

FEDERAL RESERVE BOARD

STATEMENT FOR THE PRESS

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The Review of the Month for the September Federal Reserve Bulletin is devoted mainly to a discussion of cost of living, foreign exchange, foreign trade and foreign financing problems. It says:

Cost of Living. High prices and the advancing cost of living have become the occasion of widespread anxiety in the United States, and recently have become the subject of legislative attention. The President in an address to Congress on August 8, declared that "the prices the people of this country are paying for everything that it is necessary for them to use in order to live are not justified by a shortage in supply, either present or prospective." The Federal Reserve Board in a letter of the same date to the Senate Committee on Finance and Banking (published in the August Bulletin), rejected the idea that "excessive" volume of currency was the cause of prevalent high prices. This is the view which has been consistently maintained by the Board, the letter being merely a restatement with amplified detail of the position taken by the Board on previous occasion, notably in the October, 1918, Bulletin (p. 927), where the conclusions were expressed that "the increase in the circulation of the Federal Reserve note has been in the main in response to actual needs, and that whatever inflation of prices may be said to exist can not properly be said to have been induced by overissue of Federal Reserve notes." In its recent letter, particular occasion is taken by the Board to point out "the difficulty, indeed the impossibility, of keeping in circulation an excessive volume of Federal Reserve notes. They are issued only as a need for them develops, and as they become redundant in any locality they are returned to the Treasury at Washington, or to a Federal Reserve Bank for redemption. Thus there can not at

any time be more Federal Reserve notes in circulation than the needs of the country at the present level of prices require, and as the need abates the volume of notes outstanding will be correspondingly reduced through redemption. The increased volume of Federal Reserve notes in circulation during the past three years, in so far as it is not the result of direct exchanges for gold and gold certificates which have been withdrawn from circulation, is the effect of advancing wages and prices, and not their cause."

Under the elastic note-issue system provided by the Federal Reserve Act, the Federal Reserve note possesses a self-regulating quality quite automatic in its operation. While it is technically a true statement to say that the Federal Reserve note when issued is issued by the Federal Reserve Bank, the greater truth in understanding our present monetary machinery is missed unless it is perceived that the occasion of the issue of a Federal Reserve note is determined not by the bank for itself but for the bank by the community. The question whether or not a Federal Reserve note shall be issued is decided by the business and general community in accordance with its circulation needs. It is its needs rather than the bank's desire which determines the question of issue. Thus, then, the Federal Reserve note when issued is issued at the instance of the community, not at the instance of the bank. That this must inevitably be so is clear from an appreciation of the fact that there is no method by which the Federal Reserve Banks, even should they so desire, can put out and keep out a greater quantity of notes than the convenience of the community requires, so long as the facilities for the redemption and retirement of the reserve notes provided by the Federal Reserve Act are maintained, as they have been since the organization of the Federal Reserve System, in a state of effective operation.

Banking Expansion.

While thus disposing of the currency as the cause of rising prices, the Board does not overlook the important influence exerted by

credit expansion. That the expansion of credit has been a considerable factor in our financial and price situation is clear; that it is a continuing factor and one which still calls for correction by the process of increasing production and savings and by the investment of the proceeds of savings in the absorption of Government bonds is equally clear.

The most recent data available show that for the year ending June 30, 1919, total deposit liabilities in national banks increased by the amount of \$1,902,356,000, or from \$14,021,609,000 to \$15,924,865,000, and that loans and discounts increased by the amount of \$954,436,000, or from \$9,620,402,000 to \$10,574,838,000. The increase in deposits, therefore, exceeded the increase in loans and discounts by the amount of \$948,920,000, or close to 100 per cent. The rate of increase in deposits for the year was 13.6 per cent, as against 9.92 per cent for loans and discounts. A substantial portion of the increase in deposits, it appears, must therefore be accounted otherwise than by an increase in the commercial loan account of the banks. The significant change in their resources is found in their investments in Government bonds and Treasury certificates. These increased by an amount of \$1,055,127,000, or from \$2,116,785,000 to \$3,171,912,000, an increase of 49.8 per cent. It thus appears that the increase of deposits noted above is to a considerable extent to be regarded as a pure credit expansion not called for by increased industrial activity, but occasioned by the use of the banks' credit for Government financing. It shows once more how much care and discrimination must be used in interpreting increases in bank "deposits" and bank "resources" in times like the present and the recent past, when conditions in the financial world have been so highly abnormal.

The naive idea that a bank deposit normally originates by the bank's customer making a deposit of cash in the bank does not reveal the

substance of the situation in countries like the United States, with a highly developed system of bank credit and its utilization through the form of the deposit account. The most usual form in which bank deposits originate is by borrowers going to a bank to seek accommodation and offering their notes for discount, the bank making the loan sought by the customer by opening a credit or "deposit" on its books in the borrower's favor. Normally, therefore, what are called deposits increase as loans and discounts do; in other words, as borrowings from banks increase. When such is not the case and the loans and discounts do not grow in correspondence with the deposits, the cause of expansion will usually be found in an increase in the investment account of the banks. Such, in fact, has been the trend of our banking operations during recent years, notably since our entry into the European war. It is a mistake, therefore, to deduce from the rapid increase of bank deposits inferences as to the growth in wealth or prosperity of the country at large. Were the growth of bank liabilities to be invariably taken as an index of the growth of real wealth, it would have to be admitted that some of the recent European belligerents, an inspection of whose banking situation reveals a very much more rapid growth in bank liabilities and resources than does the situation of our banks, were experiencing greater prosperity and a more rapid growth of wealth than the United States. Such has, however, only too obviously not been the case. Europe's economic and financial condition is serious and worst in those countries where the credit and banking situation is most extended.

Europe's Economic Situation. The gravity of the economic and financial situation left Europe by the war has latterly been the subject of frequent comment from statesmen and business leaders there.

The British Chancellor of the Exchequer (Mr. Austen Chamberlain) in presenting his budget last spring, called attention to "hard and inexorable economic facts obscured by a fictitious appearance of wealth". "There is," said the Chancellor,

"between two and three times as much legal tender money in circulation as there was before the war. The deposits at the joint-stock banks have more than doubled. The position of these banks, judged by every approved criterion of sound banking, is stronger than it ever was before, but the securities - British Government securities standing behind the deposits, standing behind the legal tender money - represent to a large extent not existing wealth, but wealth consumed in the operations of the war, which it must be our business to replace out of the exertions of the present. Both are drafts of future labor on the future creation of wealth. Pending their payment they are an immense reservoir of artificial purchasing power, and therefore diminishing in effect with each new increased issue.

"Look behind the counter and you see a different picture. We have sold one thousand million of our foreign investments, losing the equivalent power to draw on the wealth created in foreign countries. We have incurred debt to the extent of £ 1,300,000,000, but the position of our debtors forbids us to count upon their claims for large immediate relief. Ultimately and gradually that relief will, we hope, mature, but we can not count upon it for immediate purposes. In years to come a considerable part of our production must be devoted to paying our foreign creditors a part, and a large part, making good the wastage and arrears of war. Our roads, our railways, and in a lesser degree - still, in some degree - our machinery suffer from the absence during these past years of the ordinary upkeep and development. Houses, which were short before the war, are now hopelessly in arrears. A large part of the production of the next - I don't know whether I should say few years - a large part of the production of the coming year - both the production of labor and of capital - will be needed to make good those losses and to pay the new liabilities that we have incurred.

"I ask the committee therefore to be under no misapprehension as to the magnitude of the task which lies before us. Again I repeat that there is urgent need for national and individual economy. Nothing but the unity of all classes,

comparable to that which we have seen in the years of war, will enable us to face the years of difficulty which must follow at the conclusion of so great a crisis."

More recently the British Premier (Mr. Lloyd-George), in an address to the House of Commons on August 19th, in speaking about the financial situation, laid particular stress on the serious magnitude of England's adverse trade balance. According to his statement, that balance already amounts to \$4,000,000,000 and threatens to reach \$5,000,000,000 if Great Britain continues in its present course. Before the war the adverse balance amounted, for a series of years, to an average of \$750,000,000. This then presented no difficulty because of England's large overseas investments, the full magnitude of which have only recently become public.

The entire amount at present accruing from foreign sources is estimated at about \$500,000,000, an amount just about sufficient to pay the interest upon her foreign obligations. England's immediate problem is the reduction of the adverse balance. "We must bridge the chasm or at the bottom of it is ruin," said Lloyd-George. "We are building a temporary bridge by borrowing; not only state borrowing, but traders' borrowing, for raw material, food, etc., that will only add to the catastrophe. In every direction we are spending more, and we are earning less; we are consuming more, and we are producing less. These are facts; it can not last." In every line, except agriculture, according to the Premier's statement, British output is less.

Mr. Asquith, former British Premier, discussing the economic situation in a speech delivered before the Free Trade Union recently, asked: "What is the real remedy against high prices and of the individual hardships which the war has brought? First and foremost, public economy * * *. The next thing is increased and better production * * *. The prime economic need at this moment of mankind is that production should be increased until the maximum output is obtained. What is true at home in the domestic sphere is not only equally true but more significantly true in the international sphere."

TRADE BALANCES. The "adverse" trade balance complained of in England is most manifest in her relations with the United States. On our side it has given rise to a situation which is conventionally described as a "favorable" balance of trade because of the large excess of goods exported above those imported, leaving a resulting balance of indebtedness to be met. Looking at the matter from the point of view of the ordinary American consumer, however, the effect of such a "favorable" balance of trade is far from favorable for him. Whatever economic and financial justification there may be for the vast quantities of merchandise the United States has been sending to Europe, payment for which, looking at the transaction from the point of view of the nation as a whole, is to be made sometime in the future when

the economic and financial circumstances of the importing nations of Europe are more satisfactory, the immediate present effect of it in many lines of industry is to curtail the supplies available for the American consumer and thereby to become a factor of considerable importance in our price level. To the extent that the American consumer, or a sufficient percentage of American consumers, do not voluntarily reduce consumption by amounts sufficient to release for the use of the European consumer the great quantities of goods which are being sent oversea, there results in the American market competition between the European demand and the American demand, the inevitable effect of which is to drive up prices and to induce the speculation which rising prices usually occasion. "Buying in competition with export demand" undoubtedly has been a major cause of rising prices in the post-war period in the United States. For the fiscal year ending June 30, 1919, the exports from the United States amounted to \$7,225,100,000, and imports amounted to \$3,095,900,000, leaving therefore an excess of exports amounting to \$4,129,200,000 as against \$2,974,000,000 for the fiscal year 1918, and \$3,630,700,000 for the fiscal year 1917. It is noteworthy not only that the figures of our exports and our net exports for the year 1919 are the highest ever attained, but also that the volume of our exports showed with little interruption an increase through the fiscal year, attaining its highest point in June, the last month of the fiscal year, when our total exports amounted to \$918,300,000. Elsewhere in the current number of the Bulletin are presented details of our export trade, showing its composition by leading groups of commodities and their volume by quantity as well as by value. It appears that the greatest increase in our exports for the fiscal year 1919, as compared with the preceding year, was in the groups "Foodstuffs" prepared and unprepared. Exports in these groups showed an increase in value of over 63 per cent. Bacon, hams, and lard showed an increase in value of about 85 per cent compared with the preceding year, and an increase of more than 60 per cent in quantity. The group "Manufactures ready for consumption," which constitutes

the largest single group for both years 1918 and 1919, shows an increase for the latter year of 9.1 per cent, notwithstanding that the item "Explosives" showed a decrease of over \$250,000,000 in 1919 as compared with 1918.

Whether our export trade will keep up anything like the 1919 volume during the current fiscal year (July, the first month of the year, shows a falling off of exports by \$348,169,000), seems doubtful, but it seems highly probable that it will maintain a volume so far in excess of the normal ratio of our exports to total production in prewar days that it will be a factor of moment in the domestic price situation and in living costs. As long as circumstances make it necessary or advisable for the United States to sell a large volume of merchandise to Europe on credit, there must be shortages of supply in the domestic market unless industry is kept in a state of high activity and all hands are at work to increase output. Unless this is done resulting shortages will mean reduced consumption to be met either by voluntary saving on the part of the consumers, or compulsory saving through the process of high or even perhaps rising prices.

The whole situation is one that can be met, as pointed out by the Board a month ago, only if the doctrine "work and save" is taken to heart by every class in the Nation and made its guiding principle until the trying conditions left by the war are finally surmounted. "Only by keeping the cost of production on its present level, by increasing production and by rigid economy and saving on the part of the people can we hope for large decreases in the burdensome cost of living which now weighs us down," said the President in his address to the country on August 25.

Foreign Exchange Situation.

Closely associated with the movement of our export trade noted above, have been the further and considerable declines in the values of foreign currencies in terms of the dollar, which have given rise to considerable discussion of the probable effects of such declines. These declines are primarily due to the fact that foreign countries have large payments to make in dollars to

the United States at a time when they are not sending us commodity exports of corresponding value to their imports from us to provide the exchange requisite to pay for their American purchases. Otherwise stated, the decline in the value of foreign currencies, when exchanged for dollars, makes more expensive payments in dollars by countries having available for such purpose only their own currencies. Current discussion of these conditions too frequently treats the problem of the foreign exchanges and our export trade separately from the problem of domestic trade. It is too frequently assumed by those complaining of the fall of foreign exchanges that trade on the scale of our recent exports is a thing desirable in itself and to be kept up by keeping up the value of foreign currencies in the American market. But when the export trade is considered in connection with the domestic trade it becomes clear, as already pointed out, that the source of much of the difficulty presented by the existing situation is the continued competition of the export demand and the home demand. The state of the foreign exchanges merely reflects the state of international trade. The correction of the exchange situation so much complained of by those who look at the matter from the exclusive standpoint of the export interest, will, therefore, only find its natural and permanent solution through a reduction of our exports and an increase of our imports until they reach a point of approximate equilibrium.

Corrective effect of falling exchange. It should be understood that a decline in exchange operates as a corrective to the situation which has brought about the decline, by checking exports and stimulating imports. Viewed, therefore, purely from our own domestic standpoint, the falling exchange rates are beginning already to relieve the present abnormal and difficult situation. The large volume of exports during the past few months has been rendered possible by advances from the United States Treasury to the governments associated with us in the war. These advances have amounted, from the date of the armistice to August 31, to \$2,177,096,222. There is some danger also that the present abnormal situation may undergo a more violent change in the future when European countries shall have stocked up on commodities and our domestic consumers have gratified the mood of reaction from war economy, and we may then experience an abrupt falling off in exports so great as to embarrass some of our industries which anticipated their natural growth under the intensified stimulus of war conditions. Such a condition can be averted through timely action by the industries involved, which should be considering the steps necessary to correct such a situation in case it should arise. The fact remains, however, that the present relationship of exports to imports - the volume of one being very large and the other comparatively small - is unhealthy and seriously disadvantageous to this country, looking at the situation purely from our domestic point of view.

Looking at the matter from another angle, it is evident that European countries find it difficult in the present circumstances to make purchases in this country, but the outstanding fact is that these countries have not seen fit so far to adopt any effective measures for the correction of existing rates of exchange. Ministers of several of these countries have looked with complacency upon the decline in exchange which tends to limit purchases here. This decline makes it possible for the countries affected to leave their commerce unrestricted without danger of having their nationals overbuy in our markets.

There are many factors constantly at work which can not be fully enumerated or even traced, which tend to correct the decline of exchange, and some are already operating to that end and they will tend to operate more effectively with every successive decline, but it should be borne in mind that while declining exchange operates to set in motion certain corrective factors, after an exchange rate has had its decline and is oscillating moderately around a lower stabilized base the tendency is for all factors to adjust themselves about the new base. In other words, a declining rate of exchange tends to produce certain effects, while a rate of exchange which has experienced a decline and is more or less stable at a lower level produces these effects in a much smaller degree. The tendency of a declining rate of exchange for the currency of any country is to stimulate exports from that country and to curtail imports; a declining rate offers residents of the country involved a heavy premium on the sale of their foreign securities in countries in whose favor the exchange rate is running. This premium is in many countries a more powerful argument with the private holder of foreign securities than any government requisition can be; it tends to make foreign creditors to whom money is due in currency of the debtor country leave the funds on deposit pending a more favorable time for their transfer to the creditor country; it stimulates the nationals of the debtor country to borrow abroad and remit the proceeds home for domestic use, as any improvement in exchange will afford a profit at the time of repayment. These are a few of the corrective factors.

Providing for foreign demands. From the best information available it appears that the probable demands of foreign nations upon this country for reconstruction purposes have been greatly overestimated in the public prints. It is perhaps not unnatural in a situation where distressed peoples feel they must draw for their needs on a limited fund of capital that they should estimate their requirements very liberally or else they may not be sufficiently supplied. For many reasons it appears that the needs of Europe should be supplied through the private initiative

groups and not through the concerted efforts of the governments concerned.

From the standpoint of the borrowing country already burdened with an enormous public debt, money borrowed by private individuals for use in their own business will be expended more carefully and judiciously and better provision will be made for its repayment than would be the case if the money should be borrowed by governments, where other than purely economic conditions may influence the expenditure. It has been well said that where money is borrowed for reconstruction purposes by governments the tendency has been to establish bread lines instead of wood yards; in other words, to subsidize unemployment rather than to create employment. From the viewpoint of the lending country; i. e., the United States: after completing its own war financing the ability of our Government to assist foreign Governments without vast inflation and consequent danger to our own credit is problematic. The American people have subscribed liberally to war loans, but there is nothing to indicate that when they shall have closed the account by doing their part in such financing as remains to be done to liquidate the war bills they will be inclined to buy any considerable amounts of bonds of this Government for the purpose of further financing Europe.

The complete stabilization of foreign exchange could be effected only through unlimited advances to foreign countries, advances against which those countries will draw as their needs require. As drafts are drawn and sold abroad, the proceeds in foreign currency would go to the Governments concerned and become available for the purposes of those Governments. This process would give those Governments power to draw on this country indefinite amounts for unspecified or undisclosed purposes, and to meet these drafts our Government would have to sell additional obligations to its own citizens. Thus, to the extent of the credits extended, the burden of foreign war debts would be transferred to the shoulders of the American people, offset, of course, by such repayments on account of interest or principal as the foreign Governments might make from time to time; but even if ultimately fully offset, our own

Government obligations must still in the first instance be marketed.

Existing machinery. There is no reason to doubt that private initiative, supplemented by such facilities as governmental agencies are authorized to make under existing law, can deal effectively with the present situation. Facilities are provided by the Webb-Pomerene Act and by the War Finance Corporation act as amended. Manufacturers can combine to form export companies, putting in as capital such sums as they are severally willing to devote to the export business, and these corporations can borrow from the War Finance Corporation sums based upon their financial standing. The responsibility of the interest directly concerned is essential to prevent reckless business, and unless we propose to burden our people generally for the purpose of subsidizing exports, those whose products are to be sold and who reap the advantage of such sales ought, with the aid above outlined, to be prepared to finance their own sales.

Pending legislation and safeguards. Such are the fundamentals of the situation and the purposes to be achieved. As for providing the machinery for achieving those aims, certain things remain to be done, and legislation covering these points is now pending in Congress, notably the Edge bill, which provides Federal charters for corporations principally engaged in foreign transactions and financing, and another bill, amendatory of section 25 of the Federal Reserve Act, which permits national banks to invest 5 per cent of their capital and surplus in the stock of such corporations.

Credits extended abroad and foreign securities purchased must in nearly all cases run for periods beyond the limitations of ordinary banking credits, and banking resources can be safely utilized to a limited extent only in giving the accommodations now needed abroad. Appeal must be made to those who are in a position to purchase securities for investment and pay for them with funds accumulated to their credit in bank. Such purchases reduce bank deposits and as the proceeds are, under present circumstances, most likely to be applied directly or indirectly to the re-

duction of bank loans, they tend to strengthen the percentage of bank reserves. The fact that many banks and trust companies have investment departments and deal in securities through these departments tends to obscure this distinction. Some confusion results also from the difference between the British and American use of the term "trust company." In Great Britain a trust company is an investment corporation issuing its debentures to the investing public and holding in trust for the debenture holders the securities which it purchases. With us a trust company is practically a banking institution holding deposits which must be paid on demand or on reasonable notice.

Looking to the soundness of the American banking system, which is at all times concerned in preserving the liquidity of the banks, it is of first importance that present conditions and their bearing on the banking situation should be fully understood by the public and that our banking institutions be not loaded with slow credits and with investment securities of limited marketability. It must not be forgotten that any issue of United States Government securities beyond the ability or willingness of the investing public to absorb will mean that the obligations will go, not into the hands of investors, but must be carried by the banks either as investments or as loans, thus expanding still further an already expanded volume of credit, which it should be the aim of the banking community to reduce gradually to more normal limits.