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ADDRESS REPLY TO  
FEDERAL RESERVE BOARD

WASHINGTON

W. T. CHAPMAN, SECRETARY  
R. G. EMERSON, ASSISTANT SECRETARY  
W. M. IMLAY, FISCAL AGENT

May 29, 1920.

X-1941

SUBJECT: Discount Rates.

Dear Sir:

There is nothing in the Federal Reserve Act to sustain the view that discount rates at the Federal Reserve Banks should be fixed with a view of enabling member banks to make a profit out of their rediscount transactions. Under normal conditions the rates of a central bank, in countries where such institutions have been long established, are higher than the current open market rates.

The numerous protests which are being received at this office from Senators and Representatives and from individuals all over the country against the present discount rates of Federal Reserve Banks ignore this fact entirely, and appear to be based upon the assumption that member banks have no loanable funds except such as they are able to borrow from Federal Reserve Banks, that it is necessary for a member bank, in making loans, to charge a rate higher than the discount rate fixed by the Federal Reserve Bank and that therefore an increase in the Federal Reserve Bank rate means a corresponding increase in the rates on all loans made by member banks and that thus a hardship is forced upon legitimate borrowers who may need money for purposes of production and distribution.

The reserves required of member banks under the Federal Reserve Act are very much less than those required under the old law before the Federal Reserve Act was placed upon the statute books. There is no longer any requirement as to the amount of vault cash to be carried by member banks and their reserve balances with Federal Reserve Banks are less in proportion to the demand and time deposits held by the member banks than the proportion of lawful money to such deposits which the member banks were formerly required to carry in their vaults. The total rediscounts made by member banks with Federal Reserve Banks are about 12 per cent of their total loans. It has always been the custom of commercial banks to take care of the legitimate requirements of their good customers at rates based partly upon current market conditions and partly upon the value of the account as determined by the average balance carried. Banks have not as a rule based their rates to such customers on call money rates or upon the rates at which paper could be purchased from note brokers.

- 2 -

X-1941

The Board suggests that you consider the propriety of presenting the substance of this statement, in your own way, to member banks, letting them understand that the primary purpose of the advances recently made in discount rates at Federal Reserve Banks has been to protect the reserves of the Federal Reserve Banks and to discourage undue expansion of loans by the member banks. In making this suggestion that you communicate the substance of this letter to your member banks, the Board assumes that you can do so in a manner not calculated to invite undue pressure on the part of borrowers upon their local banks to extend credit accommodations, and if you should deem it unwise to call attention to the facts above stated at this time, you will, of course, ignore the suggestion.

Very truly yours,

G o v e r n o r

To Governors of all Federal Reserve Banks