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COMPTROLLER OF THE CURRENCY

ADDRESS REPLY TO
FEDERAL RESERVE BOARD

FEDERAL RESERVE BOARD

WASHINGTON

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May 24, 1920.

X-1936-7

Subject: Transmitting Copies of Board letter
to Senator Owen, and Response to
Senate Resolution #363.

Dear Sir:-

There is enclosed herewith for your information copy of Board's reply to a letter from Senator Owen, in which he criticises the discount policy of the Federal Reserve Banks, and also copy of the Board's reply to Senate Resolution #363.

Very truly yours,

Enc.

Governor.

To Chairmen of all F.R. Banks.

May 25, 1920.

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Sir:

On May 17th, 1920, the Senate adopted the following resolution.

"Resolved, That the Federal Reserve Board be directed to advise the Senate what steps it purposes to take or to recommend to the member banks of the Federal Reserve System to meet the existing inflation of currency and credits and consequent high prices, and what further steps it purposes to take or recommend to mobilize credits in order to move the 1920 crop".

In response the Board desires to say that it has recognized for many months past that the expansion of bank credits in this country was proceeding at a rate not warranted by the production and consumption of goods. It has repeatedly admonished the Federal Reserve Banks that influence should be exerted upon the member banks to induce them to avoid undue expansion of loans and to keep their volume of outstanding credits within moderate bounds.

Beginning six months ago the rates of discount on various classes of paper at the Federal Reserve Banks were advanced. During the latter part of January the present rates were put into effect. These advances, while undoubtedly checking credit transactions which otherwise would have been made, have not been entirely effective in bringing about the reduction in loans desired and which might normally have been expected during the early months of the year. Liquidation during these months

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is entirely natural and healthy and is necessary in order that the banks may be prepared to meet the demands made upon them during the crop making and harvesting seasons, but there has been no such liquidation and on the contrary commercial loans have steadily increased. Thus it appears that the public has anticipated demands for banking credit which are usually made later on in the year. The average reserves of the Federal Reserve Banks are now a little over $42\frac{1}{2}$ per cent, as against 45 per cent at the beginning of the year and about 51 per cent twelve months ago.

The Federal Advisory Council, which is composed of one member from each Federal Reserve District, elected annually by the Board of Directors of the Federal Reserve Bank, is required by Section 12 of the Federal Reserve Act to meet in Washington at least four times each year. The Council is authorized "to confer directly with the Federal Reserve Board on general business conditions; to make oral or written representations concerning matters within the jurisdiction of said board; to call for information and to make recommendations in regard to discount rates, rediscount business, note issues, reserve conditions in the various Districts, the purchase and sale of gold or securities by reserve banks, open-market operations by said banks, and the general affairs of the reserve banking system."

Upon receipt of a notice that the Council would hold its regular meeting on May 17th, the Board extended an invitation to the three Class "A" Directors of each Federal Reserve Bank, who are the representatives of the stockholding banks, to come to Washington at the

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same time for conference with the Federal Reserve Board and the Federal Advisory Council. This conference was held on the 18th instant and it was developed at the meeting that the present credit expansion is due in great part to the abnormally high prices of goods and commodities now prevailing throughout the country and to the congestion of food-stuffs and essential raw materials at, or near, points of production because of lack of transportation facilities.

The Board is convinced that if the unsold portions of last year's crops can be brought to market before the new crop matures, the liquidation of credits which are now tied up in carrying the old crops will be sufficient to offset to a considerable degree the credit demands which will be made upon the banks in moving the crop of 1920.

At the conference above referred to the Board's views were outlined by its Governor substantially, as follows: The member banks should lean less heavily upon the Federal Reserve Banks and rely more upon their own resources, unnecessary and habitual borrowings should be discouraged and the liquidation of long standing, non-essential loans should proceed. Banks were cautioned, however, that drastic steps should be avoided and that the methods adopted should be orderly, for gradual liquidation will result in permanent improvement while too rapid deflation would be injurious and should be avoided. The Board pointed out the necessity for extending such credits as may be necessary to promote essential production, especially of foodstuffs and that if for any reason it should prove impracticable to increase essential production, there should be greater economy in consumption and more moderation in the use of credit. The problem of the banking

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system of the country is to check further expansion and to bring about a normal and healthy liquidation without curtailing essential production and without shock to industry, and, as far as possible, without disturbance of legitimate commerce and business. In order to effect this it seems necessary to distinguish between essential and non-essential loans but the Federal Reserve Board feels it would be a most difficult task, which it should not undertake, to attempt by general rule of country-wide application to make this distinction. During the war there was a broad underlying principle that essentials must be "necessary or contributory to the conduct of the war", but notwithstanding the sharp outline of this principle much difficulty was experienced by the various war boards in defining essentials and non-essentials. All the more difficult would it be for the Federal Reserve Board to make such a general definition in the present circumstances.

Section 13 of the Federal Reserve Act defines the eligibility of paper for discount by the Federal Reserve Banks and lays down a general rule that any paper maturing within the time prescribed and "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" is eligible. No expressed condition is made regarding the essential or non-essential character of the transactions giving rise to notes which may be offered for discount and the Federal Reserve Board is not required, and properly could not be expected, generally to adopt such a criterion of eligibility. It is too much a matter of local conditions

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and local knowledge to justify at this time any general country-wide ruling by the Board even if such a ruling were deemed helpful.

On the other hand, there is nothing in the Federal Reserve Act which require a Federal Reserve Bank to make any investment or to rediscount any particular paper or class of paper. The language of both Sections 13 and 14 is permissive only. Section 4 of the Federal Reserve Act, however, requires the directors of a Federal Reserve Bank to administer its affairs "fairly and impartially and without discrimination in favor of or against any member bank", and subject to the provisions of law and the orders of the Federal Reserve Board to 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". Thus the Directors of a Federal Reserve Bank have the power to limit the volume and character of loans which in their judgment may be safely and reasonably made to any member bank

The recent amendment to paragraph (d) of Section 14 distinctly authorizes each Federal Reserve Bank on its own account, without reference to action taken by any other Federal Reserve Bank, to establish a normal discount or credit line for each member bank, and permits the imposition of graduated rates on discount lines in excess of the normal line. This amendment, however, does not repeal or modify Sections 4 and 13, and a Federal Reserve Bank is still free to decline to discount any paper which in its judgment does not constitute a desirable investment for it or which in its opinion would not constitute a safe and reasonable investment within the meaning of Section 4.

It is the view of the Board, however, that while Federal Reserve Banks may properly undertake in their transactions with member banks to discriminate between essential and non-essential loans, nevertheless that discrimination might much better be made at the source by the member banks themselves. The individual banker comes in direct contact with his customers; he is better qualified than anyone else to advise the customer, because of his familiarity, not only with the customer's business but with the general business conditions and needs in his immediate locality. In making loans he is bound by no general rule of law as to the character of the purpose for which a loan is being asked. He is entirely free to exercise discretion, and can make one loan and decline another as his judgment may dictate. He can estimate with a fair degree of accuracy the legitimate demands for credit which are liable to be made upon him, as well as the fluctuations in the volume of his deposits. He knows what industries sustain his community, and is thus qualified to pass upon the essential or non-essential character of loans offered him. He knows, or should know, what rediscount line he may reasonably expect of his Federal Reserve Bank, and he ought not to regard this line as a permanent addition to his capital. With knowledge of the limitations or penalties put upon his borrowings from the Federal Reserve Banks the banker may be depended upon to use a more discriminating judgment in granting credit accommodations to his customers, and that judgment he must exercise if the present situation is to be remedied fundamentally.

It is true that under existing conditions the volume of credit required in any transaction is much greater than was the case in pre-war times; but it is also true that the resources of the member and non-member banks would

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be ample to take care of the essential business of the country and to a large extent of non-essentials as well if there were a freer flow of goods and credit. If "frozen loans" were liquified, and if commodities which are held back either for speculative purposes or because of lack of transportation facilities should go to the markets, and if large stocks of merchandise should be reduced, the resultant release of credit would have a most beneficial effect upon the general situation. In the meantime everything must be done to expedite the release of these credits and to restrict non-essential credits in future.

While the problem of credit regulation and control is national and even international in its scope, yet in the last analysis it is merely an aggregation of individual problems, and the proper working out of the situation must depend upon the public and upon the banks which deal with the public. The public must be made to realize the necessity of economy in expenditures and in consequent demands for banking credit. The banks themselves are best able to impress the importance of this policy upon the public.

For the further information of the Senate the Board quotes from the report of the Federal Advisory Council made to it on May 18th, signed by James B. Forgan, President.

"The Council has given consideration to the matters included in your communication of April 17th and begs to reply thereto in the following manner, following the order set out by you.

(a) "Causes of continued expansion of credits and of Federal note issues."

There are many contributing causes of which the following may be regarded as paramount.

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1. We recognize, of course, that the first cause is the Great War.
2. Great extravagance, national, municipal and individual.
3. Inefficiency and indifference of labor resulting in lessening production.
4. A shortage of transportation facilities, thus preventing the normal movement of commodities.
5. The vicious circle of increasing wages and prices.

(b) 'How can the reserve position of the Federal Reserve Banks be materially strengthened before the seasonal demand sets in next fall without undue disturbance of the processes of production and distribution?'

By urging upon member banks through the Federal Reserve Banks the wisdom of showing borrowers the necessity of the curtailment of general credits, and especially for non-essential uses, as well as continuing to discourage loans for capital and speculative purposes: by checking excessive borrowings through the application of higher rates.

(c) 'If steps cannot be taken at this time leading to a more normal proportion between the volume of credits and the volume of goods, when can they be taken?'

In our opinion steps should be taken now, as outlined in answer to the last question.

(d) 'What is the effect upon the general situation of the increased Treasury borrowings and what should be the policy of the Federal Reserve Banks in establishing rates of discount on paper secured by certificates of indebtedness?'

It is obvious that the borrowings of the Treasury have the same effect upon the general credit situation as those of other borrowers. The Council would suggest the wisdom of Congressional relief from the burden of government financing by a policy of rigid economy; the provision of the tax laws for the sake of a more equitable distribution of the burden without reducing the revenue; the enactment of the budget system, the budget to include provision for the gradual payment of the short time obligations of the Treasury. These would of necessity preclude unwise appropriations, such as the proposed soldiers' bonus.

In view of the large volume of Treasury certificates of indebtedness carried by member banks at the instance of the Treasury Department, we believe that rates established by the Federal Reserve Banks on paper secured by them should not be materially greater than the rates borne by the certificates."

The Board feels assured that the banks of the country now realize the necessity of more conservatism in extending credits and of a reasonable reduction in the volume of credits now outstanding. The Board will not hesitate, so far as it may be necessary, to bring to bear all its statutory powers in regulating the volume of credit, but wishes to point out that the more vital problems relating to the movement of the 1920 crop are physical rather than financial.

This was the unanimous view of those present at the conference on the 18th instant, at which the following resolution was adopted:

"The whole country is suffering from inflation of prices with the consequent inflation of credit. From reports made by the members of this conference, representing every section of the country, it is obvious that great sums are tied up in products which if marketed would relieve necessity, tend to reduce the price level and relieve the strain on our credit system.

"This congestion of freight is found in practically all of the large railroad centers and shipping ports. It arises chiefly from inadequate transportation facilities available at this time and is seriously crippling business. We are informed that the per ton mile of freight increased in three years - 1916, 1917, and 1918 - 47%, while the freight cars in service during the same period increased 1.9%.

"A striking necessity exists which can only be relieved through the upbuilding of the credit of the railroads. This must come through adequate and prompt increase in freight rates. Any delay means the paying of greater cost directly and indirectly and places a burden on the credit system which in the approaching time for seasonal expansion may cause abnormal strain. Even under the load of war inflation, high price level, and extravagances the bank reserves would probably be sufficient if quick transportation could be assured during the time of the greatest strain.

"Therefore Be It Resolved: That this conference urge as the most important remedies that the Interstate Commerce Commission and the United States Shipping Board give increased

rates and adequate facilities such immediate effect as may be warranted under their authority and that a committee of five, representing the various sections of the country, be appointed by the Chairman to present this resolution to the Interstate Commerce Commission and the United States Shipping Board with such verbal presentation as may seem appropriate to the committee."

Much will depend upon the restoration of the normal efficiency of railroad and steamship lines. If adequate transportation facilities can be provided the Board sees no occasion for apprehension in connection with the movement of crops now being grown.

Respectfully,

Governor.

The President of the Senate.

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May 24, 1920.

My dear Senator:

Your letter of the 14th instant was duly received, but unusual pressure of routine business has prevented an earlier reply.

I notice that you renew the suggestion made in your letter of April 27th that the Federal Reserve Board lower the discount rates of Federal Reserve Banks as a means of helping to restore Liberty Bonds to par, and that you take the view that as the Federal Reserve Banks pay no interest on deposits and that as they made very large earnings last year on a four per cent rate; that "3 per cent is a rate high enough to enable them to make all the money they are entitled to make out of the public", and you say that "the Federal Reserve Banks should not be put in the attitude of profiteering or of setting the example of profiteering to member banks".

Your suggestion that the discount rates of the Federal Reserve Banks be fixed with reference to their dividend requirements is certainly a novel one, but before entering into a discussion of the propriety of fixing rates from this point of view I wish to say something regarding your intimation that the Federal Reserve Banks are putting themselves in the attitude of profiteering.

Section 7 of the Federal Reserve Act provides that "after all

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necessary expenses of a Federal reserve bank have been paid or provided for, the stockholders shall be entitled to receive an annual dividend of six per centum on the paid-in capital stock, which dividend shall be cumulative". As originally enacted this section provided further that after dividend claims had been fully met "all the net earnings shall be paid to the United States as a franchise tax, except that one-half of such net earnings shall be paid into a surplus fund until it shall amount to forty per centum of the paid-in capital stock of such bank". The Act of March 3, 1919, which passed the Senate only as a result of your watchful care throughout an all-night session near the end of the Sixty-fifth Congress, amended Section 7 by providing that "after the aforesaid dividend claims have been fully met, the net earnings shall be paid to the United States as a franchise tax except that the whole of such net earnings, including those for the year ending December thirty-first, nineteen hundred and eighteen, shall be paid into a surplus fund until it shall amount to one hundred per centum of the subscribed capital stock of such bank, and that thereafter ten per centum of such net earnings shall be paid into the surplus".

Section 7 also provides that in case a Federal Reserve Bank should be "dissolved or go into liquidation, any surplus remaining after the payment of all debts, dividend requirements as hereinbefore provided, and the par value of the stock, shall be paid to and become the property of the United States". On May 21, 1920, the paid-in capital stock of all the twelve Federal Reserve Banks aggregated \$93,786,000. On this

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basis of capitalization for the year the member banks can receive dividends at the rate of 6%, amounting to \$5,627,160; the remainder of the net earnings, however great, will be paid in larger part directly to the Government as a franchise tax, the balance being carried to the surplus funds of the Federal Reserve Banks with ultimate reversion to the Government. On May 21, 1920, the consolidated statement of the twelve Federal Reserve Banks shows bills discounted secured by Government war obligations, \$1,446,723,000; all other rediscounts for member banks, \$1,053,663,000; bills bought in the open market, \$417,368,000; making a total of notes and bills rediscounted of \$2,917,754,000. At the same time the reserve deposits of member banks were \$1,833,665,000; total reserves held were \$2,079,538,000, and Federal Reserve notes in actual circulation amounted to \$3,085,202,000.

The ability of the Federal Reserve Banks to extend so large a volume of discount accommodations is due to the use of Federal Reserve notes, and this fact ought not to be overlooked. It follows therefore that the earnings of the Federal Reserve Banks are derived in larger part from the circulation of Federal Reserve notes, which are obligations of the Government. The Federal Reserve Board is authorized in Section 16 of the Federal Reserve Act to require the Federal Reserve Banks to pay such rate of interest as the Board may establish on the amount of Federal Reserve notes outstanding less the amount of gold or gold certificates held by the Federal Reserve Agents as collateral security. On May 21st, after setting aside the reserve of 35% against net deposit liabilities, the combined statement of the Federal Reserve Banks shows a reserve against Federal Reserve notes outstanding of

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47.1%. Even though all excess gold were deposited with the Federal Reserve Agents there would be 52.9% of the outstanding note issue, or \$1,632,071,856, subject to an interest charge, the imposition of which would very materially reduce the apparent earnings of the Federal Reserve Banks. The Act gives the Board discretion in the matter, however, and no charge has been imposed for the reason that the excess earnings of the Federal Reserve Banks go to the Government in any event.

It seems to me, Senator, that you are disposed in all your discussions of the money and credit situation to ignore the fundamental law of supply and demand. Let me point out a few statements in your last letter which appear to be inconsistent. You state that you are "certainly opposed to inflation", but you are "strongly in favor of the extension of business, increasing production and improving distribution by extending credits on a stable low interest rate", and you say "The expansion of credit for such purposes is justified, but, of course, the expansion of credit beyond the available resources, even for the most important of purposes, is not justified". You say further that "credits ought to be extended at a low rate to the extent of the capacity of the Reserve Banks for productive purposes", and you intimate that as the Federal Reserve Banks pay no interest on deposits, a three per cent rate is high enough. While you do not say in direct terms that Federal Reserve Banks should stand ready to make loans on Liberty Bonds and Victory Notes at a three per cent rate your letter admits of this construction, although you do say that you do not advocate the Reserve Banks "lending beyond their resources at any rate, or on any securities". You say "Assuredly raising the rates of interest will deflate credits, even the

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credits of the United States, of which I complain, but I am anxious the Federal Reserve Board shall only deflate those credits that require deflation and not deflate credits of the Government and of legitimate productive business which ought not to be deflated". You say that "The only deflation of credit justified is the deflation of credits employed in speculative loans on investment securities, on real estate, and on commodities for hoarding by profiteers".

From all this I understand your view to be that the Federal Reserve Banks should lend at a low stable rate on Government securities and on other eligible paper, barring only "speculative loans on investment securities, on real estate, and on commodities for hoarding by profiteers" and that in your judgment this stable low rate ought to be three per cent.

You admit the correctness of the observation made in my letter of the 3rd instant that "there is a world-wide demand for capital, and the demand for bank credit in this country for agricultural, commercial and industrial purposes is heavier than has ^{ever} been known before; investment demands for new construction, for the maintenance and equipment of railroads, and for the financing of our foreign trade are very great". You ask "Are ^{these} just demands to be met by denying the credits, or are they to be repressed by raising the rates". I cannot escape the conclusion, Senator, that were the Federal Reserve Banks to establish the stable low rate proposed by you they would soon reach the limit of their available resources, beyond which point, you state, the expansion of credit, "even for the most important of purposes, is not justified". It seems to me that the adoption of the policy proposed by you would result in a wild scramble

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for discount accommodations at the Federal Reserve Banks with an enforced denial of all credit after the first few days.

The Board is insisting that all banks use a discriminating judgment in making loans, giving preference to those which are necessary for the production and distribution of the basic necessities of life, such as clothing, food and fuel, but in the exercise of this discretion it is necessary to have the restraining influence of a rate. It is idle to preach against excessive borrowings and then to invite borrowings by an artificially low rate less than half the current open market rate.

You have had a good deal to say about the low rates which prevailed in bygone years, in England, France and Belgium, and I might call your attention also to the low rates which prevailed at the Federal Reserve Banks during the year 1915 when there was no demand for loans. But we are dealing with the pressing problems of the present; changing conditions must be recognized and dealt with as occasion demands. You no doubt know, although you have never called attention to the fact, that official discount rates are high everywhere, even in countries where inflation has been carried to extremes and which are no longer on a gold basis. The official rate in Italy is $5\frac{1}{2}\%$, that of the Bank of France is 6% , and that of the Bank of England is 7% , having recently been raised from 6% .

The Federal Reserve Board does not take the view that discount rates should be arbitrarily fixed by it; it recognizes the fact that there are certain basic conditions which affect the demand for and the supply of credit throughout this country and throughout the world, and that the formal

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establishment of a discount rate is merely an interpretation of these conditions. You call attention to the fact that the open market rate in London during the war was $3\frac{1}{2}\%$. It is now $6\frac{3}{4}$ to $6\frac{7}{8}$ per cent, against an official bank rate of 7%. You do not question the wisdom of the management of the bank of England, which you say is conducted by the wisest merchants in the world, although I have always had an idea that many of these merchants are credit merchants, or private bankers, as they would be called in this country. The advances in rates in London are evidently due to natural causes and there has been no attempt to maintain artificially the low rates to which you refer. Why then is it not just as reasonable to concede to the directors of the Federal Reserve Banks and to the Federal Reserve Board some degree of honesty of purpose and intelligence in making the advances in rates of which you complain so vigorously?

From your own figures, Senator, it is clearly impossible for the Federal Reserve Banks to carry at any rate which may be fixed the entire volume of the Government war obligations, and if a stable low rate of 3% were to be established no very great volume of additional loans could be made, and instead of there being a stabilization of the bond market there would be chaotic conditions.

The obligations of the Government of the United States offer the best opportunity for investment in the world today. They are being sold now on a most attractive investment basis, and as speculative tendencies are curbed, as the gains of the profiteers are reduced, as commodity prices decline, and as the business and industry of this country settle down to a more normal peace basis, the market value of these securities will rise very

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rapidly. This conclusion is justified by the experience of the past. The six per cent 20-year bonds of the Government during the Civil War sold at a heavy discount (I think they were down at one time to about 80), but two years from the time of their greatest depression they reached par and were selling at a ^{premium} of about 25% in 1869, only twelve years before their maturity. I am satisfied that we will have a similar experience with Liberty Bonds, provided there are rigid economies in Governmental expenditures from this time forth and inflationary tendencies generally are held in check.

I do not know of anything further that I can say regarding the call money rates in New York. You continue to insist that the powers of the Government should be exercised through the offices of the Federal Reserve Board, the Federal Reserve Banks and the Comptroller of the Currency to remove the causes which lead to fluctuating rates there, and I have already pointed out to you that the interest rates in New York City are regulated by the laws of the State of New York and that there is nothing that can be done by the Federal Reserve Board, or by the Federal Reserve Bank of New York, except, perhaps, to decline to make loans on Government bonds to banks which in turn lend on Stock Exchange collateral. This would result in even higher rates.

It is interesting to note, however, that the high rates of which you complain reached their peak in November, 1919, before the discount rates of the Federal Reserve Banks had been advanced and that since the rates were advanced to their present level, on January 23rd last, call

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money rates have ruled, with the exception of one or two temporary flurries, quite steadily around their present level of from six to seven per cent.

Very truly yours,

W.P.G. HARDING,

Governor.

Hon. Robert L. Owen,
United States Senate,
Washington, D.C.