FEDERAL RESERVE BOARD

WASHINGTON

January 10, 1920

X-1786

Subject: Remarks of Mr. James B. Forgan before the American Economic Association on the subject of " Prices and Banking Policy".

Dear Sir:-

There is enclosed herewith for your information extracts from remarks by Mr. James B. Forgan, President of the Federal Advisory Council on the subject of "Prices and Banking Policy" at a recent meeting of the American Economic Association.

Very truly yours,

Enc.

Governor.

Letter to Chairmen and Governors of all F.R. Banks.

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Extracts from remarks by Mr. James B. Forgan, President of the Federal Advisory Council, on the subject of " Prices and Banking Policy " at a recent meeting of the American Economic Association.

"The most urgent practical question raised by Professor Moulton is, as to whether the Federal Reserve system is going to prove the unfailing tower of strength we have accustomed ourselves to consider it and whether, as has been generally proclaimed, it will forever prevent the recurrence of the periodical financial panics, which prior to its organization were so frequent in this country.

"Professor Moulton says that it has recently been computed 'that the Federal Reserve banks as a whole could still expand the total volume of credit by over a billion dollars before the reserves of the system as a whole would be down to the limits prescribed by law.' This may be so, provided they can continue to get an ever expanding outlet for their circulation, which now stands at over $2,800,000,000 and if they can maintain or continue to increase their reserve deposits now standing at over $1,800,000,000. These two amounts combined - $4,600,000,000, form the credit extended to the Federal Reserve banks by their member banks and the public against which they are required to keep a mimimum gold reserve of 40% on the former (their circulation) and of 35% on the latter (their reserve deposits). On the basis of the credits thus extended to them and of their gold reserve they have loaned to member banks over $2,100,000,000, about 73% of which is against Government securities, besides which they carry Government obligations amounting to $300,000,000 and Banker's acceptances, amounting to $585,000,000.

"Although composed of twelve individual entities, the Federal Reserve system must be regarded as one individual whole. The financial pressure is not felt with equal force all over the country at the same time, but varies with the seasonal requirements of different sections. The strength of the system lies very largely in cooperative action by the twelve banks, which finds its most vital expression in the maintenance of the Gold Settlement Fund in Washington. The policy of the Federal Reserve Board is to treat the twelve banks as integral parts of one system. This is necessarily so. Under this policy it is interesting to note that some of the largest Federal Reserve Banks have recently required assistance in order to keep their reserves up to the minimum legal requirements, while some of the smaller banks, which a few months ago had to be similarly assisted, now stand well to the top of the list in their per centage of reserves to deposits.

"The ratio of total reserves to net deposits and Federal Reserve notes of the system is at present 45% - the lowest point yet reached - a year ago it was 50% - two years ago 62% - three years ago 77% and four years ago 87%. These figures clearly indicate that there are limits to the Federal Reserve system as there are to all institutions of human origin and warrant the words of caution used by Professor Moulton "If we allow the situation to go forward until the reserves of the Federal Reserve system have been reduced to the legal minimum we will be in precisely the same situation that we have always been in, in time of crisis, namely with a fundamental need for a temporary expansion of loans with which to tide the business world over a threatening financial abyss, but with utter inability to make any such expansion." Of course, the Federal Reserve Board has authority in an emergency to reduce the legal reserve requirements of the Federal Reserve Banks or to suspend them for a stated period, but panic of considerable magnitude would doubtless prevail before such action would be taken or it might follow should such action be taken. It certainly behooves us to call a halt now and to give due heed as to whither we are drifting. I therefore again agree with Professor Moulton that in the light of the present situation the reserves of the Federal Reserve system should be conserved and that the only effective measure available to the Federal Reserve Banks should be applied viz. to raise the discount rates on all lines of paper discounted by them. This policy has recently been adopted so far as removing the preferential rates on loans secured by Government obligations is concerned and has already had the effect of reducing somewhat the volume of such loans, which is good as far as it goes, but this has been practically offset by an increase in commercial paper rediscounted and bankers acceptances purchased showing the correctness of Professor Moulton's statement. "If member banks are compelled to reduce their borrowings from the Federal Reserve Banks on 'war paper', the result will merely be, so long as a demand for their funds continues, to shift the borrowing process to commercial paper. There would then be no change in the total amount of credit extension by the Reserve Banks." He then draws attention to the fact that "Funds may be drawn from Federal Reserve Banks by an indirect process," referring to their purchases of acceptances in the open market. This is exactly what has taken place since the rates on 'war paper' loans were raised. He then reaches the inevitable conclusion that "if the total volume of bank loans is to be reduced it will therefore be

necessary

"for discount rates to be raised on all classes of paper and for the Federal Reserve banks to refuse to expand their own market purchases."

"In explanation of the policy of the Federal Reserve banks in regard to discount rates as heretofore approved by the Federal Reserve Board with advice of the Federal Advisory Council, I would say that conditions confronting them have prevented the application of recognized economic principles. The controlling factor has been the necessity of the Government for credit to enable it to prosecute and win the war. Not only had the Federal Reserve banks to make such rates as would enable the Government to float its low rate securities in the shape of bonds and certificates of indebtedness, but they had to take charge of these issues and do everything they could to induce their member banks, at their own expense, to help distribute them, and to extend to their customers who bought them such credit as was necessary at correspondingly preferential rates. It was patriotism that for the time being displaced or disregarded economic laws and principles. The hope for the future is in the claim of the Treasury Department that after its financing, necessary to provide for its certificates maturing within the next sixty days has been accomplished, its urgent necessities will be out of the way and its requirements will thereafter be met by floating short term certificates, issued in anticipation of the quarterly collection of Federal taxes. Such certificates having only a short time to run and the certainty of their payment at maturity will afford them a ready market with the large taxpayers as well as with the banks. It will be no longer necessary to arbitrarily distribute them among the banks by allotment in proportion to their resources. The desire to have the Government successfully achieve its last refunding operations in connection with its $2,300,000,000 of certificates maturing between December 15 and February 28 was the principal reason why the discount rates at the Federal Reserve banks were not raised on all lines of paper at the time the preferential rates on paper secured by Government bonds were withdrawn. When this Government financing is out of the way, as it is expected to be very shortly, there is little doubt in my opinion that the Federal Reserve banks under the advice of the Federal Reserve Board will raise their rates for the purpose of checking undue expansion of credit whenever such action seems necessary. Thus they will secure some control of the discount market which abnormal conditions have so far prevented. There is just a possibility that after we get through with this Government financing and with the usual first-of-the-year operations the borrowing demands of the member banks on the reserve banks may perceptibly fall off and a shrinkage in the volume of Federal Reserve notes may take place. This would occur in the natural course of events. If, however, in the interest of our foreign trade, and for humanitarian and ethical reasons, we are going to extend to European countries the credits they require, to enable them to obtain from us the foodstuffs and raw materials they so urgently need, which I firmly believe we should, there is small prospect of the demand for bank credit weakening during the year 1920. If the Government should assist in this necessary European financing, as I also think it should, it may have to be still further financed and again theories may have to be suspended in view of the conditions we will have to face. The necessities of the railroads for large amounts of credit after they are returned to their owners is another important factor which will operate in maintaining a strong demand for bank credit for some time to come.

" Under the abnormal conditions now prevailing and with such uncertainty as to future developments, there can be no doubt that the resources of the Federal Reserve Banks should be conserved as much as possible, and that the policy of the member banks should be to discriminate against all loans for speculative purposes and to make careful investigation as to the use to be made of all monies borrowed from them by their customers. I am not without hope that if such policies are pursued, financial panics may be avoided and that, notwithstanding the strain, which seems inevitable, the Federal Reserve system will prove equal to it. - But we must be on our guard; we must look ahead and not strain the elasticity of the system to the breaking point. If its reserves continue to shrink, the brakes must be applied by materially raising the discount rates.