MEMORANDUM ON DISCOUNT RATES:

With the approach of a new fiscal year and the offering of the first of a new series of Certificates of Indebtedness to be issued fortnightly to the amount of seven hundred and fifty millions of dollars until the first of October, the financing of the war enters upon a second and more serious phase. Careful reckoning should, therefore, be taken in order that the results may be satisfactory. We should be careful not to draw too optimistic conclusions from the results and experiences of the first year of our war financing.

During the past fiscal year, the expenditures of the Government amounted to over twelve and a half billions of dollars, which is almost six billions less than the expenditures that were estimated for the year - the difference being accounted for largely by inability of the Government to expend all the money that had been appropriated for the goods and services which were needed for the conduct of the war. It has placed three loans to the amount of almost ten billions and each of the loans was preceded by an offering of Certificates of Indebtedness.

The extent to which the loans issued by the Government have been actually and definitively absorbed can not be stated with finality. The increased totals for banking operations, both for Federal Reserve banks and the ordinary banks of the country, would seem to indicate that in one way or another the borrowings of the Government were in part responsible for the banking expansion. Deposits increased over thirteen hundred millions between May 1, 1917, and May 10, 1918; loans and discounts increased between the two dates five hundred and eight millions of dollars and investments in United States bonds and certificates of indebtedness (largely certificates of indebtedness) increased between the two dates, one billion eight hundred and eighty-nine million dollars, as set forth in the abstract of the Comptroller of the Currency under date of June 20, 1918.

To get a fair basis for estimating movements in leading items of the Reserve banks, a date subsequent to the important amendments of June 21, 1917, must be chosen. Between the dates of June 22, 1917, and June 21, 1918, the gold and cash holdings of the Reserve banks have grown from $1,247,698,000 to $1,981,111,000; loans and investments from $552,790,000 to $1,240,602,000, and reserve deposits from $1,440,597,000 to $2,029,557,000. The reserve percentage has moved between the two dates from 71.6% to 63.4%. There has thus been a noteworthy decline in the reserve strength of the Reserve banks, notwithstanding the fact that the gold and cash holdings have been increased by $733,413,000 through State bank membership and through gold voluntarily turned into Reserve Banks in exchange for Federal Reserve notes and otherwise, and notwithstanding the fact that the first phase of the war financing passed off with considerably greater smoothness and ease than anyone dared anticipate when the first Liberty Loan was offered. The situation is calculated to awaken very serious reflection as to the consequences that may not improbably be expected to follow the vastly increased financial requirements for the fiscal year 1919, if excessive reliance is placed on banking credit to meet the requirements.

II

The estimated expenditures of the Government for the next fiscal year are expected, according to statements of the Secretary of the Treasury, to reach an aggregate of twenty-four billions of dollars. To meet them, it is proposed to levy new taxes, chiefly on war profits, incomes and luxuries, which are expected to yield, with existing taxes, an aggregate revenue of some eight billions of dollars. Supposing that Congress authorizes as high an additional tax levy as that recommended by the Secretary of the Treasury, it is clear that the contemplated outlays of the Government will require the placing of loans to an aggregate of not less than sixteen billions of dollars.

This is the most stupendous program that has ever been proposed by any Government. The contemplated outlay for the single year amounts to more than two-thirds of the outlays of England since the beginning of the war. How is the country to take care of the vast outlay contemplated?

We have no accurate means of knowing what the total money income of the people of the United States is at the present time. If it be assumed that it may amount to as much as fifty billions at the present time, it would appear that the contemplated financial program of the Government for the fiscal year 1919 will absorb about one-half of the total money income of the country for the use of the Government. Stating the problem in its economic dimensions, it means that roughly one-half of the current product of the industry of the country - that is, one-half of the goods and services produced, or, putting the same thing in more fundamental terms, one-half of the productive capacity of the country - must be withdrawn from producing for private consumption and be put at the disposal of the Government for the fiscal year 1919, producing such things as the Government requires for the equipment, supply and use of its armed forces and those of the Governments associated with it, and, in addition, considerable quantities of provisions for the use of the civilian populations of the allied countries.

The economic problem, with which we are confronted, therefore, is that of cutting down the consumption of the stay-at-home civilian population in our own country to about fifty per cent, or one-half, of the product of our current industry. It seems clear, without argument, that this can be accomplished only by drastic revisions of customary habits and modes of living for all classes of our population - in other words, by the practice of thrift and saving on a scale of the greatest intensity. Goods of every description must be saved or altogether dispensed with; services must be saved, and, as a powerful auxiliary factor in the process, credit must be saved.

Thoughtful men everywhere in the country see that living and business can not be 'as usual' if the war is to be expeditiously and effectually financed. It follows that, if business can not be allowed to be 'as usual', neither can credit. It is an especial responsibility of the Federal Reserve System to emphasize this fundamental truth, because it now looks as though business will go on being much 'as usual' as long as credit is 'as usual'. There is, therefore, no more important problem confronting the Federal Reserve System than that of devising ways and means of exercising such control or influence over commercial credit, as will restrict its being used for dispensable and less-essential purposes and keep the way open for government financing and other essential purposes. The President, in his proclamation of May 29, 1918, called attention to the fact that, 'all of our one hundred million people must be economically and industrially adusted to war conditions if this Nation is to play its full part * *'. Industry and living, however, can not be trusted to automatically adjust themselves to war conditions however clear the need may be. The initiative must be taken by some authoritative agency and that means by the Government. The problem is too big to be handled by unofficial agencies, however willing they may be to cooperate with the Government. That is why the war has given rise to a whole series of new governmental establishments to handle the difficult commercial, industrial and financial conditions produced by the war. The adjustment of the industrial and economic life of the Nation to war conditions is their peculiar responsibility and a leading objective to the policies of such bodies as the War Trade Board, War Industries Board, the Railway, Food and Fuel Administrations, War Finance Corporation and Capital Issues Committee, is to exercise such a control and direction over trade and industry as will divert our national energies from non-essential and less-essential activities to those which are vital in hastening the supply of the Government with needed goods and services.

While the Federal Reserve Board is not one of these new agencies called out by war conditions, it, nevertheless, has a very important work to perform in helping forward the necessary readjustments of business and industry to war conditions. The Federal Reserve System - that is, the Federal Reserve Board and the Federal Reserve banks - must, therefore, have convictions on questions of fundamental policy and must have the courage to advise and act on those convictions, if the system is to be a real factor in helping to shape a national economic and financial policy that will make for strength, stability, endurance and ultimate victory.

III

What then can the Federal Reserve System do to help and hasten the adjustment of business to a war basis? This is a question which should have the constant and most studied attention of all who are concerned in the administration of the system. The field of the Federal Reserve System is not an unrestricted one, neither does it alone exercise influence in that field, but its field is a broad one and its responsibility great. The War Finance Corporation was set up to help meet the capital requirements of essential industry and the Capital Issues Committee was established to exercise a kind of censorship over the issue of new securities. The field of the Federal Reserve System is commercial credit and our instrument of operation is the discount rate. This can not be too strongly or insistently emphasized. When the Federal Reserve Board speaks authoritatively and effectively, it speaks through discount rates. All else is incidental. The law has laid down the broad principle for the guidance of the banks and the Board in the fixing of rates when it declares that rates 'shall be fixed with a view of accommodating commerce and business', leaving it to the discretion of the banks and the Board to determine what measure and kind of accommodation should be extended to different kinds of commerce and business in given conditions.

Doubtless, in all ordinary circumstances, the banks and the Board in the exercise of their discretion might safely proceed on the assumption that all kinds of legitimate commerce and business, in the absence of special need, are entitled to equal consideration. But the present are highly unusual times and and call, therefore, for the exercise of a wisely informed discretion on the part of those who control the discount policy of the country.

The question for us to consider, therefore, is what does the accommodation of commerce and business suggest at this time as an appropriate discount policy. To ask the question is almost to answer it, so obvious are the requirements of a good, national economic policy at this time. The business of the nation now is war and whatever private business obstructs the nation's business should be entitled only to that minimum of accommodation which is absolutely necessary. This means specifically at this time, as one most important step in the development of a proper national discount policy, that rates should be so fixed as to offer no encouragement to non-essential and less-essential business. The Reserve banks have at last attained a position where the rates established by them exercise a controlling influence in the market and we can not escape the responsibility of deciding how we are going to use that influence: - whether to maintain rates at an artificially low and easy level, with all that such low rates will imply in stimulating or maintaining ordinary business at its usual pace, or whether to adjust our rates to changing financial and economic conditions, in order to bring about curtailment in the use of commercial credit and thus to help bring about the adjustment of industry and living to war conditions, to which the President has called attention. The adoption of this latter policy suggests that rates should pretty generally be increased at all Reserve banks at once or in the very near future, and no exception, in my opinion, it may be added, should be

made of the rate on the 15-day notes of member banks secured by Certificates of Indebtedness.

IV.

The fact that the Treasury has started with its program of bringing out fortnightly issues of Certificates of Indebtedness in amounts of $750,000,000 up to October 1st, compels us to give immediate attention to any change which may be necessary in the rate on paper secured by such Certificates. The present rate at all Reserve Banks, except Kansas City and Richmond, is 4%, with no announced restriction on renewals. At Richmond and Kansas City, the rate was recently advanced to 4½% on recommendation of their boards.

It is my opinion that while conditions at Kansas City and Richmond are at the moment somewhat peculiar, they are not so different from conditions which other districts will soon have to face, as the borrowing program of the Government develops pressure on the banks which are expected to subscribe an amount equal to 20% of their resources to Certificates of Indebtedness. If the banks undertake to carry their quotas of Certificates as an extra load without making room for them by contracting commercial loans wherever that can safely be done without jeopardizing essential industry, the burden will come in undue amount onto the Reserve Banks and show its effect in a weakened reserve position. If, on the other hand, rates on 15-day Certificate-secured paper be raised, it will at least indicate the desire and expectation of the Federal Reserve System that it is not to be made so easy for member banks to carry the Certificates as an extra that they need do nothing to curtail. In other words, to put the matter bluntly, the Federal Reserve Board having preached the absolute necessity of saving and curtailment, ought to show that it has the courage of its convictions by adopting a discount policy which is somewhat more in accordance with its announced views than the maintenance of a 4% rate would imply.

As a matter of principle, it would appear that the rate which the Treasury has to pay on its short-term paper is the best indication and measure of the state of the money market and should, therefore, determine the rate established by Reserve banks on Certificate-secured notes. As a matter of banking expediency, however, we have followed the practice of allowing a differential under the government rate on such paper; and, it may be admitted, that it would be impracticable at this time, even if regarded desirable on general grounds, to change the practice. The question at the moment is therefore one of diminishing this differential from ½ to ¼ of one per cent by making the rate at which 15-day 4½% Certificate-secured notes of member banks will be taken by Reserve banks, 4¼% instead of 4% as at present.

Are there any objections to be made against such an increase at this time on grounds of expediency which the Banks and Board ought to respect, even if we are agreed that, as a matter of general banking policy, the reasons for an advance of Reserve Bank rates are conclusive?

Vague apprehension has been expressed that an advance of the Reserve bank rate to 4¼% might endanger the negotiation of the 4½% Certificates of Indebtedness. It is, of course, clear that the Certificates will have to be placed with the banks and that their feelings are a factor that may not safely be overlooked. They feel that they ought not to be expected to take liberally of the current offerings of Certificates unless they are assured a comfortable margin below the rate carried by the Certificates, thus enabling them to get accommodation, as they need it, at the Federal Reserve banks and, at the same time, make a certain profit on the transaction. How much concession should be made to this feeling and expectation of the banks? Enough, but not more, it seems to me, than is necessary to enable the banks

to handle the business without loss. One-quarter of one per cent will do this and leave a slight profit. To fix a rate for the purpose of enabling them to earn more implies distrust of the disposition of the banks to help the Government unless the transaction is made sufficiently profitable. It raises a doubt as to the patriotism of the banks in wishing to help through the banking end of the Government's gigantic financial program which I believe the vast majority of the banks would be quick to resent and give the lie to. The bankers are going to take the Certificates, not because they want them, but because the Treasury needs their assistance. The really patriotic banker will not be materially affected by the difference in rate and the weak banker ought not to be unduly encouraged to rely upon the Reserve banks in handling his Certificate purchases by a too low rate on rediscount. Nor should he be misled by the maintenance of an unchanged rate of 4% at the Reserve banks into thinking that the Federal Reserve Board and the Banks are taking an easy and comfortable view of the situation. Such, we know, is not the case. We know that the country is faced with very heavy financial responsibilities; there is no easy way out of them. Resoluteness and courage in facing the facts were never more needed than at the present moment. The country - it is my firm conviction - people of all classes, bankers and business men as well, are ready to do whatever they are told must be done. Are we ready to tell them in the simple, but nevertheless important and significant, manner of the discount rate? We can not escape the question and the responsibility which is ours as managers of the Federal Reserve System.

A. C. Miller - June 27, 1918.