(*d*) "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?"

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.

(*e*) "Should there be a revision of rates on paper secured by Liberty bonds and Victory notes?"

From a survey of the present rates in force by the Federal Reserve Banks it would seem that 6 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.

Discount Policy of the Reserve Banks.

In response to a resolution of the Senate, the Federal Reserve Board on May 25 transmitted to the President of the Senate the following letter:

MAY 25, 1920.

SIR: On May 17, 1920, the Senate adopted the following resolution:

"*Resolved*, That the Federal Reserve Board be directed to advise the Senate what steps it purposes to take or to recommend to the member banks of the Federal Reserve System to meet the existing inflation of currency and credits and consequent high prices, and what further steps it purposes to take or recommend to mobilize credits in order to move the 1920 crop."

In response, the Board desires to say that it has recognized for many months past that the expansion of bank credits in this country was proceeding at a rate not warranted by the production and consumption of goods. It has repeatedly admonished the Federal Reserve Banks that influence should be exerted upon the member banks to induce them to avoid undue expansion of loans and to keep their volume of outstanding credits within moderate bounds.

Beginning six months ago the rates of discount on various classes of paper at the Federal Reserve Banks were advanced. During the latter part of January the present rates were put into effect. These advances, while undoubtedly checking credit transactions which otherwise would have been made, have not been entirely effective in bringing about the reduction in loans desired and which might normally have been expected during the early months of the year. Liquidation during these months is entirely natural and healthy and is necessary in order that the banks may be prepared to meet the demands made upon them during the crop making and harvesting seasons, but there has been no such liquidation and on the contrary commercial loans have steadily increased. Thus it appears that the public has anticipated demands for banking credit which are usually made later on in the year. The average reserves of the Federal Reserve Banks are now a little over 42½ per cent, as against 45 per cent at the beginning of the year and about 51 per cent 12 months ago.

The Federal Advisory Council, which is composed of one member from each Federal Reserve district, elected annually by the board of directors of the Federal Reserve Bank, is required by section 12 of the Federal Reserve Act to meet in Washington at least four times each year. The Council is authorized "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."

Upon receipt of a notice that the Council would hold its regular meeting on May 17, the Board extended an invitation to the three Class A directors of each Federal Reserve Bank, who are the representatives of the stockholding banks, to come to Washington at the same time for conference with the Federal Reserve Board and the Federal Advisory Council. This conference was held on the 18th instant and it was developed at the meeting that the present credit expansion is due in great part to the abnormally high prices of goods and commodities now prevailing throughout the country and to the congestion of foodstuffs and essential raw materials at, or near, points of production because of lack of transportation facilities.

The Board is convinced that if the unsold portions of last year's crops can be brought to market before the new crop matures, the liquidation of credits which are now tied up in carrying the old crops will be sufficient to offset to a considerable degree the credit demands which will be made upon the banks in moving the crop of 1920.

At the conference above referred to the Board's views were outlined by its governor, substantially as follows: The member banks should lean less heavily upon the Federal Reserve Banks and rely more upon their own resources, unnecessary and habitual borrowings should be discouraged and the liquidation of long standing, nonessential loans should proceed. Banks were cautioned, however, that drastic steps should be avoided and that the method adopted should be orderly, for gradual liquidation will result in permanent improvement, while too rapid deflation would be injurious and should be avoided. The Board pointed out the necessity for extending such credits as may be necessary to promote essential production, especially of foodstuffs, and, that if for any reason it should prove impracticable to increase essential production, there should be greater economy in consumption and more moderation in the use of credit. The problem of the banking system of the country is to check further expansion and to bring about a normal and healthy liquidation without curtailing essential production and without shock to industry, and, as far as possible, without disturbance of legitimate commerce and business. In order to effect this it seems necessary to distinguish between essential and nonessential loans, but the Federal Reserve Board feels it would be a most difficult task, which it should not undertake to attempt by general rule of country-wide application to make this distinction. During the war there was a broad underlying principle that essentials must be "necessary or contributory to the conduct of the war," but notwithstanding the sharp outline of this principle much difficulty was experienced by the various war boards in defining essentials and nonessentials. All the more difficult would it be for the Federal Reserve Board to make such a general definition in the present circumstances.

Section 13 of the Federal Reserve Act defines the eligibility of paper for discount by the Federal Reserve

Banks and lays down a general rule that any paper maturing within the time prescribed and "issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes" is eligible. No expressed condition is made regarding the essential or nonessential character of the transactions giving rise to notes which may be offered for discount, and the Federal Reserve Board is not required, and properly could not be expected, generally to adopt such a criterion of eligibility. It is too much a matter of local conditions and local knowledge to justify at this time any general country-wide ruling by the Board, even if such a ruling were deemed helpful.

On the other hand, there is nothing in the Federal Reserve Act which requires a Federal Reserve Bank to make any investment or to rediscount any particular paper or class of paper. The language of both sections 13 and 14 is permissive only. Section 4 of the Federal Reserve Act, however, requires the directors of a Federal Reserve Bank to administer its affairs "fairly and impartially and without discrimination in favor of or against any member bank," and subject to the provisions of law and the orders of the Federal Reserve Board to 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." Thus the directors of a Federal Reserve Bank have the power to limit the volume and character of loans which in their judgment may be safely and reasonably made to any member bank.

The recent amendment to paragraph (d) of section 14 distinctly authorizes each Federal Reserve Bank on its own account, without reference to action taken by any other Federal Reserve Bank, to establish a normal discount or credit line for each member bank, and permits the imposition of graduated rates on discount lines in excess of the normal line. This amendment, however, does not repeal or modify sections 4 and 13, and a Federal Reserve Bank is still free to decline to discount any paper which in its judgment does not constitute a desirable investment for it or which in its opinion would not constitute a safe and reasonable investment within the meaning of section 4.

It is the view of the Board, however, that while Federal Reserve Banks may properly undertake in their transactions with member banks to discriminate between essential and nonessential loans, nevertheless that discrimination might much better be made at the source by the member banks themselves. The individual banker comes in direct contact with his customers; he is better qualified than anyone else to advise the customer, because of his familiarity, not only with the customer's business but with the general business conditions and needs in his immediate locality. In making loans he is bound by no general rule of law as to the character of the purpose for which a loan is being asked. He is entirely free to exercise discretion, and can make one loan and decline another as his judgment may dictate. He can estimate with a fair degree of accuracy the legitimate demands for credit which are liable to be made upon him, as well as the fluctuations in the volume of his deposits. He knows what industries sustain his community, and is thus qualified to pass upon the essential or nonessential character of loans offered him. He knows, or should know, what rediscount line he may reasonably expect of his Federal Reserve Bank, and he ought not to regard this line as a permanent addition to his capital. With knowledge of the limitations or penalties put upon his borrowings from the Federal Reserve Banks the banker may be depended upon to use a more discriminating judgment in granting credit accommodations to his customers, and that judgment he must exercise if the present situation is to be remedied fundamentally.

It is true that under existing conditions the volume of credit required in any transaction is much greater than was the case in prewar times; but it is also true that the resources of the member and nonmember banks would be ample to take care of the essential business of the country and to a large extent of nonessentials as well if there were a freer flow of goods and credit. If "frozen loans" were liquefied, and if commodities which are held back either for speculative purposes or because of lack of transportation facilities should go to the markets; and if large stocks of merchandise should be reduced, the resultant release of credit would have a most beneficial effect upon the general situation. In the meantime everything must be done to expedite the release of these credits and to restrict nonessential credits in future.

While the problem of credit regulation and control is national and even international in its scope, yet in the last analysis it is merely an aggregation of individual problems, and the proper working out of the situation must depend upon the public and upon the banks which deal with the public. The public must be made to realize the necessity of economy in expenditures and in consequent demands for banking credit. The banks themselves are best able to impress the importance of this policy upon the public.

For the further information of the Senate the Board quotes from the report of the Federal Advisory Council made to it on May 18, signed by James B. Forgan, president:

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

"(*a*) 'Causes of continued expansion of credits and of Federal note issues.'

"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.

"(b) '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?'

"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 nonessential uses, as well as continuing to discourage loans for capital and speculative purposes; by checking excessive borrowings through the application of higher rates.

"(c) 'If steps can not 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?'

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

"(d) '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?'

"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 provision 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."

The Board feels assured that the banks of the country now realize the necessity of more conservatism in extending credits and of a reasonable reduction in the volume of credits now outstanding. The Board will not hesitate, so far as it may be necessary, to bring to bear all its statutory powers in regulating the volume of credit, but wishes to point out that the more vital problems relating to the movement of the 1920 crop are physical rather than financial.

This was the unanimous view of those present at the conference on the 18th instant, at which the following resolution was adopted:

The whole country is suffering from inflation of prices with the consequent inflation of credit. From reports made by the members of this conference, representing every section of the country, it is obvious that great sums are tied up in products which if marketed would relieve necessity, tend to reduce the price level, and relieve the strain on our credit system.

This congestion of freight is found in practically all of the large railroad centers and shipping ports. It arises chiefly from inadequate transportation facilities available at this time and is seriously crippling business. We are informed that the per ton mile of freight increased in three years—1916, 1917, and 1918—47 per cent, while the freight cars in service during the same period increased 1.9 per cent.

A striking necessity exists which can only be relieved through the upbuilding of the credit of the railroads. This must come through adequate and prompt increase in freight rates. Any delay means the paying of greater cost directly and indirectly and places a burden on the credit system which in the approaching time for seasonal expansion may cause abnormal strain. Even under the load of war inflation, high price level, and extravagances the bank reserves would probably be sufficient if quick transportation could be assured during the time of the greatest strain.

Therefore be it resolved, That this conference urge as the most important remedies that the Interstate Commerce Commission and the United States Shipping Board give increased rates and adequate facilities such immediate effect as may be warranted under their authority, and that a committee of five, representing the various sections of the country, be appointed by the chairman to present this resolution to the Interstate Commerce Commission and the United States Shipping Board with such verbal presentation as may seem appropriate to the committee.

Much will depend upon the restoration of the normal efficiency of railroad and steamship lines. If adequate transportation facilities can be provided, the Board sees no occasion for apprehension in connection with the movement of crops now being grown.

Respectfully,

W. P. G. Harding,
Governor.

The President of the Senate.

Methods Followed by City Banks in Granting Accommodation to Correspondents.

Herewith is presented a first installment of the results of a study made by the Division of Analysis and Research of the Federal Reserve Board of the methods pursued by city banks in granting accommodation to their correspondents. The particular object of this inquiry is to ascertain the extent to which relatively standardized methods are in vogue and how the practice of banks has developed since the adoption of the Federal Reserve System.

The following installment of this study presents the results of inquiries made with the assistance of leading New York City institutions. Similar inquiries into the situation in the South and West are now in progress, and the further results of the investigation will be published in a later issue.

The methods which are followed in the extension of accommodation to banks differ in important particulars from those followed in extending accommodation to mercantile houses. With the latter, borrowing is assumed to be only a natural and recurring operation. The general operations of the enterprise are considered, and on this basis the line of credit is extended. Borrowing by a bank, however, is in general not so regarded. Instead of viewing its transactions as a whole and on this basis determining the line of accommodation, it is desired rather to go back of the general operations and to consider the specific transactions which occur, to the extent at least of having the paper representing this transaction as collateral, and analyzing these bills receivable to some extent. In consequence no line of credit is in general fixed, but each individual case is considered on its merits, specific amounts being granted as needed. The line of credit then is employed only in a somewhat restricted sense. The position which is assumed with respect to bank borrowing is well stated by one institution in the following words: "We avoid as far as possible suggesting lines or limits as to the extent we would serve the borrower, simply indicating our disposition to fully meet their reasonable requirements in liberal proportion to balances maintained and with due regard to amount of their capital investment and borrowings elsewhere, but quite frequently the borrowers suggest lines themselves which we agree to if circumstances warrant, conditioned on everything continuing satisfactorily." One institution, however, regularly fixes lines for its bank borrowers as well as for its mercantile accounts, while another quite frequently fixes lines in the case of banks, especially southern, western, and southwestern banks which are regularly in need of funds each year.

The amount which is loaned is also often limited by law. In the case of national banks, section 5202 of the Revised Statutes limits the indebtedness for loans or rediscounts, other than with the Federal Reserve Bank, to the amount of unimpaired capital, and in many States there are provisions covering this matter. A leading institution states that when a State bank appears to be borrowing or rediscounting to an amount in excess of its capital and surplus it is generally made the subject of special consideration and inquiry. Another institution also states that it endeavors to limit accommodation to the capital investment, while in the case of a third bank the accommodation granted is always less than the capital. With another bank, the line granted is limited to the capital.