to a more normal proportion between the volume of credits and the volume of goods, when can they be taken?"

Recommendation:

In our opinion steps should be taken now, as outlined in answer to the last question.

TOPIC NO. 4.—"What is the effect upon the general situation of the increased Treasury borrowings and what should be the policy of the Federal Reserve banks in establishing rates of discount on paper secured by certificates of indebtedness?"

Recommendation:

It is obvious that the borrowings of the Treasury have the same effect upon the general credit situation as those of other borrowers. The Council would suggest the wisdom of Congressional relief from the burden of government financing by a policy of rigid economy; the revision of the tax laws for the sake of a more equitable distribution of the burden without reducing the revenue; the enactment of the budget system, the budget to include provision for the gradual payment of the short time obligations of the Treasury. These would of necessity preclude unwise appropriations, such as the proposed soldiers' bonus.

In view of the large volume of Treasury Certificates of Indebtedness carried by member banks at the instance of the Treasury Department, we believe that rates established by the Federal Reserve banks on paper secured by them should not be materially greater than the rates borne by the Certificates.

TOPIC NO. 5.—"Should there be a revision of rates on paper secured by Liberty bonds and Victory notes?"

Recommendation:

From a survey of the present rates in force by the Federal Reserve banks it would seem that six per cent is now being charged on paper secured by Liberty bonds and Victory notes. In the judgment of the Council when and if any further revision of rates should be made there should be shown due consideration for the original subscriber of government securities.

(Signed) JAS. B. FORGAN, President.

The following members of the Federal Advisory Council were present at this meeting: Messrs. James B. Forgan, President; L. L. Rue, Vice-President; Philip Stockton, A. B. Hepburn, W. S. Rowe, J. G. Brown, Oscar Wells, F. O. Watts, E. F. Swinney, R. L. Ball, A. L. Mills, and Merritt H. Grim, Secretary.

RECOMMENDATIONS OF THE FEDERAL ADVISORY COUNCIL TO THE FEDERAL RESERVE BOARD

September 21, 1920

TOPIC NO. 1—CREDIT CONTROL.—1. What are the objects sought to be attained by the policy of credit control in the existing circumstances?

Is the object

(a) To maintain or to strengthen reserves?

(b) To stabilize the existing situation by prevention of further expansion?

(c) To bring about a discriminating deflation by reducing the total volume of credit?

Recommendation:

From the statistics compiled by Professor Kemmerer of Princeton, bank deposits increased from $12,678,000,000 in 1913 to $27,928,000,000 in 1919. At the same time the ratio of cash reserves to total deposits diminished from 11.7 in 1913 to 6.6 in 1919.

"Taking the index numbers of the United States Bureau of Labor Statistics as the most comprehensive and most scientifically prepared of the index numbers covering the entire period 1913 to 1919 inclusive, we may say that the wholesale price level increased from 1913 to April, 1920, 165%; in other words, if one calls the dollar of 1913 a 100% dollar in its purchasing power over commodities at wholesale, the dollar of today is approximately a 38% dollar."

This was the condition of affairs when the Federal Reserve Board undertook to exercise its power over credit for the purpose of protecting personal and commercial interests. All experienced business men knew that prices would seek a lower level, by gradual process if good judgment and conservatism prevailed, or by a commercial debacle if the illogical, ill-considered and extravagant methods brought about by the war were permitted to continue. Under these circumstances, and none too soon, the Federal Reserve Board exercised its power over credit in order to constrain bankers and business men to exercise conservatism and help strengthen commercial and financial conditions. The Board in so doing have accomplished a great work and have demonstrated one of the powers for good which the Federal Reserve System possesses. Naturally their first move was in the direction of strengthening the bank's reserves. That means strengthening the bank and putting it in a liquid position—in the position in which a well managed bank should always be, to respond to the demands of its clientele. Strengthening he reserves meant curtailing credit and *ipso facto* would prevent "further expansion." No one wishes to "Stabilize" existing conditions, but to get away from them to a safer and more conservative level. This would naturally bring about a "Discriminating deflation" by extending credit to such industries as were essential and needed support in order to preserve the general business welfare, and by restraining credit to activities which though perfectly legitimate were nevertheless non-essential to the general welfare and should be promoted by the funds of their owners and managers, and not be allowed to absorb commercial resources needed for the financing of business closely connected with the public welfare.

2. Can a substantial reduction in the volume of credit be effected without injury to the legitimate business of the country and without curtailment of essential production?

Recommendation:

A substantial reduction of the volume of credit can be effected without injury to the legitimate industry of the country and without curtailing of essential production. Not only this but such reduction in volume of credit may be made to materially strengthen the credit fabric of the country as a whole.

The first and most beneficent effect of the act of the Federal Reserve Board in controlling credit was to arrest the attention of the whole country and to incur high commendation from conservative forces and incur criticism ranging from mild to violent from certain sections or interests. It made everybody stop and think and the discussion which ensued showed plainly that the Board was right. The psychological attitude of the country toward business immediately began to change and from wild extravagance and a disposition to enter into new and ill-considered business, there came about a feeling of conservatism. People began to ask themselves just where they stood, how much they were really worth, and how they would fare if called upon to liquidate their outstanding obligations. Drafts drawn against goods shipped abroad were not always paid and sometimes returned. People began to repudiate their contracts to receive goods, especially in cases where the price had receded. Competition in business has brought about a most unfortunate practice—people order goods and then if it does not suit their convenience, they refuse to receive and pay for the same. This has continued so long and is so much the custom that manufacturers and wholesalers, hardly expect to hold their customers to rigid fulfillment of their contracts, if a change in the market or a change in business conditions makes it desirable for them to repudiate. Such repudiation of purchases began to happen generally and manufacturers and wholesalers found themselves possessed of large volumes of very high-priced goods which they could not market without loss. That is the condition of the mercantile industry in our country today. They have for years dictated the price of their goods and they are now endeavoring to dispose of them to the public without material abatement in prices. It is generally realized that they cannot accomplish such results; recessions in price have already set in and are bound to be more pronounced. Business people will have to liquidate their goods in order to liquidate financial obligations. This will bring about competition in selling throughout the country, something that has not existed for several years and this competition in its normal and natural course will clarify the situation and bring about normal conditions.

3. To what extent has one or more of these objects been attained in each District and in the country at large?

Recommendation:

The object sought to be accomplished by the Federal Reserve Board has been and is being accomplished in all Districts.

4. To what extent is it necessary to distinguish between the immediate objective of the policy of credit control and the remoter objective, such as reduction in the cost of living?

Recommendation:

The immediate effect of credit control is to safeguard the situation, to enable all business to function normally and the Board should at all times make this clear. Although a logical result may be lower prices and lower cost of living, it should distinctly appear that the Board does not seek to control or regulate prices, but leaves the price level to competition under the law of supply and demand.

5. What is the proper conception of the "normal credit condition" which the Federal Reserve Banks should seek to bring about?

> *Note*: Obviously if "liquidation" or "stabilization" of the existing credit situation are to be regarded as the objectives of the Federal Reserve policy of credit control, a condition which can be regarded as "normal" will be attained very much more quickly than if the objective is a reduction in considerable amount of the total volume of credit.

Recommendation:

The proper concept of "a normal credit condition" is something that varies with the years, with the crops, with commerce, involving domestic and foreign exchange, and with all the varying influences that make up the activity of a commercial nation. The making of crops has to be financed. While we are greatly indebted to nature for her annual contribution to the prosperity and happiness of mankind, the volume of that contribution depends very largely upon mankind's activities. The latent resources so abundant and so valuable nevertheless must be exhumed and that costs time and money and is a regular business in itself. A normal credit condition would seem to be one in which funds were obtainable in sufficient volume to enable the individual, the corporation, the great transportation systems of the country, the municipality and the state to obtain funds at reasonable rates with which to prosecute their respective enterprises. This is not a static world; there should also be funds available for new and enlarged enterprise, for installation of new and improved methods and processes, which the inventive genius of mankind is constantly producing.

6. Methods of credit control. Consideration of the efficacy of different methods of credit control.

(a) Horizontal increase of rates, especially of commercial rates; a canvass of the experience of banks which have put into effect a 7% commercial rate, to wit, New York, Boston, Chicago and Minneapolis.

(b) Progressive rate schedules starting with 6% as a basic rate; a canvass of the experience of Federal Reserve Banks of Kansas City, Dallas, St. Louis, and Atlanta.

(c) Other methods of dealing with the situation, such as the implication that increased offerings by member banks will force higher rates or recourse to the progressive rate; a canvass of the experience of Federal Reserve Banks of Cleveland, Philadelphia, Richmond, and San Francisco.

(d) Restricting issues of Federal Reserve notes to Federal Reserve Banks as a potential means of enforcing credit control; canvass of English experience and views.

Recommendation:

The different methods of credit control have not had a sufficient test period for the experience of the banks to be conclusive. It is found that each class of banks holds its own method to be most satisfactory and in such a situation there should be further experience before we could give to the Board any conclusion as between the three methods in use or advise any present attempt at uniformity in method.

7. Inter-Reserve Bank rediscounts as related to the problem of credit control. Is the existing policy and practice with respect to such rediscounts satisfactory and sound?

(a) To effect an approximate equalization of reserves?

Recommendation:

The existing policy with respect to Inter-Reserve Bank rediscounts is sound and the Board is to be highly commended for the manner in which they have made it effective.

(b) At the same rate fixed for its member banks by the bank granting the accommodation?

Note: When recourse was first had to inter-bank rediscounts it was thought that the value of a Federal Reserve Bank's endorsement was entitled to recognition in the form of a reduced discount rate. More recently this idea has been abandoned and rediscount transactions between Federal Reserve Banks are made at the rates established for member banks by the Federal Reserve Bank extending the accommodation. The question now arises, however, whether a Federal Reserve Bank which has been able to maintain high reserves by reducing the demands for accommodation from its own member banks, which are its depositors, should be required to extend accommodations to member banks in other Districts through the medium of their Federal Reserve Bank at the same rates as are established for their own members.

Recommendation:

The rate of such rediscounts should be variable and fixed by the Board from time to time as the situation may appear to require and without any special regard either for the profit or loss to the contracting banks. In the present situation we approve the action of the Board in fixing the rate of such rediscounts at seven per cent.

TOPIC No. 2.—LOANS SECURED BY LIBERTY BONDS AND VICTORY NOTES.

1. Is there any moral obligation resting upon any of the Federal Reserve banks to establish rates lower than commercial rates for paper of this classification?

Recommendation:

It is difficult for this Council to determine whether any moral obligation exists in *any* of the Federal Reserve Districts.

On the general proposition of moral obligation arising out of the methods adopted in the various Liberty Bond campaigns the Council is equally divided, voting 6 to 6.

2. Would liquidation of loans of this class be retarded or promoted by the establishment of lower rates?

Recommendation:

The establishment of lower rates doubtless would retard the liquidation of loans by Liberty Bonds and Victory Notes.

3. If lower rates are deemed desirable, would it be equitable and practicable to have such rates apply to original subscribers only?

Recommendation:

It might be equitable to confine preferential rates to original subscribers only, but we are informed that you have been advised that it would not be legal, and in our opinion it would not be practicable.

4. Should member banks' collateral notes be fully secured, taking market value instead of face value as a basis?

5. If so, how and when could the new policy be put into effect with a minimum of friction?

Recommendation:

Yes. We understand this is the practice in some districts and should be made general.

TOPIC NO. 3.—FEDERAL RESERVE NOTE ISSUES.

1. Is the note-issue policy of the Federal Reserve System subject to legitimate criticism?

Recommendation:

We regard the note-issue policy under the Federal Reserve System as sound and therefore not subject to legitimate criticism.

2. What connection is there between changes in the volume of credit and the volume of currency?

3. Is there any difference in relation to effect upon prices between the volume of credit and the volume of currency?

Answer:

It is not clear to the Council just what is meant by these questions. They are too involved to admit of their being satisfactorily answered in the time at the Council's disposal.

4. Can the note-issue policy of the Federal Reserve System be properly charged with any important responsibility for inflated prices, if so, what has been the responsibility and in what way does the issue of Federal Reserve notes promote or assist inflation.

Recommendation:

An increase of the Federal Reserve note issue was made necessary by war conditions and doubtless had some influence in inflating prices, but in the opinion of the Council there has been no undue issue of these notes.

5. Can the accepted principles of bank-note-currency regulation, applicable in normal circumstances when the commerce of the world is conducted on a gold standard, be safely taken as a guide in the abnormal circumstances now existing, when the gold standard is virtually suspended, except in the United States and Japan?

6. In connection with the policy of credit control should the present note-issue policy of the Federal Reserve System be changed and restrictions be thrown around the issue of Federal Reserve notes?

7. If the issue of Federal Reserve notes should be restricted, what form should the restriction take and what effect would different methods of restrictions have?

(a Imposition of charges against Federal Reserve notes upon the uncovered part of circulation issued to them at a given rate, for example, a fixed rate of 5% or a rate varying with the commercial rate.

(b) Would it be practicable to establish for each member bank a so-called normal currency limit and to impose charges upon member banks calling for notes in excess of their limit?

(c) Would it be advisable while continuing to have the Federal Reserve Banks pay all transportation charges on incoming currency, to have shipments of outgoing currency made at the expense of the consignees?

(d) Restrictions by definition of the character of the paper acceptable as collateral by the Federal Reserve Agent against the issue of Federal Reserve notes. Should member banks' collateral notes or customers' notes secured by Government obligations be taken as collateral for Federal Reserve notes?

(e) Limitation of the total volume of Federal Reserve notes by the Federal Reserve Board, the maximum amount being fixed pro rata for each Federal Reserve Bank. (The Federal Reserve Board has statutory power to accept in part or to reject entirely all applications for Federal Reserve notes).

Would restriction of note issues in any of the above mentioned ways operate to promote a better control of credit, and if so, what would be the effect upon the commerce and business of the country?

Recommendation:

We know of no reason why the principles under which bank note currency as issued under the Federal Reserve system should be changed as sufficient time has not elapsed to test its flexibility in response to business conditions. The Council is of the opinion that no alteration should be made in the regulations governing the currency issued which would impair its elasticity.

The following members of the Federal Advisory Council were present at this meeting: Messrs. James B. Forgan, President; L. L. Rue, Vice-President; Philip Stockton, A. B. Hepburn, W. S. Rowe, J. G. Brown, Oscar Wells, F. O. Watts, C. T. Jaffray, E. F. Swinney, R. L. Ball, A. L. Mills, and Merritt H. Grim, Secretary.