I. CREDIT CONTROL.

1. What are the objects sought to be attained by the policy of credit control in the existing circumstances?

Is the object

(a) To maintain or to strengthen reserves?

(b) To stabilize the existing situation by prevention of further expansion?

(c) To bring about a discriminating deflation by reducing the total volume of credit?

From statistics compiled by Professor Kemmerer of Princeton, bank deposits increased from $12,678,000,000 in 1913 to $27,928,000,000 in 1919. At the same time the ratio of cash reserves to total deposits diminished from 11.7 in 1913 to 6.6 in 1919.

> "Taking the index numbers of the United States Bureau of Labor Statistics as the most comprehensive and most scientifically prepared of the index numbers covering the entire period 1913 to 1919 inclusive, we may say that the wholesale price level increased from 1913 to April, 1920, 165%; in other words, if one calls the dollar of 1913 a 100% dollar in its purchasing power over commodities at wholesale, the dollar of today is approximately a 38% dollar."

This was the condition of affairs when the Federal Reserve Board undertook to exercise its power over credit for the purpose of protecting personal and commercial interests. All experienced business men knew that prices would seek a lower level, by gradual process if good judgment and conservatism prevailed, or by a commercial debacle if the illogical, ill-considered and extravagant methods brought about by the war were permitted to continue. Under these circumstances, and none too soon, the Federal Reserve Board exercised its power over credit in order to constrain bankers and business men to exercise conservatism and help strengthen commercial and financial conditions. The Board in so doing have accomplished a great work and have demonstrated one of the powers for good which the Federal Reserve System possesses. Naturally their first move was in the direction of strengthening the bank's reserves. That means strengthening the bank and putting it in a liquid position - in the position in which a well managed bank should always be, to respond to the demands of its clientele. Strengthening the reserves meant curtailing credit and <u>ipso facto</u> would prevent "further expansion". No one wishes to "Stabilize" existing conditions, but to get away from them to a safer and more conservative level. This would naturally bring about a "Discriminating deflation" by extending credit to such industries as were essential and needed support in order to preserve the general business welfare, and by restraining credit to activities which though perfectly legitimate were nevertheless non-essential to the general welfare and should be promoted by the funds of their owners and managers, and not be allowed to absorb commercial resources needed for the financing of business closely connected with the public welfare.

2. Can a substantial reduction in the volume of credit be effected without injury to the legitimate business of the country and without curtailment of essential production?

A substantial reduction of the volume of credit can be effected without injury to the legitimate industry of the country and without curtailing of essential production. Not only this but such reduction in volume of credit may be made to materially strengthen the credit fabric of the country as a whole.

The first and most beneficent effect of the act of the Federal Reserve Board in controlling credit was to arrest the attention of the whole country and to incur high commendation from conservative forces and incur criticism ranging from mild to violent from certain sections or interests. It made everybody stop and think and the discussion which ensued showed plainly that the Board was right. The psychological attitude of the country toward business immediately began to change and from wild extravagance and a disposition to enter into new and ill-considered business, there came about a feeling of conservatism. People began to ask themselves just where they stood, how much they were really worth, and how they would fare if called upon to liquidate their outstanding obligations. Drafts drawn against goods shipped abroad were not always paid and sometimes returned. People began to repudiate their contracts to receive goods, especially in cases where the price had receded. Competition in business has brought about a most unfortunate practice - people order goods and then if it does not suit their convenience, they refuse to receive and pay for the same. This has continued so long and is so much the custom that manufacturers and wholesalers, hardly expect to hold their customers to rigid fulfillment of their contracts, if a change in the market or a change in business conditions makes it desirable for them to repudiate. Such repudiation of purchases began to happen generally and manufacturers and wholesalers found themselves possessed of large volumes of very high-priced goods which they could not market without loss. That is the condition of the mercantile industry in our country today. They have for years dictated the price of their goods and they are now endeavoring to dispose of them to the public without material abatement in prices. It is generally realized that they cannot accomplish such results; recessions in price have already set in and are bound to be more pronounced. Business people will have to liquidate their goods in order to liquidate financial obligations. This will bring about competition in selling throughout the country, something that has not existed for several years and this competition in its normal and natural course will clarify the situation and bring about normal conditions.

3. To what extent has one or more of these objects been attained in each District and in the country at large?

The object sought to be accomplished by the Federal Reserve Board has been and is being accomplished in all Districts.

4. To what extent is it necessary to distinguish between the immediate objective of the policy of credit control and the remoter objective, such as reduction in the cost of living?

The immediate effect of credit control is to safeguard the situation, to enable all business to function normally and the Board should at all times make this clear. Although a logical result may be lower prices and lower cost of living, it should distinctly appear that the Board does not seek to control or regulate prices, but leaves the price level to competition under the law of supply and demand.

Question - What is the proper conception of the "normal credit condition" which the Federal Reserve Banks should seek to bring about?

Note: Obviously if "liquidation" or "stabilization" of the existing credit situation are to be regarded as the objectives of the Federal Reserve policy of credit control, a condition which can be regarded as "normal" will be attained very much more quickly than if the objective is a reduction in considerable amount of the total volume of credit.

The proper concept of "a normal credit condition" is something that varies with the years, with the crops, with commerce, involving domestic and foreign exchange, and with all the varying influences that make up the activity of a commercial nation. The making of crops has to be financed. While we are greatly indebted to nature for her annual contribution to the prosperity and happiness of mankind, the volume of that contribution depends very largely upon mankind's activities. The latent resources so abundant and so valuable nevertheless must be exhumed and that costs time and money and is a regular business in itself. A normal credit condition would seem to be one in which funds were obtainable in sufficient volume to enable the individual, the corporation, the great transportation systems of the country, the municipality and the state to obtain funds at reasonable rates with which to prosecute their respective enterprises. This is not a static world; there should also be funds available for new and enlarged enterprise, for installation of new and improved methods and processes, which the inventive genius of mankind is constantly producing.

5. Methods of credit control. Consideration of the efficacy of different methods of credit control.

(a) Horizontal increase of rates, especially of commercial rates; a canvass of the experience of banks which have put into effect a 7% commercial rate, to wit, New York, Boston, Chicago and Minneapolis.

(b) Progressive rate schedules starting with 6% as a basis rate; a canvass of the experience of Federal Reserve Banks of Kansas City, Dallas, St.Louis, and Atlanta.

(c) Other methods of dealing with the situation, such as the implication that increased offerings by member banks will force higher rates or recourse to the progressive rate; a canvass of the experience of Federal Reserve Banks of Cleveland, Philadelphia, Richmond, and SanFrancisco.

(d) Restricting issues of Federal Reserve notes to Federal Reserve Banks as a potential means of enforcing credit control; canvass of English experience and views.

The different methods of credit control have not had a sufficient test period for the experience of the banks to be conclusive. It is found that each class of banks holds its own method to be most satisfactory and in such a situation there should be further experience before we could give to the Board any conclusion as between the three methods in use or advise any present attempt at uniformity in method.

6. Inter-Reserve Bank rediscounts as related to the problem of credit control. Is the existing policy and practice with respect to such rediscounts satisfactory and sound?

(a) To effect an approximate equalization of reserves?

The existing policy with respect to Inter-Reserve Bank rediscounts is sound and the Board is to be highly commended for the manner in which they have made it effective.

(b) At the same rate fixed for its member banks by the bank granting the accommodation?

Note: When recourse was first had to inter-bank rediscounts it was thought that the value of a Federal Reserve Bank's endorsement was entitled to recognition in the form of a reduced discount rate. More recently this idea has been abandoned and rediscount transactions between Federal Reserve Banks are made at the rates established for member banks by the Federal Reserve Bank extending the accommodation. The question now arises, however, whether a Federal Reserve Bank which has been able to maintain high reserves by reducing the demands for accommodation from its own member banks, which are its depositors, should be required to extend accommodations to member banks in other Districts through the medium of their Federal Reserve Bank at the same rates as are established for their own members.

The rate of such rediscounts should be variable and fixed by the Board from time to time as the situation may appear to require and without any special regard either for the profit or loss to the contracting banks. In the present situation we approve the action of the Board in fixing the rate of such rediscounts at seven per cent.

II. LOANS SECURED BY LIBERTY BONDS AND VICTORY NOTES.

1. Is there any moral obligation resting upon any of the Federal Reserve banks to establish rates lower than commercial rates for paper of this classification?

It is difficult for this Council to determine whether any moral obligation exists in <u>any</u> of the Federal Reserve Districts.

On the general proposition of moral obligation arising out of the methods adopted in the various Liberty Bond campaigns the Council is equally divided, voting 6 to 6.

2. Would liquidation of loans of this class be retarded or promoted by the establishment of lower rates?

The establishment of lower rates doubtless would retard the liquidation of loans secured by Liberty Bonds and Victory Notes.

3. If lower rates are deemed desirable, would it be equitable and practicable to have such rates apply to original subscribers only?

It might be equitable to confine preferential rates to original subscribers only, but we are informed that you have been advised that it would not be legal, and in our opinion it would not be practicable.

4. Should member banks' collateral notes be fully secured, taking market value instead of face value as a basis?

5. If so, how and when could the new policy be put into effect with a minimum of friction?

Yes. We understand this is the practice in some districts and should be made general.

III. FEDERAL RESERVE NOTE ISSUES.

1. Is the note-issue policy of the Federal Reserve System subject to legitimate criticism?

We regard the note-issue policy under the Federal Reserve System as sound and therefore not subject to legitimate criticism.

2. What connection is there between changes in the volume of credit and the volume of currency?

3. Is there any difference in relation to effect upon prices between the volume of credit and the volume of currency?

It is not clear to the Council just what is meant by these questions. They are too involved to admit of their being satisfactorily answered in the time at the Council's disposal.

4. Can the note issue policy of the Federal Reserve System be properly charged with any important responsibility for inflated prices, if so, what has been the responsibility and in what way does the issue of Federal Reserve notes promote or assist inflation?

An increase of the Federal Reserve note issue was made necessary by war conditions and doubtless had some influence in inflating prices, but in the opinion of the Council there has been no undue issue of these notes.

5. Can the accepted principles of bank-note-currency regulation, applicable in normal circumstances when the commerce of the world is conducted on a gold standard, be safely taken as a guide in the abnormal circumstances now existing, when the gold standard is virtually suspended, except in the United States and Japan?

6. In connection with the policy of credit control should the present note-issue policy of the Federal Reserve System be changed and restrictions be thrown around the issue of Federal Reserve notes?

7. If the issue of Federal Reserve notes should be restricted, what form should the restriction take and what effect would different methods of restriction have?

(a) Imposition of charges against Federal Reserve notes upon the uncovered part of circulation issued to them at a given rate, for example, a fixed rate of 5% or a rate varying with the commercial rate.

(b) Would it be practicable to establish for each member bank a so-called normal currency limit and to impose charges upon member banks calling for notes in excess of their limit?

(c) Would it be advisable while continuing to have the Federal Reserve Banks pay all transportation charges on incoming currency, to have shipments of outgoing currency made at the expense of the consignees?

(d) Restrictions by definition of the character of the paper acceptable as collateral by the Federal Reserve Agent against the issue of Federal Reserve notes. Should member banks' collateral notes or customers' notes secured by Government obligations be taken as collateral for Federal Reserve notes?

(e) Limitation of the total volume of Federal Reserve notes by the Federal Reserve Board, the maximum amount being fixed pro rata for each Federal Reserve Bank. (The Federal Reserve Board has statutory power to accept in part or to reject entirely all applications for Federal Reserve notes).

Would restriction of note issues in any of the above mentioned ways operate to promote a better control of credit, and if so, what would be the effect upon the commerce and business of the country?

We know of no reason why the principles under which bank note currency as issued under the Federal Reserve system should be changed as sufficient time has not elapsed to test its flexibility in response to business conditions. The Council is of the opinion that no alteration should be made in the regulations governing the currency issued which would impair its elasticity.

FEDERAL ADVISORY COUNCIL
WASHINGTON

September 21,1920.