FEDERAL RESERVE BOARD

WASHINGTON

X-3170
July 18, 1921.

SUBJECT: Correspondence Regarding Decline of Prices of Agricultural Commodities.

Dear Sir:

There are enclosed herewith for your information copies of correspondence between the Governor of the Federal Reserve Bank of Richmond and an official of a mercantile company in South Carolina. In his letter Governor Seay discusses the charge that the credit policies of the Federal Reserve Banks have been the direct cause of the deflation or decline of prices of agricultural commodities.

Very truly yours,

(Enclosures)

G o v e r n o r.

Governors of all F.R.Bs. except Richmond
copies to Chairmen.

(C O P Y)   X-3170-a

July 2, 1921.

Dear Sir:

Your letter of June 30th in which you ask for a brief report from us as to conditions in our particular line, also any other lines as far as they - incidental to our operations - come under our observation.

The purchasing and debt-paying power of a large portion of our population has absolutely been destroyed, as a result of the deflation policy of the Federal Reserve System. This policy has paralyzed our agriculture and stagnated our commerce, and, unless relieved, eventually the consumers will pay a fearful penalty. The policy has of course resulted in forcing down prices of agricultural products. This has always been the case, following great wars in which we always have great inflation. Where credits have been restricted and rates of discount raised it has always resulted in bringing about artificial deflation and forcing down prices, and has brought tremendous losses.

As the result of close study of the situation, we find that throughout the agricultural sections of the South, practically the same conditions exist. The farmers are unable to secure credits of either money or goods with which to produce, except in a limited way. They are loaded with debts which were incurred on the peak of inflation in the spring of 1920 for the production of that crop. We had eighteen months of prosperity and business activity, following the cessation of hostilities, and the present distressing financial conditions, therefore, are certainly not the natural aftermath of the World War, but the result of the deflation policy as outlined above.

Millions of people in Europe and Asia who own lands, forests, mines and factories and who are an industrious people, are in desperate need of our raw products, while on our side, as a result of this policy, we are being smothered by the very products which they are needing so badly. We are suffering, not from over-production but from under-consumption. There are no markets for staple products, except in a very limited way and at prices of less than one-third the cost of production.

Unless these conditions are relieved, through a lowering of the re-discount rate to say 4 per cent. on bonds, (this being the understanding of the people who purchased the bonds), and 4½% on agricultural and commercial paper, through a renewal of agricultural loans until markets can be opened and confidence restored, and through more liberal extensions of credits, conditions will grow steadily worse and a large portion of the agricultural section of the nation will face universal bankruptcy.

In our immediate section, there has been a drastic reduction in cotton acreage; in fact, in all agricultural production. We find that the same condition exists throughout the State. The report just issued by the U. S. Agricultural Department shows a reduction in cotton acreage of 28.4 per cent. and a drastic reduction in the use of fertilizers, showing that the cotton yield of this year's crop will be the smallest in the last twenty-five years. In fact, even with ideal weather conditions, we cannot expect it to be otherwise, due not only to the reduction in acreage, but also, on account of the distressing financial conditions, of the fertilizers used, there was not only a drastic reduction in tonnage, but only the cheapest material was purchased by the farmer.

In my humble judgment, confidence can only be restored and the present conditions remedied, by an immediate reversal of the policy which created them. A lowering of the re-discount rate charged by the Federal Reserve Board to 4 per cent on bonds and to 4½ per cent on agricultural and commercial paper, renewal of agricultural loans until confidence can be restored and markets opened; extension of credits based upon credits justified by the gold reserve; we view as a world-wide necessity.

We beg to remain,

Very respectfully,

Vice-President.

C O P Y X-3170b

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FEDERAL RESERVE BANK OF RICHMOND

July 11, 1921.

My dear Sir:

Your letter of the 2d, written in reply to our request for a brief report from you as to conditions in your line and locality, for the purpose of incorporation in our monthly report on trade and financial conditions, has come to my attention.

Your letter is a very interesting one, and your opinions, whether we may be able to agree with them or not, are welcomed and encouraged, because they are needed to make up that composite viewpoint which alone can truly depict conditions as reflected by actual physical circumstances and the mental attitude of the people of a locality or district.

I am going to take the liberty of analyzing and commenting upon several of your statements, in the hope that it may be profitable to both of us. First, you state that --

> "The purchasing and debt-paying power of a large portion of our population has absolutely been destroyed as the result of the deflation policy of the Federal Reserve System."

By this I assume you mean that the credit policy or practice of the Federal Reserve Banks has been the direct cause of the "deflation" or decline in the prices of commodities, particularly of agricultural commodities. Of course, it must be admitted that anyone who incurs obligations based upon high-priced commodities, or labor, or securities, or real estate, or anything else, is seriously handicapped in his ability to pay by a drastic decline in the price of any of these things. That has always been the case and always will be; it is axiomatic. As to the cause of these severe declines inprices, there you will find a very great divergence of opinion. First and foremost must always be taken into account the antecedent rise, the natural law that what goes up is bound to come down -- no matter what sends it up. As opposed to your opinion, I held the view that the action of the Federal Reserve Banks in protection of their reserves, which were being rapidly exhausted, -- exhaustion of which would have caused collapse and ruin entailing universal disaster, from which there could have been no recovery except by the long, tedious, patient, toiling process of building up after destruction, -- was no more responsible for what you call the "deflation" of prices than you are responsible for the action of the law of gravitation.

This "deflation" or decline in prices was not peculiar to our own country, and to attribute such declines here or in other countries to the policy of the Federal Reserve System is arbitrarily to assign it to an influence which it does not and cannot exercise but which is the result of those laws of action and reaction which have been at work from the beginning of things.

The first serious shock which the business world received, as a forewarning of what was likely to happen everywhere in the world, was the sudden and violent decline in the silk market in Japan and the demoralization of business and finance there. The significance of that decline was not grasped at the time. Then came along an equally violent decline in wool prices; the market simply disappeared overnight. Then came declines in sugar prices and in cotton prices, in copper, rubber, anda wide range of staple commodities. You might go around the world and in every land you would find a parallel.

This country waked up to the fact that the power to buy things at very high prices was limited by the income and disposition of a very large proportion of its population. The governments of the world were no longer buying goods in unlimited quantities for war purposes, and the peoples of exhausted countries had not the means to buy them, whatever their needs. Moreover the capacity for production, stimulated by the urgent demand of war and the consequent high prices, was tremendously increased. It gradually became apparent that the supply of raw products and the manufacturing capacity were both greater than the people were able to absorb. What was bound to be the result? Credit was powerless to sustain prices. From that time on it became, day by day, increasingly apparent that the supply of things which the peoples of the world were bound to have was greater than was supposed, and greater than their incomes would enable them to purchase at the prices exacted. A very large proportion of the world had little or no income with which to purchase anything, even the bare necessities of life, and hundreds of millions of dollars were contributed by charity in this country to meet the needs of such people.

Surely no man can contend, with any show of reason that these things were brought about by the policy of the Federal Reserve System and by interest rates established by Federal Reserve Banks, which rates at no time were really very high, and which were never as high as the rates charged by private owners of capital.

In one paragraph of your letter you state:

> "The policy has, of course, resulted in forcing down prices of agricultural products. This has always been the case following great wars, in which we always have great inflation."

In another paragraph of your letter you say:

> "We had 18 months of prosperity and business activity following the cessation of hostilities, and the present distressing financial conditions, therefore, are certainly not the natural aftermath of the World War but the result of the deflation policy as

outlined above."

There seems to be an inconsistency and even a contradition between these statements. It was during the period of "18 months of prosperity and business activity" to which you allude that the extraordinary expansion or inflation of bank credit took place, until it reached a dangerous point beyond which it could not have gone much further without an inevitable, sudden and violent collapse. It was during this period of what you call "prosperity" that the production of commodities, and particularly manufactured products of a peace-time nature, was stimulated and competition in the purchase of such commodities, under the cultivated belief that they would go still higher, resulted in rapidly rising prices requiring more and yet more credit to finance transactions. Moreover this should be taken into account, and it is an extremely important factor in considering business activity and the course of prices during the period to which you refer: After the armistice there remained about $2,500,000,000 of loans to foreign countries unexpended and available, and our large exports to Europe in 1919 were paid for very largely out of this fund, provided by the people in this country through Treasury loans. That situation in itself would have served to keep business active for a time.

For the full period of a year, the attention of the whole country was called to these conditions and the inevitable consequences. Rates of discount at Federal Reserve Banks were gradually raised, and warnings were given people to exercise restraint in the use of credit. But notwithstanding these warnings and increases of the discount rate, many writers who should have known better bitterly scored what they termed restrictions of credit when, as a matter of fact, credit was being continuously expanded. During the most violent stages of price adjustment, credit was being expanded, not contracted. Nobody would heed the warnings. The individual banks the country over lent out all of their reserves -- every dollar and more, too, -- and borrowed from Federal Reserve Banks to recreate or replace their reserves. It did not take long to discover that credit obtained against commodities and goods at high prices was being used to hold them off the market and create a belief in scarcity and force up the price. When this became well understood, the game was up.

You further state:

> "Millions of people in Europe and Asia who own lands, forests, mines and factories and who are industrious people are in desperate need of raw products, while on our side, <u>as a result of this policy</u>, we are being smothered by the very products which they are needing so badly. We are suffering not from overproduction but from under-consumption."

Can anyone explain how these millions of peoples in Europe and Asia who own lands, forests, mines and factories can use them in paying you for your raw products? Raw products are not usually paid for in any such way. The best thought of this country has been vainly searching for a way by which the people who have no liquid capital and little credit can buy our goods and by which we can safely sell them our goods under such conditions.

What has been done already in the way of granting them credit? Your statement appears to imply that there is some easy way of continuing it, and even that the Federal Reserve System has the power of doing it. These countries to which you allude already owe us the incredible sum of about 18 billion dollars, made up about as follows:

Advances for War Loans	$10,000,000,000
Surplus War Material sold Abroad	3,000,000,000
Due to American Exporters and Manufacturers	3,000,000,000
Due to American Investors, etc....................	2,000,000,000
Total	$18,000,000,000

There is a limit to this thing. Corporations have been formed for the purpose of aiding exporters to do more business with these foreigners described by you, but a very small amount of business has resulted, because no way has yet been found by which credit can safely be extended in large volume to people who cannot pay, or if they can pay at all can only pay by slow degrees as they accumulate capital. Our merchants are slow to take further risks. Doubtless you know that hundreds of millions of dollars in goods were repudiated by foreign buyers, and were left on docks unclaimed.

The English government agreed to assume 85% of the risk of its manufacturers in selling to these people whom you describe, but I am informed by very competent authority that comparatively little business has been done under that guarantee, because the English merchants are unwilling to assume the balance of 15% of the risk, and have found that the people have nothing available as a basis of credit and that they cannot safely extend credit. As to "underconsumption", it has always, everywhere been demonstrated that people under stress of circumstances can and will govern their consuming capacity, and that without material distress. The difference between extravagant and frugal consumption in this country alone, is sufficient to bring about temporary depression.

Is the Federal Reserve System to blame for these conditions?

You say:

"Unless these conditions are relieved through a lowering of the rediscount rate to, say, 4% on bonds and 4½% on agricultural and commercial paper, through a renewal of agricultural loans until markets can be opened and confidence restored, and through more liberal extension of credits, conditions will grow steadily worse and a large portion of the agricultural section of the nation willface universal bankruptcy."

Loans are being constantly renewed. In your State particularly, there has been practically no liquidation for a year. I am wondering what you mean by a more liberal extension of credits. There are 99 member banks in South Carolina, 91 of which are borrowing from us. (The 8 banks which are not borrowing, amount to a small sum in resources.) This bank is lending those 91 banks 308% of the amount which they contribute to the lending power of the Federal Reserve System. This is between five and six times the amount of the reserve deposits of those banks in the Federal Reserve Bank of Richmond. Take the two member banks in your city by way of illustration: We are lending to these two banks ten times the amount of their reserve deposits. Would you contend for a more liberal grant of credit than this? In some cases in South Carolina -- principally the cases of small banks -- we are lending ten to fifteen times the amount contributed by those banks to the lending power of the Federal Reserve Bank of Richmond. We are lending to the banks of North and South Carolina 47 million dollars, which is practically one-half of the largest amount ever borrowed at any one time by the national banks of the country prior to 1913, or before the establishment of the Federal Reserve System. Besides, the member banks of your State are borrowing between six and seven million dollars from other banks, which get the funds from the Federal Reserve System.

We often hear that the farmers cannot obtain credit from their local banks. What is the reason when the Federal Reserve Bank is lending its member banks so freely? As I have stated, the Reserve Bank is lending to some of these banks beyond all reason, and to all of them with the utmost liberality consistent with prudence. If, then, the banks, notwithstanding, are not in a position to lend to their agricultural customers as may be needed, it is due to one of two causes: First, a lack of capital in the community; or, second, to the management of the banks in placing their loans. In a very large number of cases, the banks have so loaned their funds that they have become tied up and they can do no more than renew the loans time after time. We, of course, have access to the statements of all member banks, and I feel that I am wholly justified in making the statement that the inability of banks to make temporary loans is due to the fact that they have so managed their funds as to allow them to become tied up. Sometimes the causes of this are beyond their control, but far more often indeed, due to the nature of the loans themselves. The experience of banking everywhere is that there is danger in heavy borrowing by banks, and the safety of the National Banking System was founded upon two principles: First: that no bank should become liable in an amount greater than its capital stock; and, second, in the limitation that was placed by the law upon the amount which a national bank could lend to one borrower.

This week I participated in a conference with cotton men from the far South, or men interested in the cotton business, some of them bankers. One of them stated that he was lending to his cotton borrowers all that he was willing to lend, which illustrates the principle which

I have enunciated above. These men appeared to have no delusion as to the causes of the decline of cotton prices, and stated that they, and many others whom they knew, more than a year ago when many people were advocating the holding of cotton for 40 cents, were selling their cotton as fast as they could and as fast as the market would take it, knowing what would come.

As soon as capital becomes sufficiently plentiful, the natural course of interest rates will be to decline. Nobody can say at this time that capital is plentiful. Then why should it be made artifically cheap? Look at the rates which cities, counties, and towns have to pay for their funds; Look at the rates which railroads and great manufacturing corporations have to pay for large loans; Look at the rates which governments, both foreign and domestic, have to pay for large loans; Capital can only be called abundant when banks have surplus funds of their own which they are anxious to place. It cannot be abundant when they are forced to borrow from other banks or from Federal Reserve Banks for the purpose of lending. It would, therefore, serve no good purpose for Federal Reserve Banks to lower their rates, but, on the contrary, would give a false impression as to the supply of capital. Banking institutions are not borrowing institutions; they arelenders, and the sound opinion everywhere is that banks should be borrowers only for seasonal operations which demand greater use of capital, or for extraordinary emergencies to tide over difficulties in individual cases. For banks to borrow in order to lend at a profit has been everywhere, at all times recognized to be an unsound practice. No bank can absolutely control the use of funds which it lends. Particularly is this true in the cases of large cities and large banking institutions. In my judgment, to lower the interest rate to any such figures as you specify would not only be responsible for a false idea as to the abundance of capital but would result in stimulating the use of liquid capital in directions in which by no means it ought to go under existing conditions, and would make the situation worse instead of better.

We are advised that your State Bankers' Association at their recent Convention unanimously rejected a resolution that the Reserve Bank rates should be reduced to the figures specified by you.

As for this bank, it is lending as liberally to its member banks -- particularly in South Carolina -- as any borrowers have the right to expect, and further "liberal extension of credits" in such cases could not possibly be allowed with prudence. When either banks or individuals are already borrowing more than their equitable proportion of available funds, and in many cases beyond the limits dictated by experience, prudence and safety, how can there be talk of still more liberal extension of credits? The trouble lies deeper than this, and it can only be cured by time and the reaccumulation of capital by the slow process of saving and the discharge of debts by the products of labor. There is no universal remedy, nor is there any specific cause for the declines of which you complain, but rather a cause complicated by and embracing the operations of all natural and economic laws.

Yours very truly,

(Signed) GEO. J. SEAY,

Governor.