C O P Y

November 17, 1919.
X-1727

My dear Senator:

Receipt is acknowledged of your letter of the 14th instant.

The Federal Reserve Act is intended for the benefit of commerce and industry and not for the stimulation of the investment market or of speculative movements. The short title of the Act reads, as follows: "An Act To provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." Section 13 of the Act provides in part that Federal Reserve Banks may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange 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. It provides further that nothing contained in the Act shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount; "but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States".

The Board has repeatedly called attention to the fact that resources obtained from the Federal Reserve Banks should not be used for speculative purposes, and at various times when there has been unusual speculative activity it has issued public warnings as to the bad effect of such activities upon the banking situation. The first warning of this kind was issued as long ago as October, 1915, and the warning has been repeated on several occasions since that date when conditions made it necessary.

On June 10, 1919, the Board made public a letter, which it had addressed to all Federal Reserve Agents, reading as follows:

"The Federal Reserve Board is concerned over the existing tendency towards excessive speculation, and while ordinarily this could be corrected by an advance in discount rates at the Federal Reserve Banks, it is not practicable to apply this check at this time because of Government financing. By far the larger part of the invested assets of Federal Reserve Banks consists of paper secured by Government obligations, and the Board is anxious to get some information on which it can form an estimate as to the extent of member bank borrowings on Government collateral made for purposes other than for carrying customers who have purchased Liberty Bonds on account, or other than for purely commercial purposes."

This letter was sent out for the purpose of ascertaining to what extent Government obligations were being used to secure loans from Federal Reserve Banks for other than commercial purposes or for carrying subscriptions.

In its monthly publication, the Federal Reserve Bulletin, the Board has called attention repeatedly since that date to the dangerous speculative tendencies which have been prevalent.

In a printed statement during the summer, the Board made the specific announcement that it would not sanction any policy which would require the Federal Reserve Banks to withhold credits demanded by commerce and industry for the processes of production and distribution in order to enable member banks to furnish cheap money for speculative purposes.

In ordinary circumstances and normal times one check would have been to advance discount rates, but owing to the fact that the Government has sold over twenty-one billion dollars of Liberty Bonds and Victory Notes, many of which securities have been sold to persons who were unable to pay for them in full but were obliged to pay for them in instalments out of savings or accrued incomes, it was felt that an advance in the discount rate on notes secured by Government obligations should, so far as possible, be avoided.

The speculative movement continued; its demands on the banks for credit coming on top of commercial requirements, of the seasonal crop moving demand, and of demands arising out of the unusual congestion of export commodities at ports owing to the delays in transportation. As a consequence of these conditions, the reserves of the Federal Reserve Banks began to decline, and those of the Federal Reserve Bank of New York, in particular, dropped to such an extent that the Board, about two weeks ago, approved an increase in discount rates of that institution averaging about one-half of one per cent. All other Federal Reserve Banks, shortly afterwards, expressed the desire to put into effect a similar advance in their rates, which the Board approved.

The Federal Reserve Bank of New York, on November 2nd, the date on which the advance in its rates was made public, issued the following statement supplementing the repeated warnings of the Board:

> "The reason for the advance in rates announced today by the Federal Reserve Bank of New York is the evidence that some part of the great volume of credit, resulting from both Government and private borrowing, which war finance required, as it is released from time to time from Government needs, is being diverted to speculative employment rather than to reduction of bank loans. As the total volume of the Government's loans is now in course of reduction corresponding reductions in bank loans and deposits should be made in order to insure an orderly return of normal credit conditions."

Notwithstanding this notice, activities on the exchanges continued and the reserves of the Federal Reserve Bank still declined. During the week ending November 8th the Federal Reserve Board sold to other Federal

Reserve Banks ninety million dollars of acceptances for account of the Federal Reserve Bank of New York, but in spite of this action the reserves of the New York bank fell to forty per cent. In these circumstances, in order to prevent further expansion, it became necessary to call the attention of the large rediscounting banks to the situation.

The high rates for call money which have prevailed continuously for the past two weeks and intermittently for several months past, were in themselves very clear indication of the strained position into which the unbridled speculation had thrown the stock market and rendered a readjustment inevitable unless the resources of the Federal Reserve Banks were to be indirectly drawn upon for stock market purposes. The public has had ample notice of the Board's policy.

You are so familiar with the Federal Reserve Act that it is hardly necessary to call your attention to that paragraph of Section 4, which treats of the duties of the board of directors of a Federal Reserve Bank and which provides that "Said board shall administer the affairs of said bank fairly and impartially and without discrimination in favor of or against any member bank or banks and shall, subject to the provision of law and the orders of the Federal Reserve Board, 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". This would, of course, afford means for a strict rationing of credits should such an extreme course ever become necessary. It is interesting to note that there no longer exists in the mind of the public or in fact a connection between call money rates and the commercial paper market, and it must be gratifying to all those interested in sound banking methods that the events of the past week have had no effect upon the market for commercial paper.

Very truly yours,

Governor.

Hon. R.L. Owen,
United States Senate.