FEDERAL RESERVE BOARD

WASHINGTON

X-2091

December 17, 1920.

SUBJECT: Proposed Legislation Establishing a Maximum Federal Reserve Bank Discount Rate.

Dear Sir:

There is enclosed herewith for your information copy of a letter in reply to a communication from the Chairman of the Senate Committee on Banking and Currency, requesting an expression of the views of the Federal Reserve Board with regard to a bill recently introduced in the Senate which, if enacted, would fix the maximum rate of interest or discount which Federal reserve banks could charge member banks in any contract, agreement or any other financial transaction had with them at five per centum per annum.

Very truly yours,

G o v e r n o r.

To the Chairmen and Governors of all F.R.Bs.

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Federal Reserve Bank of St. Louis

December 16, 1920;

Dear Mr. Chairman:-

You have requested the views of the Federal Reserve Board with regard to Senate Bill No. 4560, which, if enacted, would fix the maximum rate of interest or discount which Federal Reserve Banks could charge member banks in any contract, agreement, or any other financial transaction had with them at five per centum per annum.

The Federal Reserve Board desires to put itself on record as unalterably opposed to this bill or to any other bill which in any way attempts to limit the power now vested in it and in the Federal reserve banks to regulate the rates of discount which those banks may charge.

It is essential to the proper functioning of any central banking system that the central bank or banks of discount shall have complete control over their rates. This control over rates in normal times is the usual and most effective means of protecting the gold reserves of a country against withdrawals for foreign account, and in domestic transactions it insures the accummulation in normal times of a reserve sufficient to meet the seasonal and emergency demands of the central bank or banks. It is the general practice of central banks to fix their rates slightly above the market rates. This is particularly true of the Bank of England and in view of the frequent references which are made to this institution in public discussions it may be of interest to review its experience in the matter of discount rates since the passage of the Bank Act of 1844, as shown by the table on page 33 in a book entitled "Bank Rate and the Money Market" by R. H. Inglis Palgrave, F.R.S. The annual average bank rate of the Bank of England during the years 1845 to 1871, inclusive, was higher than the annual average market rate in sixteen of the twenty-six years and was lower than the annual average market rate in the other ten years, but from the year 1872 to the end of the period covered by the table, 1900, the average Bank rate was higher than the average market rate in every year. From 1900 down to the present time the average Bank rate has continued to be higher than the average market rate.

Up to the year 1833 the Bank of England was subject to the usury laws. In his book entitled "Essai Sur La Fondation Et L'Histoire de la Banque D'Angleterre, 1694 - 1844" Dr. A. Andreades, of the University of Paris, refers, on page 361, to the release of the Bank from the application of the usury laws and describes the conditions which led to this action by Parliament. The conditions then existing in England were not altogether unlike present conditions in this country, and it is noteworthy that instead of attempting to impost restrictions upon the Bank, Parliament liberalized its powers and relieved it from the old restrictions which had seriously impaired its efficiency in dealing with the situation.

In explanation of the fact that the discount rates of the Federal reserve banks are at the present time below the market rates it may be

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appropriate to quote the following from an address which I made to the American Farm Bureau Federation at Indianapolis on December 7, 1920:

"Normally the discount rate of a Federal reserve bank should not control the rates at which member banks loan money to their customers. In the countries which have central banks there is a well-established policy that the central bank discount rate should be maintained at a figure slightly in excess of the current market rate. The wisdom of such a policy is apparent for it eliminates all consideration of profit in rediscount transactions and gives the central bank better control over its own reserves and causes the banks which deal with the public to rely to a greater degree upon their own resources in extending accommodations while still affording them an outlet for any undue accummulation of loans. Because of the exigencies of war financing, it has not been practicable for the Federal reserve banks up to this time to adopt this policy and as a rule Federal reserve bank discount rates are lower than the rates charged by member banks. It is believed that conditions are gradually adjusting themselves so that Federal reserve bank rates may be maintained at a level slightly higher than current rates not only without any disturbance to commerce and business but to their distinct benefit. In fact, this adjustment has already begun in some cities where member banks have reduced their rates on commercial paper".

The enactment of a law fixing the maximum rate to be charged by Federal reserve banks at five per cent would, of course, make it impossible to bring this necessary corrective principle into permanent operation, for it would be effective only at times when current market rates for money might fall below five per cent. The Board desires to call your attention to the fact that only three States - Illinois, Louisiana, and Michigan - have a legal rate of interest as low as 5% and in each of these States a higher contract rate is permissible - Illinois and Michigan, 7%, Louisiana, 8%. In thirty-two States the legal rate of interest is 6%; seven States have a legal rate of 7%, and in six States and in the District of Columbia the legal rate of interest is 8%. In eleven States - Arizona, Arkansas, Florida, Kansas, Minnesota, Nebraska, North Dakota, Oklahoma, Oregon, Texas and Wisconsin - a contract rate of 10% is allowed, and in ten other States - Colorado, Connecticut, Idaho, Montana, Nevada, New Mexico, South Dakota, Utah, Washington and Wyoming - 12% is the contract rate. In seven States - Georgia, Indiana, Iowa, Mississippi, Missouri, Ohio and South Carolina - having a legal rate of less than 8%, a contract rate of 8%, is allowed. Four States - California, Maine, Massachusetts and Rhode Island - permit any rate to be charged under contract, and in New York any rate agreed upon in writing is legal on collateral demand loans of $5,000 and over.

The theory that discount transactions should yield a profit to the member banks is a fallacy which owes its wide credence in part to

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the fact that the Federal reserve banking system, which has some of the attributes of a central banking system, is comparatively new, and partly to the abnormal times through which we have passed, the inevitable effects of which are now being experienced. The fact is, however, that the potential profits of the member banks should not be permitted to influence the determination of the Federal reserve bank rates. On the contrary, member banks should rely mainly upon their own resources in normal times in order that when seasonal and emergency demands do arise the reserves of the Federal reserve banks may be available to meet those demands and sufficient to prevent the emergencies from developing into panic conditions. In this connection your attention is invited to an editorial which appeared in the Dallas (Texas) Morning News of Friday, June 11, 1920, copy of which is enclosed herewith.

If Federal reserve bank rates were fixed at 5% at the present time there would undoubtedly be a very strong incentive to the member banks to utilize to the utmost the rediscount facilities of the Federal reserve banks, because in an 8% money market there would be a spread of 3% between that rate and the Federal reserve bank rate which would represent a profit to be derived by the member banks on rediscount transactions. In states which have no important financial centers but in which rates as high as ten and twelve per cent, are authorized by law, the incentive to rediscount with the Federal reserve banks would be even greater. It is the opinion of the Federal Reserve Board, confirmed by past experience, that the lowering of the Federal reserve bank rates to 5% would have but very little if any effect on the market rates which could not be fixed by legislative enactment but which are determined by the inevitable operation of the law of supply and demand. Nor are banks generally inclined - particularly banks in agricultural sections - to give their customers the benefit of Federal reserve bank discount rates. It should be borne in mind also that with Federal reserve bank rates at 5% the incentive to speculation would increase the demand for credit and the net result would be that borrowers for legitimate commercial and agricultural purposes would find it difficult and expensive to obtain credit. Ultimately, of course, the limit of expansion would be reached, and in the Board's opinion it would be reached within a very short time, for it must not be forgotten that there are about $25,000,000,000 of Government obligations available as collateral for loans eligible for rediscount by Federal reserve banks. If the limit of expansion should be reached, the Board believes that a condition of depression infinitely more serious and more widespread than that now existing would follow.

The Board calls the attention of the Committee to the fact that the bill under consideration would operate as a repeal of the provisions of Section 11 (c) of the Federal Reserve Act which require the Federal Reserve Board to impose a graduated tax upon a Federal reserve bank whenever its reserves fall below a specified minimum, the Federal reserve bank being required "to add an amount equal to said tax to the rates of interest and discount fixed by the Federal Reserve Board". If the bill under consideration were enacted, five per cent would be the maximum rate a Federal reserve bank could charge even if its reserves were rapidly dwindling to the vanishing point.

In conclusion and by way of summary, if this bill should become a law it is the Board's firm belief that the Federal reserve banks would

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find it impossible while functioning in a normal way to protect their gold reserves, that the Federal reserve system would within a very short time cease to be in any sense a reserve system and would become a mere instrument for the acceleration and perpetuation of expansion, and that a wholesale scramble for the funds of the Federal reserve banks would ensue which would leave those banks only two alternatives - one, to lend their funds at the rate prescribed until the exhaustion of their reserves had been completed, and the other to fix a definite limit upon their total volume of loans, thus adopting a rigid system of credit rationing. In the one case they would reach a point where they would be unable to make further rediscounts no matter how insistent or meritorious the demands might be, and in the other they would find it necessary to place all applications for discount accommodations on a waiting list until repayment of prior loans made new funds available.

Very truly yours,

W. P. G. HARDING

Governor.

Hon. George P. McLean, Chairman,
Committee on Banking and Currency,
United States Senate.

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