F E D E R A L   R E S E R V E   B O A R D

WASHINGTON

CONFIRMATION OF TELEGRAM

November 6, 1919.
X-1717

Morss	Boston
Strong	New York
Passmore	Philadelphia
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Board hopes you will do what you can to discourage member banks from using advance in Federal Reserve Banks rates as excuse for increasing interest charge to those borrowers on Government securities who are doing what may be reasonably expected in the way of liquidation. In such cases member banks should be satisfied with moderate difference in their favor. Board does not mean to suggest reduction in rates heretofore charged customers on such transactions or to advocate any policy which would result in delay of orderly liquidation of bond secured loans.

HARDING.

THE SECRETARY OF THE TREASURY
WASHINGTON

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November 5, 1919. X-1718 a

Dear Governor Harding:

I hope that the Federal Reserve Board will not allow the Governors of the Federal Reserve Banks to rely wholly or too heavily, for the prevention of the abuse of the facilities of the Federal Reserve System, upon the increase in rates now established with the approval of the Board, myself included.

The experience of all European countries (and Japan), including those countries which have been neutral in the war and those which have maintained a high central bank rate, supports the view that discount rates will not suffice in these extraordinary times.

The Reserve Banks' rates should, of course, scientifically be above the commercial rate and not below it. That cannot happen until the independent resources of the banks suffice for the normal requirements of their customers for commercial, industrial and Government purposes. Banks cannot be expected to meet these requirements habitually at a loss. Their dependence upon the Federal Reserve System should be seasonal or occasional and not habitual. Until that condition comes about as a result of the production and saving of wealth the tendency will be, as Reserve Bank rates are increased, for the rates to the Government and rates to the commercial borrower to be increased in turn. The world has been for five years consuming or destroying more than it has produced. My own belief has been and is that with the curtailment of export demand consequent upon the curtailment of foreign credits and with industrial production proceeding full steam ahead we should soon have reached an equilibrium in this country at least. In the meantime, however, the labor situation has become so acute as gravely to threaten production and the speculative mania has developed to such an extent as gravely to threaten our credit structure.

The conditions under which changes in the Reserve Banks' rates of discount would operate effectively do not exist here today. An increase in the discount rate will not result in the importation, nor curtail the exportation, of gold to any material amount. It will not result in a curtailment of the importation of goods nor in increasing our exports materially. In the present position of the international balances and of the foreign exchanges and because of gold embargoes the Federal Reserve Bank rates cannot function internationally, and will operate solely upon the domestic situation. In that condition an important further increase in Federal Reserve Bank rates might have the effect of penalizing and discouraging the borrower for commercial and industrial purposes, thus curtailing production and distribution and increasing the shortage of goods, and consequently the price of them, and thus, in turn, stimulating speculation. (An increase in rates (per cent. per annum) falls very lightly upon the borrower for speculative purposes, who figures a very large profit on the turnover in a day, a week, a month or some other short period). It might have also a very grave effect upon the Government's finances.

In consequence of the war the Government has issued some $25,000,000,000 of interest bearing securities which are of prime eligibility. Before the war, when the Government's debt was only $1,000,000,000 and that all stored away in strong boxes, the possession of eligible paper was very strong presumptive evidence of the right of a member banks to borrow. Now and for the life of this great war debt the possession of eligible paper will be no evidence at all.

Therefore, I believe it to be of prime importance that the Federal Reserve Board should insist upon and that the Governors of the banks should exercise a firm discrimination in making loans to prevent abuse of the facilities of the

Federal Reserve System in support of the reckless speculation in stocks, land, cotton, clothing, foodstuffs and commodities generally.

We cannot trust to the copybook texts. Making credit more expensive will not suffice. There is no precedent in history for the great war which we have been through nor for the conditions now existing. The Reserve Bank Governor must raise his mind above the language of the textbooks and face the situation which exists. He must have courage to act promptly and with confidence in his own integrity to prevent abuse of the facilities of the Federal Reserve System by the customers of the Federal Reserve Banks, however powerful or influential.

Speculation in stocks on the New York Stock Exchange is no more vicious in its effect upon the welfare of the people and upon our credit structure than speculation in cotton or in land or in commodities generally. But the New York Stock Exchange is the greatest single organized user of credit for speculative purposes. It is the organized instrument of a countrywide speculation. I believe that the practice of financing speculative transactions in stocks by loans on call, with daily settlements, is unsound and dangerous to the general welfare. Call money loaned to carry speculative transactions in stocks is only liquid when there is no need. The paper is not self-liquidating and, in the case of an emergency, as, for example, upon the outbreak of the European war, and throughout the period of our participation in the war, such loans are in the mass uncollectible. The use of Liberty Bonds, Victory Notes and Treasury Certificates as collateral for borrowings made by member banks from the Federal Reserve Banks for the purpose of carrying speculative transactions in stocks makes it the right as well as the duty of the Federal Reserve authorities to see to it that the methods of financing such transactions are reformed and reformed immediately.

Open and notorious manipulation of stocks has been taking place during the period of, say, nine months, since the removal of the control of the Sub-Committee on Money of the Liberty Loan Committee. This manipulation, which takes the form of putting up the price first of one stock and then of another, no matter what may be the conditions, for the purpose of stimulating interest on the part of the uninitiated public, is, I imagine, contrary to the law of the State of New York and the rules of the New York Stock Exchange. In any event, it needs only vigorous action to put an end to it. The Federal Reserve Bank of New York in its relation to the Subcommittee on Money of the Liberty Loan Committee, which Committee was at all times in touch with the officers of the Stock Exchange, naturally sought the views of the Treasury by reason of the fact that its prime duty concerned the sale of Liberty Bonds. A control now put into effect will be primarily for the conservation of the general credit situation and should therefore be initiated and supervised, not by the Treasury, but by the Federal Reserve Board.

I need not say that such steps should be taken not only firmly but with discretion and in such a way as not to involve grave hardship to individuals or injury to the general welfare.

I have written this letter believing that you and the other members of the Board are in general accord with the principles and views expressed in it and that it might be of some assistance to you in dealing with the problem with the Governors of the Banks to have this written expression of the views of one of the members of the Board whose other official duties prevent his frequent attendance at your meetings.

I need scarcely add that this letter is written in no spirit of criticism. The Governors of the Federal Reserve Banks have served their country with devotion, courage and wisdom during the trying period that is past. It would be difficult for me to give adequate praise to the patriotic spirit of self-sacrifice which has actuated them or adequate appreciation to the skill and sagacity with which they have performed their duties. During the war they have naturally turned for leadership to the Treasury since its operations were the dominating factor in the financial situation. It would, however, be a great misfortune if, now that the Treasury operations are on a diminishing scale, the Governors of the Federal Reserve Banks are allowed to feel that the problems of the future were for them to solve each according to his own best judgment. The need of leadership is no less great, the need of examining the situation from a broad national and international point of view is no less imperative. I look to see the Federal Reserve Board, not critically nor aggressively but patiently and persistently, provide this leadership.

Very truly yours,

CARTER GLASS.

Hon. W.P.G. Harding,
Governor, Federal Reserve Board.