REPORT OF JOINT COMMISSION OF AGRICULTURAL INQUIRY.

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REPORT OF

THE JOINT COMMISSION OF AGRICULTURAL INQUIRY.

Introduction.
(Page references are to pages of the report).

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The Senate concurrent resolution 4 which created the Joint Commission of Agricultural Inquiry, requires the commission to investigate and report to Congress upon six subjects.

This report deals with the fifth subject, namely, the banking and financial resources and credits of the country, especially as affecting agricultural credits. 7

Summary.

The difficulties of the farmer are due in a measure to the credit restrictions and limitations of the past eighteen months, and in part to the fact that the banking machinery of the country is not adequately adapted to the farmer's requirements. 7

The proposed bill to amend the Federal Farm Loan Act and the Federal Reserve Act. 9

Discount rates of Federal Reserve banks should normally be slightly above the market rates on the same class of paper. 11

Until our entrance into the World War, the rates of the Federal Reserve banks were, for the most part, above market rates on prime commercial paper. 11

Since our entrance into the World War, the rate policy of the Federal Reserve banks was subordinated to the requirements of the Treasury, and the Treasury policy of borrowing funds for the war at rates of interest below the market rate, and discount rates thereafter were below the market rates on the character of paper to which they applied. 11

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The cost of the war could not be met out of current taxes, and it was necessary to provide for immediate payments by means of the expansion of manufacture of credit. 11

This necessitated the use of the lending power of the Federal Reserve banks through loans to member banks at a rate of interest below the rate carried by the bond and certificate of indebtedness issues of the Government. 11

This policy induced large borrowings on the part of member banks from Federal Reserve banks, and larger expansion of loans and discounts of the member banks. 11

The greatest expansion of loans and discounts of all banks occurred in the period between November, 1914, and our entrance into the war. 12

During this period, the loans and discounts of all banks in the country expanded 40 per cent, while prices increased 75 per cent. 12

During the war period loans and discounts expanded 14 per cent and prices increased 17 per cent. 12

In the post-war period loans and discounts expanded 30 per cent, and prices increased 33 per cent. 12

In the early part of 1919, the question arose of increasing the discount rates of the Federal Reserve banks in the direction of the sounder policy of maintaining these rates above the market rates for commercial paper and above the rates on Government bonds and certificates of indebtedness. 12

At this time the Government was considering the flotation of the Victory loan which it was then thought would involve $6,000,000,000. 12

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The Treasury was unwilling to undertake the flotation of this loan at a rate of interest comparable with commercial rates on account of the possible effect upon existing issues of private securities, and its possible effect in requiring the refunding of the issues of Government bonds already floated. 12

The discount policy of the Federal Reserve banks was again subordinated to the Treasury policy in securing its credit requirements, although at this time the tendency toward expansion, speculation, and extravagance was beginning to be apparent. 12

This was clearly the time for a policy of advancing the discount rates of the Federal Reserve banks with a view of curtailing the expansion, speculation, and extravagance which was then beginning. 12

A policy of restriction by advances in the discount rates could and should have been adopted in the early part of 1919, notwithstanding the difficulties which the Treasury anticipated in floating the Victory loan if such a policy were adopted. 12

Had this policy been adopted in the early part of 1919, much of the expansion, speculation, and extravagance could have been avoided. 12

Had such a policy been adopted in 1919, the difficulties, hardships, and losses which occurred in 1920 - 1921 as a result of the process of deflation and liquidation would have been diminished. 12

The Federal Reserve banks and the Federal Reserve Board took no action in the direction of restriction by increases in discount rates until December, 1919, when slight advances were made, followed in January, 1920, by more radical advances and by further increases during the remainder of 1920. 12

In the meantime there began and continued a period of expansion, extravagance, and speculation, the like of which has never before been seen in this country, or perhaps in the world. 12

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When finally the Federal Reserve Board and the Federal Reserve banks adopted the policy of restriction, loans and discounts, currency and prices had reached such a point that deflation was accompanied by perpendicular and very material declines of prices accompanied with great losses and hardships. 13

The reserves of individual Federal Reserve banks, and of the system as a whole, began to dwindle rapidly. In some of the reserve banks, the reserves fell as low as 9 per cent, and at one time it is said that the reserves of one of the banks were entirely exhausted. 13

The tremendous drain upon the credit resources of the country brought about the over extension of many of the banks, and with some to the point where they were utterly unable to loan additional funds to their customers without danger of insolvency. 13

From 1915 to 1920, the ratio of loans and discounts of national banks to capital and surplus had increased from 3.8 to 1 to 5.5 to 1. 13

In many cases, further expansion could not be made without endangering the interests of depositors and stockholders. The policy of the Federal Reserve banks, therefore, during this period, underwent a change. Discount rates were raised, particularly upon certificates of indebtedness and Government bonds, resulting in the liquidation of this class of paper by the member banks, and the freeing of the funds invested in them for other purposes. 13

With the exhaustion of the credits of European Governments in this country, the purchasing power of Europe in our markets began to fail. This resulted in a sharp decline in exports, particularly of farm products. 13

This exhaustion of credit, coupled with the decline in exports, gave impetus to the decline in prices. 13

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With the beginning of this decline, the forces of reaction and depression began to operate. Goods were thrown on the market, orders were cancelled, the buyer's strike developed, unemployment ensued, and complete industrial depression followed. 13

Goods began to congest the channels of commerce, and more and more credit was required to carry these goods until they could be marketed. 13

It was necessary, by a high level of discount rates, to keep these credit requirements in such a relation to prices that bank failures would not result and a financial crash increase the inevitable industrial depression resulting from declining prices. 13

The commission believes that the policy of lower discount rates and greater liberality in extending credits could have been adopted in the latter part of 1920 and in the early months of 1921, and that such a policy would have retarded the process of liquidation and thus spread the losses incident to the inevitable decline of prices to a lower level over a longer period, and that the adoption of such a policy at that time would have been advisable. 13

About one-third of the banks at this period were greatly over-extended. 14

It was the position of the Federal Reserve Board that a policy of cheap money at this time, coupled with an invitation to them to further extend themselves, and the ratio of loans and discounts to capital, might have resulted in bank failures. 14

The Federal Reserve Board and Federal Reserve banks took the position that they were confronted with a choice between continuing the high discount rates and the consequent pressure upon commercial and agricultural industries on the one hand, and a policy of lower discount rates involving a possible financial crisis in the midst of an industrial crisis on the other. 14

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The Federal Reserve banks, with the approval of the Federal Reserve Board, took the first choice, and discount rates were continued upon practically the same level as before. 14

It seems probable that a change in the policy of the Federal Reserve system with reference to discount rates would have accomplished a reversal in part of the psychological and economic factors which at this time were moving in the direction of lower prices, and at the same time would have tended to induce on the part of the banks a more liberal attitude toward furnishing additional credit. 14

The pressure of discount rates and of liquidation in the agricultural sections resulted in great hardship, losses and sacrifice. These were not confined, however, to agricultural sections. 14

The pressure was greater upon the agricultural sections: -

(a) Because of the peculiar conditions surrounding the marketing of agricultural crops;

(b) Because the crops of 1920 had been produced at costs greater than those applicable to any other crops in the history of the country.

(c) Because prices of agricultural commodities declined to a greater degree and with greater rapidity than the prices of other commodities. 14

The liquidation of bank loans and discounts in agricultural sections was less than in the industrial sections. 14

In fact, but little actual liquidation of loans and discounts had taken place in the agricultural sections of the country as a whole up to May, 1921. 14

Certain exceptions noted:-

Liquidation of loans and discounts in the Kansas City district in the period between March 4, 1920 and April 28, 1921, amounted to 13 per cent, and was substantially

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as great in the agricultural sections as in the industrial sections.

In the Dallas district, the loans and discounts in agricultural counties were reduced 6.33 per cent, and in non-agricultural counties 12.6 per cent.

In the Minneapolis district, the loans and discounts were reduced 4.81 per cent in agricultural counties, and 12.02 per cent in non-agricultural counties.

The above does not mean that there was no pressure for liquidation in agricultural loans as well as industrial and commercial loans. It means rather that the prices received by the farmer were not sufficient to liquidate the debts he had made in producing the crop and in extending his plant and operations during the more prosperous period which preceded the crisis. 14

Liquidations in bank loans in the agricultural counties in the Kansas City district were materially larger than in the agricultural counties of the other Federal Reserve districts. 14

This enforced liquidation undoubtedly resulted in great hardships and losses from forced sales of farm commodities, particularly in the case of cattle. 14, 15

The deflation, hardships, and losses increased in the Kansas City district particularly, and in other districts in which the progressive rate was applied and by the application of progressive rates upon borrowing in excess of the basic line of the borrowing banks. 15

The pressure of liquidation may be indicated by a reduction in deposits as well as by a reduction in loans and discounts. This pressure in agricultural sections is exhibited by the fact that the reduction of total deposits (time and demand) in agricultural counties was 11.1 per cent as compared with 5.2 per cent in semi-agricultural counties and 4.4 per cent in industrial counties. 15

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In demand deposits, the reduction was 20.02 per cent in agricultural counties, 13.14 per cent in semi-agricultural counties, and 10.07 per cent in industrial counties. 15

It was contended that high rates for call money on the New York stock exchange brought a withdrawal of funds to New York which were sorely needed by industry and agriculture. 15

The rates for call money in New York during the period from January, 1920, to June, 1921, were continuously below 10 per cent, with the exception of the period from January to March, 1920. 15

Beginning with November, 1919, and continuously throughout 1920 and the first half of 1921, the loans of New York City banks made on the stock exchange for out-of-town correspondents as well as the balances of country banks with New York City banks continuously declined. 15

The Gold Settlement Fund statistics show the continuous flow of money on ordinary transactions from the Federal Reserve Bank of New York to other Federal Reserve banks during this period. 15

The very great demands for money by industry and agriculture resulted in the withdrawal of funds from New York, causing higher interest rates, - instead of the demands of the stock exchange resulting in the withdrawal of funds from the banks serving industry and agriculture. 15

The position of the Federal Reserve Board and the Federal Reserve banks during the war period and the cycle of expansion, extravagance, etc. which followed it, was extremely difficult. 15

Enormous issues of war bonds were floated through them and their auxiliary organizations. 15

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Their policy was not only interwoven with the policy of the Treasury Department, but subordinated to it. 15

The decisions which had to be made were difficult and important. 15

Doubtless in these circumstances mistakes of judgment were made which the clearer judgment of retrospect would change. 15

The commission believes that a policy of sharp advances in discount rates should have been inaugurated the first six months of 1919, and cannot excuse the action of the Federal Reserve Board and the Federal Reserve banks in this period in failing to take measures to restrict the expansion, inflation, speculation, and extravagance which characterized the period. 15

CHAPTER I.

The Federal Reserve System.

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CHAPTER II.

The Operations of the Federal Reserve System Related to Economic Periods.

Development of the Federal Reserve System 27

Periods:

I. November, 1914 - April, 1917.
II. April, 1917 - August, 1918.
III. August, 1918 - March, 1919.
IV. March, 1919 - June, 1920.
V. June, 1920 - June, 1921.

I. November, 1914 - April, 1917. 30

Prices increased enormously - 75%
Farm products from 101 to 181
Food from 105 to 182, etc. etc.
Wheat rose to $2.95 in May, 1917
Exports increased 352% mostly for war.
Bank loans, state and national, increased 41%
General stock of money increased 27.4%
Increase in price caused by
(a) War demand
(b) Gold imports
Federal Reserve bank rates higher than market rates. 31

II. April, 1917 - August, 1918. 36

Great increase in production
Great increase in prices
Farm products, - 181 to 230
Control of production and consumption
Food Administration
Fuel Administration
R. R. Administration
War Finance Corporation
Capital Issues Committee
Bank loans, state and national increased 11.9%
Federal Reserve bank discounts, etc. increased 171%
Federal Reserve notes increased 238%.
General stock of money increased 33.9%
Government excess of disbursements 12.3 billions financed by Treasury. 37, 38

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III. August, 1918 - March, 1919. Temporary deflation. 41

Prices declined
Production fell off
Exports fell off slightly
Loans and deposits of national banks practically stationary
Federal Reserve notes declined slightly
General stock of money declined slightly
Federal Reserve banks discouraged expansion by direct action but did not advance discount rates.

IV. March, 1919 - June, 1920. Post war inflation. 42

Great inflation
Great increase in prices. 33-1/3%
Great speculative activity.
Government restraints removed.
Farm products. 228 to 244
Food products 203 to 287
Loans and discounts, state and national banks increased 24.7%.
Federal Reserve bank discounts etc. increased 33.4%
Federal Reserve notes increased 24.7%
Exports sustained by loans of 2-1/2 billions to foreign Governments.

Prices and bank expansion.

	Price Advance.	Banking Expansion	
Prewar period	75%	40%	
War period	17%	14%	
Post war period	33%	30%	43

Government's revenues in 1919 overtook expenditures. 43

This released credit which would have reduced borrowings from Federal Reserve banks if rates had been increased so as to prevent credit being employed in speculative industries. 43

Up till 1919, total expenditures of Government for all purposes from beginning of war was 27.8 billions, of which 6.9 billions had been raised by taxation. 43

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No further bond issue could be made without added inflation or manufacture of credit. 44

Increase of Federal Reserve discount rates just before Victory loan would have diminished its success or compelled its failure. Leffingwell quoted. 44

Increased discount rates would have necessitated higher rates in Victory Loan issue.

Treasury objected.

If rate of Victory loan had been that of other taxable investments or of short term Treasury certificates, of acceptances (4-1/4%) or on commercial borrowings (5-1/2%) pressure to refund outstanding bonds on basis of higher Victory Loan rates would have increased and possibly have been irresistible. 44

Such high rates in Victory loan would increase interest rates generally and depreciate the value of the outstanding Government bonds carrying lower rates. 44

Might have caused large liquidation of securities other than Government bonds, and depreciation of securities held by savings banks, trust companies, insurance companies, etc.

The advantages of increased discount rates to prevent speculation and inflation yielded to the apprehensions of the Treasury. 44

<u>Treasury difficulties should not have controlled the Discount policy of the Federal Reserve banks.</u> 44

Had Federal Reserve banks in spring of 1919 increased rates promptly and progressively, much of the speculation, expansion and inflation of the succeeding 12 months might have been greatly retarded, if not wholly prevented. 44

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Loans and discounts of member and Federal Reserve banks continued to expand in spite of direct action and remonstrance. 44

The Federal Reserve banks, however, did not increase discount rates until December, 1919, when slight increases were made, followed by more radical increases in January, 1920 and others later in 1920. 45

Meantime the inflation and speculation continued and prices went to unheard of levels.

Sharp increases at beginning of this period would have:

(a) Served as warning.
(b) Served to check the economic and psychological forces which combined to produce an unparalleled era of expansion, inflation, high prices, etc. 45

It is altogether probable, if it is not wholly certain that had a sound policy been adopted at the beginning of this period, liquidation would have been less precipitous, the decline less abrupt, and the attendant hardships and losses upon banks, individuals, etc. correspondingly diminished. 45

V. June, 1920 - June, 1921. Deflation and Liquidation. 45

Spring of 1920. Deflation began 45

Exports declined
Consumption fell off
Stream of production flowing from farmer to consumer backed up in channels of distribution.
Higher discount rates and tight money operated as dikes to keep goods flowing in channels of trade.
Prices fell below cost of production.
Cost of production higher in 1920 than in any preceding year.
Receipts from farm products could not liquidate the indebtedness against them and provide for new production.
More credit needed to finance new production and carry 1920 production until it could be moved. 45

Buyers' panic at end of 1919. 45

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Supply not adequate to meet demand.

Marked increase of orders. 45

A runaway, sellers market. 46

Suddenly bubble burst
Cancellation of orders
Prices fell precipitately
Causes:-
(a) Wave of cancelled orders
(b) Fright accompanying it
(c) Exhaustion of credit preceding it.
Price decline without parallel in 120 years. 46

These conditions forced upward the loans and discounts of state and national banks and deposit and currency liabilities of Federal Reserve banks. Figures. 46

During this period, the policy of Federal Reserve rates lower than rates carried by Government securities passed away. 46

Discount rates during this period were more radical in increase than any previously adopted. 47

Especially so as to increase on collateral notes secured by Government obligations, which were increased from 4-3/4 to 5% in some cases, from 4-3/4 to 5-1/2 in others, and later to 6%. 48

These increases were under general policy of uniform rates on all paper of the same maturity regardless of the collateral supporting it. 48

Claimed to be sound central banking practice. 48

All loans for same maturities by Federal Reserve banks, being indorsed by member banks are presumed to be good, whatever the collateral, commercial paper or Government paper, and should take same discount rate. 48

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That is to say:-

Difference in rate should be based upon maturity and not on character of collateral.

Sixty-six per cent of borrowings of member banks at this time were based on Government paper.

The increase in discount rates thus forced banks to dispose of much of their holdings of this kind of paper.

This released funds invested in war paper and made possible a reduction of member banks borrowings from Federal Reserve banks. 48

This theory is sound and in line with central banking practice.

Its application at this time resulted in hardship upon some member banks, and was, perhaps, needlessly drastic. 48

Federal Reserve banks, as previously stated, to aid Treasury finance, gave a preferential rate in favor of paper secured by Government bonds.

The effect of above increase:

(a) Penalized the member bank borrowing on Government securities owned by it, for the benefit of its customers.

(b) Penalized the banks loaning at low rates to customers on their notes secured by Government bonds.

(c) Destroyed advantage of Government bonds as basis of loans by member banks from Federal Reserve banks.

(d) Induced liquidation of these bonds by member banks.

This tended to depress price of Government bonds. Tables. 48 and 49

During a period of sharp and short duration, of unusual expansion and contraction, curves representing (a) movement of loans and discounts, (b) movement of deposits, (c) movement of prices, would tend to run parallel. 49

The chart showing this, - B page 51, - shows prices falling while (a) increase, and thus it is apparent that the strain of credit becomes greater and greater. 49

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The point of greatest stress upon credit would occur at point at which the curve of loans and discounts and currency issues, and the curve showing prices and stocks of goods were the furthest apart. 49

If this condition continued, the credit structure would break, with resulting panic and bank failures. 50

That is, as prices fall and loans and discounts increase, the margin diminishes.

Debts must ultimately be paid out of goods. 50

The higher price of goods, relatively, the more easily the debts can be paid.

The more debts to be paid, the more difficult to pay under falling prices. 50

Assuming a drop in prices inevitable in 1920, some action of Federal Reserve Board was necessary to bring the debts to be paid into a closer relation to the price of goods. 51

Position of Federal Reserve Board very difficult in period following armistice.
(a) Duty of Board and banks to provide for essential credits.
(b) Duty to limit credits for non-essential and speculative credits.
(c) Duty to prevent banks to overextend. 51

Balance between these was extremely delicate.

It is probable that the Federal Reserve Board and some of the Federal Reserve banks, with a view to preserving the integrity of the banking system, and to prevent a financial panic, imposed excessive pressure in the direction of reduction, or at least, prevention of expansion of loans and discounts of the member banks. 52

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Policy of Federal Reserve Board and Federal Reserve banks during all of this period, and increasingly during latter half of 1920, was one of restriction of credit. 52

An alternative policy would have been extension of all credit desired for any purpose.
Would have involved dangers:-
(a) Might later have resulted in large number of failures.
(b) Undue reduction of reserves
(c) Excessive currency issues resulting in depreciated currency.
(d) Loss of confidence in banking system, runs on banks, and demands for redemption of Federal Reserve notes in gold. 52

Increased discount rates could be effective only against banks borrowing from Federal Reserve banks. Tables. 52
Tables show 6941 banks (73%) were borrowing from Federal Reserve banks and 2467 (27%) not borrowing, in year 1920. 52, 53

Federal Reserve Board and Federal Reserve banks can not directly control or supervise the loan policy of member banks; can not require a bank to make a loan, nor prohibit it. 53

Nor can they directly control loan policy of 20,000 state banks and trust companies, not members, representing 35 or 40% of bank resources of U. S. 53

Only restraint, restriction of credit against member banks, through:
(a) Refusing loans in individual cases.
(b) Pressure of discount rates on those which were borrowing

Restraint was exercised in both (a) and (b).

There were cases where it resulted in hardship on member banks and on their customers. 53

The policy of Federal Reserve banks reflected necessity for control, restraint and restriction. 54

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Could not be uniformly applied:
(a) Conditions in districts not uniform; demands for customers loans in some districts greater in proportion to banking resources than in others.
(b) Condition of member banks not uniform.
(c) Loan policies of member banks influenced more by individual judgment of local conditions than by considerations of general policy affecting country as a whole. 54

Question of loans by Federal Reserve bank different from loan by a member bank.
Amount of a loan to a member bank only arises when member bank attempts to borrow more than amount to which it is fairly entitled. 54

While loans and discounts of banks and Federal Reserve banks increased until October, 1920 and currency issues until Jan. 1921, the net result of the period from June, 1920 to June 1921 was a decline. 54

Loans and discounts, all banks, state and national declined 9.5%.

Loans and discounts of national banks declined 11.8%

Total bills, etc. of Federal Reserve banks declined 36.3%

Federal Reserve notes in circulation declined 18.5% 55

General stock of money <u>increased</u> 3.4%

From June, 1920 to June, 1921
Prices decreased 44.9%
Loans and discounts decreased 18%
Farm products decreased 53.9% 55

Federal Reserve bank reserves increased from 43.6 to 60.8% caused
(a) Liquidation of member bank borrowings
(b) Net importations of gold 55

Progressive rates explained
(See also p.25) 55

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In districts where progressive rate applied, and in some others, the resources of the Federal Reserve banks were largely absorbed by a relatively small number of banks. 56

This absorption reduced ability to lend to other member banks. 56

Progressive rates by penalizing banks which were borrowing excessively, tended to reduce their borrowings, making a larger amount of funds available for banks borrowing moderately or not at all. 56

Commission able only to obtain data as to progressive rates in Kansas City District. 56

Complaints against progressive rates.
1. Resulted in exorbitant rates on member bank loans.
2. Excessive pressure on member banks to reduce borrowings from Federal Reserve banks.
3. Excessive rates on borrowings of some banks and consequent hardship.

Kansas City District fairly typical. 56

Chart C, p. 57, shows:
Jan. 1920. 14 Kansas City banks had absorbed 34% of normal lending power of the Federal Reserve bank, and 9 Omaha banks 23.5%. Total 57%. 56

April 1920. The 14 Kansas City banks had absorbed 50% and the 9 Omaha banks 23%. Total 73%. 56

This left only 27% of normal lending power for the 1063 other member banks. 56

In period from April, 1920, to December 31, 1920:
Banks not previously borrowing had absorbed 12%. 57
Borrowing banks increased from 178 (16.8 of all banks) to 416 (38.3% of all banks).
Borrowing banks total borrowings from Federal Reserve bank increased from 106.8 millions to 117.3 millions or 9%.
Borrowings of the 14 Kansas City banks fell off from 50% to 36%, and the 9 Omaha banks fell off from 23% to 13%. 57

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Progressive rates compelled reduction in proportion of lending power absorbed by 14 Kansas City and 9 Omaha banks. 58

Also permitted use of lending power to meet requirements of other banks previously borrowing moderately or not at all. 58

Chart D, p. 59 shows distribution of credit based on loaning power of Federal Reserve bank including rediscounts from other Federal Reserve banks which were not included in Chart C, p. 57. 58

Chart D shows similar decline in absorption by the 14 Kansas City banks and 9 Omaha banks (progressive rate banks). 58

Shows also that all other banks paying progressive rates, - exclusive of those in Kansas City and Omaha, - continued to increase their borrowings until December, 1920, during period of sharpest decline of the borrowings of the Kansas City and Omaha member banks. 58

Shows also:

That banks borrowing within their basic line <u>increased</u> until August, 1920, when they absorbed 31% of total lending power of Federal Reserve bank. 58

From August, 1920, to December, 1920, they declined to 17%. 58

Chart also shows that effect of progressive rate was to reduce borrowings of city banks and to permit an increase in borrowings of country banks. 58

What actually happened, as the chart shows, was that the borrowings of the Kansas City and Omaha banks were transferred to country banks, thus increasing their proportion of borrowings subject to progressive rates and decreasing that of the Kansas City and Omaha banks subject to progressive rates. 58

Table, p. 60, shows gain in rates paid on progressive plan over what they would have been under a uniform 7% rate. 59

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Average rate paid by banks borrowing at progressive rates, 6.76% 62

Average rate paid by all banks at normal and progressive rates, 6.61% 62

Total interest paid by all banks in Kansas City was $325904.78 less than if 7% rate had been in effect. 62

Chart also shows:
If all banks in district had borrowed total amount of basic lines, the liabilities of the Federal Reserve bank would have been extended by 50 millions of dollars. 62

Governor Miller testified that total amount of interest in excess of 12% refunded to country banks was less than $300. 62

Interest charges made by member banks paying progressive rates were same as those paying normal rates or those which had not rediscounted at all with Federal Reserve banks. 62

Interest charged by member banks subsequent to application of progressive rates were no higher than rates charged before. 62

Whatever may be said as to effect of progressive rates on the average, both as to compelling liquidation and average rate of interest, the fact still remains that:

(a) Its application in many instances resulted in unconscionable rates upon the borrowings, or some portion thereof, of banks borrowing in excess of their basic line. 62

(b) Its application served to exert pressure for liquidation upon those banks and communities where the needs were greatest, that is, to penalize the banks making the greatest efforts to serve their customers. 62

The application of such a uniform and arbitrary rule to all banks *** without regard to peculiar circumstances *** can not be justified from standpoint of sound banking, nor from standpoint of the consideration to which the public is entitled from banks *** exercising public functions ****. 62

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The infirmity of the progressive rate is its substitution of fixed, arbitrary rule for the exercise of sympathetic discretion in making loans. 63

Deflation was more rapid in Kansas City District than in other fairly comparable agricultural districts. 67

Relative degree of deflation of loans and discounts in country as compared with city banks.

Country banks increased their borrowings in all districts except Kansas City. 68
Amounted to 33%. 68
Chicago increased 83%
Minn. " 29%
Dallas " 15%
Atlanta " 44%
Richmond " 27%
Kansas City decreased 4%. 68

Progressive rate was in effect in Atlanta, St. Louis, Kansas City and Dallas
Not in effect in Chicago and Minneapolis 68

Examination of tables shows:-

1. Amount and rate of deflation was not controlled by progressive rates.
Rate of deflation was 35% in Kansas district ,(progressive rate) and 35% in Minneapolis (non progressive rate).
The non-progressive rate banks of Chicago decreased 30%, while Dallas (Progressive rate) decreased 12% and Atlanta (progressive) <u>increased</u> 26%. 68

2. The reduction in loans and discounts in country banks was relatively less than in city banks. 68

Chart F, page 79 shows:
Borrowings of member banks in Atlanta and Richmond were in excess of total basic lines during entire period from June 1920 to July 1921. 78

Borrowings of member banks in Minneapolis district were in similar excess except in March and April, 1921. 78

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CHAPTER III.

Chapter III.
Policy of Treasury in relation to Federal Reserve policy. 80

It is assumed that war requirements could not be immediately provided out of increased production or decreased consumption. 80

Some portion of cost of war must have been furnished through increase of bank credits.

This credit was in part manufactured credit.

Principal question was rate of interest Government bonds should bear. 80

Two policies possible:-
1. To sell bonds at market rate or at a relatively high rate 80

2. To sell bonds below market rate or at a relatively low rate. 80

Considerations favoring 1.

(a) High rate would encourage saving.
(b) Would result in transfer of existing capital from non-essential and low rate investments to Govt. bonds.
(c) Would absorb free capital, discourage non-essential production.
(d) Would limit expansion and inflation
(e) Would reduce consumption
(f) All of above would retard rise of prices.
(g) Lower prices would reduce amount of money needed by Government.
(h) The higher rate would have tended to maintain the price of Government bonds at par. 80

Considerations favoring 2.

(a) Treasury should secure funds at lowest possible rate 81

Sound only if same amount of money required to finance war at high as at low rate of interest. 81

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Considerations favoring 2 (Continued) | Page No.

(b) Any policy should avoid too sudden changes in rates which would cause rapid changes in general interest rates, with resulting dislocation and embarrassment to industry. 81

Commission is of opinion:

Advantage of low rates more than offset by the inflation it caused and the attendant high prices. 81

Low rate policy increased total expenditure for interest and principal of debt.

Investors, buying from patriotic motives suffered:-

(a) From low rates and consequent depreciation of market value of the bonds.

(b) Whole country suffered from increased cost of war

Advantage or disadvantage of the 2 policies is measured by inflation necessarily following either.

The inflation under the low rate policy was measurably greater than under high rate policy. 81

Method of inflation or manufacture of credit by Federal Reserve banks.

(a) Buyers were encouraged to borrow money with which to purchase Liberty bonds at same rate as that paid on the bonds, depositing the bonds as collateral. 81

(b) This increased loans and discounts of the lending banks and also deposits to credit of Government.

These bonds carried themselves.

The Government left the funds with the banks for some weeks at 2% interest and no reserve was required.

The banks made a profit and the increase of their deposits gave larger sums for short time loans to their customers, this tending to cause inflation. 81

(c) When the Government called for these funds the banks would obtain advances from Federal Reserve banks on their notes with the bonds as collateral, or they would rediscount the notes of their customers, so secured. 82

(d) The proceeds of every $5 would appear on Federal Reserve bank books as about $2 in deposits and $3 in Federal Reserve notes 82

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On the deposits thus created future loan expansion by the member banks would arise. 82

(e) According to Persons, a deposit in Federal Reserve Bank of $100,000 will support 1.1 or 1.2 millions of loans by member banks, 11 or 12 to one, and will permit an equal increase in Federal Reserve notes and deposits of member banks combined. 82

(f) The Government, on withdrawing these funds, usually paid them to American producers of war material, either directly or through loans to allied Governments.

(g) These funds promptly came back to the banks as commercial deposits.

(h) This increased the assets and liabilities of the Federal Reserve banks and member banks.

This procedure forced Federal Reserve banks to extend credit without loss to the member banks. 82

Or even to furnish a profit to the member banks in the first instance by discount rates lower than rate borne by the bonds. 83

Thus the successful sale of Liberty bonds at low interest rates was necessarily predicted on low discount rates by the Federal Reserve banks. 83

This low rate policy was contrary to the policy of the great financial countries of the world prior to the war and in some cases during the war. 83

Certificates were also issued in anticipation of loan and tax payments. 83

More important in creation of bank credit and expansion of loans and discounts than Liberty bonds or Victory notes. 83

Reason was:-
Primary ownership largely remained with the banks.
Difficult or impossible to sell them on an investment basis

This made necessary disposal of the bonds to the banks on a basis which would make it profitable for the banks to handle them. 83

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The banks received a larger return from the purchase of certificates than the rate borne by the certificates.

The banks gave credit to Government for their subscriptions. This increased equally its deposits and loans.

While the banks paid 2% on these deposits, they need keep no reserve and they often were not drawn out by the Government for a considerable time.

When called for, the banks could borrow from Federal Reserve bank at a rate no higher or even lower than the certificate rate. 83

In this way a proportion of the credit expansion implied in making these loans was transferred to the Federal Reserve bank. 83

As the deposits thus created in the Federal Reserve banks were drawn upon by member banks for vault cash and till money, part of these deposits were converted into Federal Reserve notes. 83

When the funds were paid by the Government to manufactures, etc. they promptly returned as individual deposits. 84

Against these deposits the banks had to keep reserves, thereby increasing the loans and deposits liabilities.

On sale of the long time Government bonds, the certificates issued in anticipation were retired.

In so far as the bonds were purchased by investors who did not have to borrow, the inflation was reduced, because the redemption of the certificates reduced the bank investments and the banks could reduce their debt to the Federal Reserve banks and thus prepare for another period of short time Government accommodation. 84

CHAPTER IV.

Federal Reserve policy in 1920. 85

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In Sept. 1920, decline of prices well under way.

General index fell from 272 to 242
Agric. products " " 244 to 210

Lower discount rates demanded to check this decline

Claimed fall in prices due to high discount rate policy of Federal Reserve banks.

Lower discount rates were asked in order to arrest process of liquidation.

No change in policy was made. 85

Factors in rate making:-
(a) Condition of lending banks
(b) Reserve ratio of Federal Reserve banks
(c) Possibility of gold withdrawals
(d) General condition of business

Causes of decline in prices, especially of agricultural products:
(a) Falling off in exports. 85
(b) " " speculative demand. 86
(c) Reduction in domestic consumption in latter part of 1920 and first half of 1921. 86
(d) Psychological attitude of the people. 86

In 1919 great complaint against high cost of living. 86

Senate Resolution, May 17, 1920.
Asked Board steps it proposed to take to meet existing inflation of currency and credit and the consequent high prices. 86

Newspaper propaganda, coupled with expansion of credit *** reversed the psychological attitude which had contributed to inflation of prices and bank credit. 86

The drop in prices, heralded as beginning of deflation introduced psychology of fear into bankers minds.

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Made them ignore banking maxim that in times of credit strain, money should be lent freely though at a high rate.
Made them exert pressure for liquidation. 86

Merchants were forced to sell stocks to liquidate loans.
Buyers bought only from day to day.
Orders were cancelled.
Consumers bought only for immediate essential needs. 86

Production slowed down.
Unemployment increased.

A change in Frederal Reserve policy would probably have reversed in part the psychological and economic factors tending to lower prices. 86

Would have tended to produce a more liberal attitude in banks as to furnishing additional credit.

Such a change of policy would necessarily mean an extension of loans.

Desirability of such a change in policy must depend on supply of funds available.

Banks can lend freely only when their condition will admit without endangering interests of depositors and stockholders. 86

What was the condition of the banks in last part of 1920:

Varied widely 87

One-third were greatly extended

One-third moderately extended

One-third loaning within very conservative limits. 87

This condition shown by numbers borrowing from Federal Reserve banks:

One-third borrowing very heavily
One-third borrowing moderately
One-third borrowing not at all. 87

Those not borrowing at all could meet their requirements by borrowing from Federal Reserve banks.

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Those borrowing moderately could borrow more.

Those borrowing immoderately could not extend further credit without danger of their solvency.

Where a bank is in latter situation, where additional loans dangerously decrease ratio of capital to loans and discounts, or to deposits, the remedy is to increase its capital and not increase its borrowings from the Federal Reserve banks. 87

Banking capital has not kept pace with deposits during the period of deflation.

From June 30, 1913 to June 30, 1920:-
National banks
Deposits increased 109%
Capital and surplus increased 22%

Ratio of capital to deposits:
1913. 1 to 5.45
1920. 1 to 10.89. 87

Margin of safety had thus decreased 50%.

Ratio of capital to loans and discounts:-

1913. 1 to 5.84.
1920. 1 to 9.95. 87

If capital had maintained same ratio as deposits, 16.8 billions of additional loans could have been made by member banks. 87

This possible expansion is wholly theoretical, as it would be limited by reserve requirements which would greatly reduce its aggregate. 87

It is clear that in many cases, inadequacy of capital and not insufficiency of Federal Reserve bank credit was a factor which limited and restricted credit during this crisis. 88

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Federal Reserve Board and Federal Reserve banks bound to consider effect of a more liberal policy.
Must result in more loans. As banks loan in period of falling prices the strain upon credit becomes more and more pronounced. 88

Danger of bank failures increases.

Federal Reserve Board and Federal Reserve banks felt this danger of bank failures was a real menace, which would have been greatly increased by a discount policy sufficiently liberal to arrest the process of liquidation. 88

The Commission, however, believes that notwithstanding this danger, a more liberal policy could have been adopted in the latter part of 1920 and the early part of 1921, and that it would have served to arrest in part the tide of deflation and reduce the hardships and losses incident thereto. 88

Whatever may be said of the policy adopted from the standpoint of wisdom and necessity, in the light of the psychological and economic factors necessary to be considered, it is evident that the application of the policy in the rural sections resulted in great hardship and distress and contributed to some results economically undesirable. 88

This hardship was due, in large measure:-

(a) To excessive cost of producing the 1920 crop

(b) To the slower turnover incident to farming operations.

Pressure for liquidation compelled in many cases the sale of immature cattle and calves which seems likely to result in a shortage of meat supply during the coming season of production. 88

The pressure for liquidation forced sales while a wiser and more discriminating policy would have suggested carrying the borrower until less disastrous sales could be made. 88

Farmers difficulties were increased:-
Prices of what he sold declined faster than prices of what he had to buy. 89

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Had the change in policy, if carried out, arrested the decline in prices of what he had to buy, without arresting the decline of prices of what he had to sell, his condition would have been worse than what it was. 89

Federal Reserve banks ratio of reserves in May 1920 had fallen to 42.7%.

Omitting inter-Federal Reserve bank rediscounts, the ratio of reserves in many of the southern and western Federal Reserve districts was far below 40%. 89

In Atlanta, Minneapolis, Kansas City and Dallas, the reserve ratio, unadjusted, fell below 20%, at times during last half of 1920. 89

At one time during 1920, 7 of the Federal Reserve banks were borrowing from the other 5. 89

The Federal Reserve Board could have suspended the reserve requirements, but would have created an anomalous condition:-

The purpose of the suspension would be to enable member banks to increase loans.

The banks, however, would have to pay a tax on the reserve deficiency. 89

The purpose of the tax, to be added to the discount rate, is to cause a reduction in borrowings from Federal Reserve banks, so as to bring up the reserve ratio to required amount of 40%. 90

To have suspended reserve requirements in latter half of 1920 would be to encourage larger borrowings from the Federal Reserve banks, on the one hand, and to discourage them on the other, by increase in the discount rate. 90

Studies made by Commission:

1. Was expansion in bank loans during the 4 or 5 years ended with June 1920 more or less rapid in rural districts than in financial and industrial centers? 91

Examined into by Dr. David Friday. 91 to 101

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The tables prepared by Dr. Friday show:-
The expansion in agricultural states during the period of inflation was at least as great, if not greater, than in the industrial states. 101

Another study in cooperation with the Federal Reserve Board and Federal Reserve Bank of New York:

Between May 4, 1920 and April 28, 1921.

(a) Loans and discounts.

Banks in agricultural counties declined.	1.2%
" " semi- " " "	1.3%
" " non " " "	5.6%

(b) Borrowings from Federal Reserve banks.

Banks in agricultural counties increased	56.6%	
Banks in semi " counties remained stationary		
" " non " " declined.	28.5%	101

Pressure of liquidation is also shown by reduction of deposits in above study.

Agricultural counties decreased	11.1%	
Semi " " "	5.2%	
Non " " "	4.4%	115

This reduction is emphasized as to agricultural counties by fact that time deposits increased except in Minn. and Kansas City districts. 115

Increase was over 594 millions or 10% 116

Demand deposits

Agricultural counties decreased	20.02%	
Semi " " "	13.14%	
Non " " "	10.07%	116

In agricultural counties, demand deposits decreased 469 millions while loans and discounts decreased only 36.5 millions. 117

Means that farmers being unable to sell their products for enough to liquidate their loans, or to sell them at all in many cases, drew down their deposits to pay their debts to merchants, factors, etc. who in turn paid the wholesalers or manufacturers, who in turn, liquidated their bank loans. 117

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This process, added to the liquidation in industrial sections, resulted in a total reduction of bank loans of 827 millions and a reduction of total deposits of 665.7 millions. 117

Conclusion of commission from above studies:-

1. Expansion of bank loans in rural districts during inflation period ending June 1920, was relatively greater than in industrial sections. 117

2. The action of the Board and Federal Reserve banks during the 15 months preceding April 28, 1921, did not produce a greater curtailment of bank loans in rural districts than in the financial and industrial sections. 117

3. Credit was not absorbed by the financial centers at the expense of rural communities for the purpose of speculative activities.

4. The pressure of liquidation and depression in the agricultural sections was reflected in a reduction of deposits, which was relatively larger in agricultural and semi-agricultural counties than in the industrial centers. 117

These conclusions are supported by an analysis of borrowings of member banks from Federal Reserve banks, dividing the Federal Reserve districts into:-

1. Industrial section.
   Federal Reserve banks of Boston, New York, Philadelphia and Cleveland.

2. Cotton section
   Federal Reserve banks of Richmond, Atlanta, and Dallas.

3. Agricultural and live stock section.
   Federal Reserve banks of Chicago, St. Louis, Minneapolis, Kansas City and San Francisco. 118

Table 35.
Total amount of all paper held by Federal Reserve banks during period from January, 1920, to May 31, 1921, divided into 3 sections, - industrial, agricultural and live stock, and cotton. 118

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Comparison with peak, - October, 1920, and May 31, 1921.

1. Total paper, all districts.

Industrial fell off from 109 to 66.3 = 42.7

Agricultural and live stock fell from 109.4 to 82 = 27.4

Cotton section fell from 112.6 to 92.5= 20.1

2. Agricultural paper, all districts.

From January 1920 to May, 1921. Rose from 27.1 to 178.1

In agricultural section rose from 66.8 to 259.8
In agricultural and live stock section
rose from 34.1 to 184.8
In cotton section " " 8 to 158.2 119

3. Live stock paper

Industrial section. Rose from 10.4 on Jan. 30, 1920
to 303.6 in August, 1920.
August 20, 1920 to May 31, 1921, fell to 43.8
Not sufficient in volume to be indicative. 120

Cotton section.

Rose from 32.5 in Jan. 1920 to 161.2 in April 1921.
Fell to 169.2 in May, 1921.

Agricultural section.

Rose from 44.3 in Jan. 1920 to 136.5 in Oct. 1920, and
then fell to 84.4 in May 1921. 120

All districts combined.

Rose from 42.3 in Jan. 1920 to 136.9 in Oct. 1920 and
then fell to 96.2 in May 1921. 120

This table indicates:

(a) The increase in discounts of agricultural and live
stock paper was relatively greater than that of
all other paper.
(b) The liquidation of discounts of agricultural and
live stock paper was relatively less than the
liquidation of all other discounts. 120

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CHAPTER V.

Federal Reserve policy as indicated by a comparison of interest rates on U. S. certificates, bank acceptances, commercial paper, and discount rates. 121

New York is the money center of the U.S.

Transactions in U.S. certificates, acceptances (domestic and foreign), bankers acceptances, and commercial paper, center in New York.

The discount rates of Federal Reserve Bank of New York, therefore, indicate the general relation between interest rates and discount rates. 121

Chart K. p. 122
Shows relation between Federal Reserve Bank of New York. Discount rates and the market rate for U.S. certificates, bankers acceptances and commercial paper.

From Jan. to April 1920.
Federal Reserve bank rate lower than market rate for all above except U.S. certificates.

Since Jan. 1921.
Federal Reserve bank discount rate higher than U.S. certificates and bankers acceptances but lower than market rate for commercial paper. 121

Relation between Federal Reserve bank rates and market rates is important for reason that when Federal Reserve bank rate is higher than market rates, banks would derive profits from paying off their indebtedness to the Federal Reserve bank. 121

Chart L. p. 123
Relation between rates of issue of U.S. Treasury certificates and rate of Federal Reserve Bank of New York on advances on such certificates.

Chart M. and table 36 p. 124
Comparison between Federal Reserve Bank of New York. Discount rates on 4 to 6 months commercial paper, with the market rate.

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Until April, 1917, entrance into war, the Federal Reserve bank discount rate on commercial paper was higher than the market rate. 125

After April, 1917, was always lower. 125

Charts N and O.
Relation between minimum discount rate of Bank of England and the market rates on 90 day bills. 125

Bank of England rate higher than market rate. 125

Chart K.
Shows that Federal Reserve Bank of New York discount rates on U. S. certificates, since January, 1921, has been above market rate. 122
Also that Federal Reserve bank discount rate on acceptances since January, 1921, has been above the market rate. 122

Tables 38 and 39.
Official discount rates. Foreign central banks. 127

These tables show:-
Discount rates of Great Britain, Spain, Denmark, Japan and Norway were increased before those of the Federal Reserve Bank of New York. 128

Japan.
Oct. 1919. Increased from 6.5 to 7.3%
Nov. 1919. " " 7.3 to 8.03%
Coincident with break in the silk market and resulting financial crisis. 128

CHAPTER VI.

Earnings of Federal Reserve banks as related to Federal Reserve policies. 129

Public service and not profit is the purpose of the Federal Reserve system. 129

Profit from discount rates should not be and has not been a factor in determining rates. 129

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No incentive to profit because of the franchise tax. 129

Profits depend on volume of member bank borrowings and bills purchased. 129

Borrowings are larger in times of financial stress, and, therefore, gross profits are larger. 129

Table 40, p. 130.
Profit and loss account of Federal Reserve banks, 1920. 130

Gross earnings.
1920. 181. 2 millions. 130

Net earnings.
1920. 149.2 millions. 132

Dividends. 5.6 millions
Surplus 82.9 "
Franchise tax
60.7 "

Conclusion of commission
Profits of Federal Reserve banks bear no relation to policy of Federal Reserve Board and Federal Reserve banks in determining discount rates. 132

CHAPTER VII.

Movement of funds in and out of New York City. 133

Banking resources of New York City:-
2/5 of resources of all national banks in U.S.
1/5 of resources of all banks in U.S. 133

New York City is financial center of U.S.

New York City is today the money market of the world. 133

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Question to consider:-
Was credit or funds drawn from the interior to the financial centers. 133

Chart P.
Rise and decline of deposits in New York City and rest of country. 134

During 1919.
Deposits outside of New York City rose from 7.5 billions to 9.1 billions.

During 1920.
This level maintained outside of New York City.

During 1920.
Deposits of New York City banks fell off 370 millions

During 1920.
Decline of deposits of all banks accounted for by decline in New York City. 133

During 1921.
Deposits of banks outside of New York City began to decline but at much slower rate than in New York City 133

July 13, 1921.
1. Banks outside of New York City
Fell from 9.1 billions to 8.7 billions. 4%
2. New York City banks
Fell from 5 billions on Dec. 31, 1920 to 4.5 billions on July 13, 1921. 10% 133

Chart Q.
Shows same. 133

Table 41, page 135.
Percentage of decline. Loans and deposits.
New York City banks and all banks in U.S.
Loans and deposits reached peak earlier in New York City than in country as a whole. 135
Total decline of both loans and deposits was greater proportionately in New York City than in country as a whole. 135

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Chart B.
Balances of out of town banks with New York City banks.
Loans placed by New York City banks for out of town banks, on call. 136

During expansion of 1919 until Jan. 1920:-
These balances increased rapidly
Balances of out of town banks were 840 millions
Loans placed for them by New York City banks were 680 millions - total 1.5 billions. 136

From Jan., 1920 - Jan., 1921:-
These balances and loans decreased 450 millions.

From Jan., 1921, to July 20, 1921:
Decreased an additional 175 millions. 136

These reductions indicate:
(a) A movement of money away from New York City to the country sections during the period of greatest stress in the country districts.

(b) That instead of money being drawn from the interior to New York City, the opposite was the case. 138

Above conclusion is fortified by gold settlement fund transactions.

Table 43 A.
Gold settlement fund transactions Jan. to June, 1920.

Table 43 B.
July to December, 1920. 138

Table 43 C.
Jan., 1921, to July 20, 1921. 139

Above statements cover period from Jan., 1920, to July 20, 1921. 139

Results in entire period.
Ordinary transactions.
Net loss to N. Y. 1.7 billions.
Offsets.
Treasury deposits. 1.0 billions.
Balence on sales and purchases of acceptnaces 629 millions. 140

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Statement shows distinct tendency towards withdrawal of funds from New York City banks through check clearances, offset only by extraordinary transactions. 140

Tables 44 A and 44 B.
Loans to and deposits from out of town correspondents.
November 15, 1920.

Table 44 A.

Total loans outside New York district	1.3 billion
Total loans and investments	5.4 "

Table 44 B.

Total deposits from outside New York district	1.2 billions
Total borrowings from Federal Reserve bank.	880 millions

Shows:-
(a) Loans to banks, railroads, agricultural and industrial etc. outside of New York district exceeded deposits from same sources by 96.8 millions. 140

(b) In general,
Accommodation received by corporations, etc. outside of New York district from New York City banks was approximately equal to the deposits received by New York City banks from institutions and persons outside the New York district. 140

Chart S, Table 45, p. 141.
Street loans.

Shows:
1. During 1919, call funds from (a) out of town banks and (b) New York City banks increased with great rapidity. 142

2. Funds from out of town banks increased greater than from New York City banks. 142

During 1920.
Shows:-
Sharp decline coincident with pressure for loans for agricultural and commercial purposes, both in New York City and outside. 142

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Shows also:-
When funds began to be withdrawn from the stock exchange in latter part of 1919. Interest rates on call money rose sharply from 6% to 14%. 142

Chart also shows:
(a) The increase in the call loan rate was brought about by the decline in amount of available funds for call loans.

(b) The increase in rates did not result in drawing funds from the interior of the country. 142

(c) During 1920 and 1921, when funds both from New York City and outside were declining, the average call renewal rate ranged higher than during the preceding two years when funds available for call loans were increasing. 143

Chart T. Street loans. 52 New York City banks. 143

Chart U.
Relation of total loans of all stock exchange banks and the average call loan rate. 144

Both above charts show:-
(a) That the increase in the average call loan rate, in most cases followed a decline in the total funds available for stock exchange loans.

(b) The reduction of call loan funds either resulted from or was coincident with the pressure for commercial, industrial, and agricultural loans both in and out of New York City and the higher rates offered for these types of paper. 143

While it is true that the great demand, during 1920, for loans for agricultural, industrial and commercial purposes drew funds out of the stock market and New York City, to the country districts, it is equally true that in periods of sustained high interest rates in New York or on the stock exchange money flows from the country to New York City. 144

Money is a commodity and, like other commodities, flows to place where it commands the highest price. 144

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Chart U.
Street loans of New York City banks and call loan rates. 144

Chart V.
Loans of reporting banks in U.S. and street loans of New York City banks. 145

Above charts show:-
Stock exchange loans in New York City decreased more rapidly and to a much greater extent than loans and investments of all reporting banks. 145

This suggests that the demand for loans in the country generally resulted in the withdrawal of funds from the New York Stock exchange. 145

CHAPTER VIII.

Defects and deficiencies of the banking machinery. 146

Basis of credit machinery consists of 30,000 independent state and national banks.

Independent banking, though well adapted to our independent commercial system and the spirit of our institutions, results in certain limitations upon the full use of the banking power of the country. 146

(a) Difficult to carry out a uniform policy, either of liberality or of curtailment.

(b) The system is subject to the individual differences of management and of policy of 30,000 banks. 146

(c) Makes it impossible for full utilization of the resources of some banks in the locality to give relief where other banks in same locality are extended to limit of safety. 146

Do not recommend legislation permitting any general or universal system of branch banking in U.S. 146

Possibilities of credit control by large financial centers might constitute a menace. 146

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A system of limited branch banking might furnish a possible solution.

Inauguration of such a system involves reconsideration of whole policy of independent banking.

Commission does not feel warranted in making a definite recommendation but suggests that appropriate committees of Congress consider it. 146

Further defects in our banking machinery:-

(d) 20,000 banks, having from 35 to 40% of our banking resources, are not members. 146

(e) These banks must rely on their correspondents in times of stress.

(f) They contribute little to general reserves of the country. 146

(g) If permitted to borrow, directly or indirectly, from Federal Reserve banks in times of stress they do so at expense of the reserves contributed by member banks. 146

(h) These country banks are usually small and can not expand adequately in crises. 147

(i) They are largely state banks, and have no access to Federal Reserve bank reservoir of credit. 147

Other defects;

(j) Member banks can not furnish from 6 months to 3 years credits absolutely necessary to farmers for production purposes. 147

Stock raisers require 3 year credits. 147

Grain crops often require credit for longer than 1 year. 147

e.g. winter wheat, if fertilizer is used.

(k) Credit should be available on a maturity basis which will assure the farmer he will not be pressed for payment until his product is ready for market. 147

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(1) Absolutely necessary to fill the gap between short time now furnished and long time credit only partially furnished by the national, state and commercial banking system and largely furnished by farm mortgage institutions and the Federal Farm Loan system. 147

In addition to being provided with cash for production and marketing of crops, credit must be furnished for fertilizer and other expenses incident to production. 147

Limitations of Farm Loan system. 148

Not intended to furnish funds for production and marketing.

Practically limited to long time loans of a more or less permanent nature, such as those specified in the Act.

Federal Reserve system established Federal Reserve banks as central reservoirs of commercial banking and Congress limited the rediscount powers to paper of relatively short maturity.

The 90 day limitation is generally sufficient to cover the needs of commerce and industry.

The 6 months limitation takes care of the short term borrowings of farmers for temporary purposes.

Loans covering the period of both production and orderly marketing including breeding and fattening of live stock, requiring maturities of from 6 months to 3 years, are not eligible under Federal Reserve system. 148

Federal Reserve investments must be confined to those of a self-liquidating nature and of shorter maturities. 148

New Federal legislation is therefore necessary.

The possibility of renewals under Federal Reserve system is not sufficient. 149

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Essentials of proposed legislation:-

1. Amend Farm Loan Act.

(a) To permit Federal Land banks to rediscount agricultural paper having a maturity from 6 months to 3 years, for national banks, state banks and trust companies, savings institutions and incorporated live stock loan companies.

(b) To permit Federal land banks to loan directly to cooperative associations of farmers organized under state laws, when secured by warehouse receipts covering staple agricultural products.

(c) Permit Federal land banks to establish separate departments for purpose of issuing short time debentures having a maturity of not more than 3 years, secured by loans described above in (a) and (b). 149

(d) Necessary capital for the separate departments to be furnished from the Federal Treasury. 149

(e) The rates of interest under (a) and (b) and on the short time debentures need not necessarily coincide with the rates of interest on farm land mortgages and farm loan bonds covering these mortgages issued by Farm Land banks. 149

(f) To permit Federal Reserve banks to purchase debentures issued under these proposed amendments under the same terms and conditions as now govern their purchase of farm loan bonds. 149

(g) To permit Federal Reserve banks to rediscount for Federal land banks or joint stock land banks, with their indorsement, any loans made under (a) and (b) above when within a maturity of 6 months. 150

Farm land banks, not having large fixed capital, must obtain funds by sale of their bonds in the investment market, to provide capital for new loans. 150

Because of seasonal nature of agricultural requirements, it would not be practicable to require farm land banks to borrow by bond issues the amounts necessary to satisfy the peak of the farmers' demands. 150

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Desirable, therefore, if not necessary, to enable them to rediscount with Federal Reserve banks their loans upon security of agricultural products, when within maturity of six months. 150

Not necessary to admit farm land banks into Federal Reserve system.

Because of their limited working capital, they should not be required to make any deposit with the Federal Reserve banks as a prerequisite to rediscounting loans as above referred to.

These recommendations will effectually bridge the present gap, without establishing new and untried machinery or sacrificing any of the fundamental principles upon which both the Farm Loan System and the Federal Reserve System must rest. 150

CHAPTER IX.

Statistical tables showing movement of money and credit.
Table 47, page 154.
Given a complete picture of movement. 151

CHAPTER X.

Minority opinion of Ogden L. Mills. 153

Concur in report, with one exception:-
Can not agree with the statement that "a change in policy as to discount rates, late in the year 1920, would have accomplished a reversal in part of the psychological and economic factors which at this time were moving in the direction of lower prices."

This suggestion is:-
(a) Out of harmony with the balance of the report.

(b) Inconsistent with the facts brought out by our investigation.

Higher discount rates did not produce the break in prices.

Inconceivable that their reduction could have counteracted the economic forces leading to inevitable deflation. 158

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1. Federal Reserve bank rates were below market rates throughout year 1920.

2. Only 9840 banks out of a total of 28,210 are members of Federal Reserve system.
   (a) Many of those banks are to a great extent free from competition and charge rates fixed by local custom and local circumstances.

   (b) Decrease of a Federal Reserve bank rate from 7 to 6% can have no effect on a western or south western bank charging 8, 10 or 12%.

   (c) Federal Reserve discount rates can only be effective in restriction of loans and discounts of banks which are borrowing from the Federal Reserve banks. In Sept., 1920, in New York district, there were 454 non-borrowers against 323 borrowers.

3. Borrowings from Federal Reserve banks, May 4, 1920, to April 28, 1921.

Agricultural counties.	Increased 56.6%
Non- " "	Decreased 28.5%

If statement I object to is true, a lower Federal Reserve discount rate would have maintained industrial prices to the further disadvantage of the farmer. 158

4. While it can not be conclusively proved that credit stringency was not an initial factor contributing to price deflation, there is no evidence to show it was. 158

Admits that once prices started to drop, credit stringency was the cause of much hardship and, in many cases, of increased losses.

Do not believe that increased Federal Reserve discount rates and contracting credit were the primary causes of the sharp price deflation of the 2nd half of 1920. 158

(a) The price peak of all commodities was reach in May,1920.159

Loans of all reporting banks, and discounts of Federal Reserve banks continued to increase until Oct., 1920.

Federal Reserve note issues continued to increase until Jan., 1921.

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Certain agricultural commodities reached their peak in 1919, and fell rapidly before any material increase in Federal Reserve bank rates, and before any credit stringency was felt.

e.g. - Hogs, bacon, cattle, dressed mutton and butter. 159

In all these instances, there was a direct relationship between the price peak and the export trade peak. 159

The hog export peak was in June, 1919, and the price peak in July, 1919.

The same as to bacon.

The cattle export peak was in August, 1919, and the price peak in November, 1919.

The cotton export peak was in April, 1920, and the price peak in the same month.

The total farm index peak was in March, 1920 and the price peak in April, 1920. 159

Many other instances showing relationship between production and consumption peak and the price peak.

No such relationship can be established between increased Federal Reserve bank discount rates and the drop in price of any single commodity. 159

(b) Agricultural prices broke more sharply than any other, and yet, from May 1920 to May 1921, the liquidation of loans in agricultural counties was relatively much less than in industrial counties.

(c) Interest rates are only a small percentage to total outlay, which is largely accounted for by cost of labor, cost of material, transportation and distribution. 159

(d) Price deflation was world wide. Crisis began in Japan in 1919.

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Price level began to fall:-
Great Britain. April, 1920.
France and Italy. May, "
U. S., Germany, India and Canada. June, 1920.
Netherlands. August, 1920.
Australia. Sept., 1920. 159

Conclusion.

This minority opinion given because many believe that the increase in Federal Reserve bank rates was a primary cause of decline in prices in 2nd half of 1920, which so disastrously affected agricultural products.

Such an opinion inevitably leads to the conclusion that the Federal Reserve Board and Federal Reserve banks constitute an agency by means of which prices may be raised or lowered. This opinion is so contrary to economic facts and to the purposes of the Federal Reserve system, that it should not be permitted to pass unchallenged. 159

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INQUIRY INTO THE REPORT OF THE JOINT AGRICULTURAL COMMISSION AS RELATES TO ITS CRITICISM OF FEDERAL RESERVE POLICIES.

The criticisms of Federal Reserve policies are chiefly confined to two periods:-

1. Post war inflation. March 1919 - June 1920.
2. Deflation and liquidation. June 1920 - June 1921.

I.

First period.
Post war inflation. March 1919 - June 1920

Criticisms made by the Commission:

1. The low rate policy of the Federal Reserve Board and the Federal Reserve banks was unsound. Digest p. 11. Report p. 43

2. Discount rates should have been radically increased during the spring of 1919, to check speculation and inflation.
Digest p. 9. Report p. 15
" " 11. " " 43

3. Such radical increase in discount rates would have forced the member banks to apply the Government credit which was released in 1919, towards paying off their borrowings from the Federal Reserve banks, instead of using it to feed speculation. Digest p. 11. Report p. 43.

4. The application of such a "sound policy" would have made the subsequent liquidation less precipitous and would have mitigated the hardship on banks and individuals.
Digest p. 3. Report p. 12
" " 5 " " 13
" " 13 " " 45

5. The Federal Reserve Board should have insisted upon such a radical increase of discount rates, in spite of the fact that such action would have forced the Treasury to issue the Victory notes at higher rates, corresponding to the market value of money. Digest p. 12. Report p. 44.

6. The inflation caused by the low rate policy was measurably greater than would have followed a high rate policy.
Digest p. 24. Report p. 81.

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7. The low rate policy increased Government expenditures for principal and interest. Digest p. 24. Report p. 81.

8. The low rate policy depreciated the market value of the Liberty bonds causing loss to investors. Digest p. 24. Report p. 81.

9. The low rate policy increased the cost of the war. Digest p. 24. Report p. 81.

10. The low rate policy was contrary to the policy of the great financial centers of the world prior to the war, and, in some cases, during the war. Digest p. 25. Report p. 83.

II.

Answer to the above criticisms as shown by findings of the Commission.

1. The Commission finds that the whole question of Federal Reserve discount rates during this period hinged on whether the victory notes should be issued at a relatively low rate or at a higher rate approximating the market rate for money. Digest p. 23. Report p. 80.

2. The Commission admits that if the victory notes were to be issued at a relatively low rate the discount rates of the Federal Reserve banks must have been maintained at correspondingly low rates. Digest p. 25, Report p. 83.

3. The Commission finds that higher rates fixed in the approaching Victory notes:-

    1. Would increase interest rates generally throughout the United States. Digest p. 12. Report p. 44.

    2. Would depreciate the market value of all outstanding Liberty bonds. Digest p. 12. Report p. 44.

    3. Would force great liquidation in all securities. Digest p. 12. Report p. 44.

    4. Would depreciate the market value of securities held by savings banks, trust companies, insurance companies, etc. Digest p. 12. Report p. 44.

    5. Would give rise to a demandfor refunding outstanding Liberty bonds which might have been irresistible. Digest p. 12. Report p. 45.

    6. Would result in a dislocation and embarrassment to industry growing out of the general increase in interest rates. Digest p. 24. Report p. 81.

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Notwithstanding the above,
The Commission finds that higher rates in the Victory notes:-

1. Would encourage savings.

2. Would cause a transfer from non-essential and low rate investments to Government bonds.

3. Would absorb free capital.

4. Would discourage non-essential production

5. Would limit expansion and inflation

6. Would reduce consumption

7. Would retard the rise in prices

8. Would reduce the amount of money needed by the Government for the war, the higher interest rates being offset by the smaller amount needed.

Digest p. 23. Report pp. 80, 81.

The Commission further finds that the decisions which had to be made were difficult and important and that doubtless, in these circumstances, mistakes of judgment were made which the clearer judgment of retrospect would change.

Digest p. 9. Report p. 15.

III.

Deflation and liquidation period. June 1920 - June 1921.

Criticisms made by the Commission.

The Commission finds:-

1. The policy of the Federal Reserve Board was one of <u>reduction</u> or, at least, <u>prevention of further</u> expansion of loans and discounts of member banks.

   Digest p. 16. Report p. 52.

2. That, although admittedly exercised with a view to preserve the integrity of the banking system and to prevent financial panic, it is <u>probable</u> that the pressure was excessive.

   Digest p. 16. Report p. 52.

3. That this pressure was exerted in the only way it could be exerted, viz., in refusing loans to member banks in individual cases and by the pressure of discount rates on borrowing member banks. Digest p. 17. Report p. 53.

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4. That there were cases where such pressure resulted in hardship on member banks and their customers.
Digest p. 17. Report 53.

5. That the action of the Federal Reserve Board in wiping out the differential rates on Government paper was sound in theory and in line with central banking practice, but that its application penalized member banks which were borrowing on their own Government securities or were loaning at low rates on customers notes secured by Government bonds.
Digest p. 15. Report p. 48.

6. That this action forced member banks to liquidate their holdings of Government bonds and depressed the market value of Government bonds.
Digest p. 15. Report p. 48

7. That the Federal Reserve Board, on the assumption that a decline in prices was inevitable in 1920, should have taken some action to bring debts to be paid into closer relation with the goods with which only the debts could be paid.
Digest p. 16. Report p. 51
See - Digest p. 8, 24 A. " " 13

8. That the drop in prices introduced into the public the psychology of fear and made the banks ignore the banking maxim that, in times of stress, credit should be granted freely though at a higher rate, and make them exert pressure for liquidation.
Digest p. 28, Report p. 86.

9. That a change in Federal Reserve policy would probably have reversed in part this psychological factor.
Digest p. 28. Report p. 86.

10. That notwithstanding the apprehensions of the Federal Reserve Board and Federal Reserve banks that a change in policy, - resulting in a general invitation to member banks to increase their loans, - might result in bank failures, the Commission is of the opinion that:

A more liberal policy could have been adopted.
That such a policy would have served to arrest in part the tide of deflation and to reduce the hardships and losses incident thereto.
Digest p. 30. Report p. 88.

11. That it is evident that the application of the policy in rural sections resulted in great hardships and distress and contributed to some results economically undesirable,- whatever may be said otherwise in support of the policy from the standpoint of its wisdom and necessity, and in the light of the psychological and economic factors which it was necessary to consider. Digest p. 30. Report p. 88.

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11 A. The pressure of liquidation in agricultural sections was shown by a greater relative decline in deposits than in semi-agricultural and industrial sections. Digest p. 7. Report p. 15.

12. That the hardship on rural sections was due largely to:-

Excessive cost of producing the 1920 crop.
Slower turnover for farmers.
Pressure for liquidation forced sale of immature cattle and calves, which will produce a shortage of meat supply.
Sales were forced when borrower should have been carried. Digest p. 30. Report p. 88.
Prices of what he had to sell declined faster than those he had to buy. Digest p. 30. Report p. 89.

13. That progressive rates resulted, in many instances, in unconscionable rates upon the borrowings, or some portion thereof, of member banks in excess of their basic lines. Digest p. 21. Report p. 62.

14. Penalyzed banks which were making the greatest effort to serve their customers. Digest p. 21. Report p. 62.

15. The application of such a uniform and arbitrary rule to all banks, without regard to peculiar circumstances, can not be justified from the standpoint of sound banking, nor from the consideration to which the public is entitled from banks * * * exercising public functions. Digest p. 21. Report p. 62.

IV.

<u>Answer to above as shown by findings of the Commission.</u>

1. The increased discount rates and subsequent tight money operated as a dike to keep goods, - which were backed up in the channels of distribution from the farmer to the consumer, - flowing in the channels of trade, notwithstanding the obstacles of declining prices and slackening demand.
Digest p. 13. Report p. 45.
See infra- Digest pp. 8, 24 A. " " 13

2. The causes of the headlong fall in prices were:-
Cancelled orders. Digest p. 14. Report p. 46.
Public fright. Digest p. 14. Report p. 46.
" " 27. " pp. 85, 86.

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Preceding exhaustion of credit.	Digest p. 14.	Report p. 46
Falling off in exports.	" " 27.	" pp. 85, 86
" " " speculative demand.	" " 27.	" " 85, 86.
" " " domestic consumption.	" " 27.	" " 85, 86.

3. The expansion of loans during the inflation period was relatively greater in the rural districts than in the industrial sections.
Digest p. 33. Report p. 117
" " 34. " " 120.

4. The policy of the Federal Reserve Board and Federal Reserve banks during the deflation period did not produce a greater curtailment of loans in the rural districts than in the financial and industrial sections. Digest p. 33. Report p. 117.

5. The rediscounts by Federal Reserve banks of agricultural and live stock paper was relatively greater than the rediscounts of all other paper. Digest p. 34. Report p. 120.

6. The liquidation of agricultural and live stock paper was relatively less than the liquidation of all other discounts.
Digest p. 34. Report p. 120.

6 A. In fact, but little actual liquidation of loans and discounts had taken place in the agricultural sections of the country as a whole up to May 1921. Certain exceptions noted.
Digest p. 6. Report p. 14.

7. The Federal Reserve Board was in a very delicate position.
Its duty was:-
To provide for essential credits
To limit non-essential and speculative credits.
To prevent banks overextending.
Digest p. 16. Report p. 51
The balance between these was extremely delicate.
Digest p. 16. Report p.51.

8. The Commission, - while of the opinion that it is probable that the Federal Reserve Board and some of the Federal Reserve banks imposed excessive pressure towards reduction or prevention of expansion of loans, - states specifically that the alternative of its policy, - the extension of all credit desired for any purpose, - would have involved the following dangers:-
A large number of bank failures.
An undue reduction of reserves
Excessive currency issues resulting in depreciation
Loss of confidence in the banking system
Runs on banks
Demand for redemption of Federal Reserve notes in gold.
Digest p.17. Report p. 52

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9. The Commission specifically finds that
   Before the application of progressive rates the Federal Reserve Bank of Kansas City's resources were largely absorbed by a relatively small number of banks in Kansas City and Omaha, which, in April 1920, were absorbing 73% of the normal lending power of the Federal Reserve bank.
   Digest p. 19. Report p. 56.

10. The progressive rates reduced these borrowings largely thus increasing the funds of the Federal Reserve bank available for other banks borrowing moderately or not at all.
   Digest p. 19. Report p. 56.

11. The chart shows that the progressive rates permitted an increase in the borrowings of country banks.
   Digest p. 20. Report p. 58.

12. The borrowings of the Kansas City and Omaha banks were transferred to the country banks.
   Digest p. 20. Report p. 58.

13. The average rate, normal and progressive, paid by all banks in the district was 6.61%. Digest p. 21. Report p. 62.

14. The average rate paid by all banks borrowing at progressive rates was 6.78%. Digest p. 21. Report p. 62.

15. The total interest paid by all banks in Kansas City was $325,904.78 <u>less</u> than would have been paid had the rate been a flat 7% rate. Digest p. 21. Report p. 62.

16. The progressive rate did not cause any increase in customers rates; whether the loaning banks were borrowing at normal rates, progressive rates, or were not borrowing at all, the customers rate was the same.
   Digest p. 21. Report p. 62.

17. Progressive rates did not control either the <u>amount</u> of deflation or the <u>rate</u> of deflation. Digest p. 22. Report p. 68.

18. The reduction of loans and discounts, under progressive rates, was relatively less in country banks than in city banks.
   Digest p. 22. Report p. 68.

19. The expansion of loans during inflation period was relatively greater in the rural than in industrial districts.
   Digest p. 33. Report p. 117
   " " 34. " " 120.

20. The policy of the Federal Reserve Board and Federal Reserve banks during the deflation period did not produce a greater curtailment of loans in the rural than in the industrial sections. Digest p. 33. Report p. 117.

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21. The rediscounts by the Federal Reserve banks of agricultural and live stock paper were relatively greater than the rediscounts of all other paper. Digest p. 34. Report p. 120

22. The liquidation of agricultural and live stock pwper was relatively less than the liquidation of all other discounts.
Digest p. 34. Report p. 120
" " 6 " " 14.

23. If a more liberal policy had been adopted by the Federal Reserve Board and as a result the prices of what the farmer had to buy were stabilized more than the prices of what he had to sell, his condition would have been worse than before.
Digest p. 31. Report p. 89.

24. In the spring of 1920 * * * the stream of production flowing from the farmer to the consumer began to back up in the channels of distribution, although higher discount rates and tight money, like dikes erected along the banks of the stream, served as influences to keep goods flowing in the channels of trade, notwithstanding the obstacles of declining prices and slackening demand.
Digest p. 13. Report p. 45.

24 A. It was necessary, by a high level of discount rates, to keep these credit requirements in such a relation to the prices of goods that bank failures would not result and a financial crash increase the inevitable industrial depression resulting from declining prices.
Digest p. 5. Report p. 13

25. Credit was not absorbed by financial centers at the expense of rural communities for purpose of speculative activities.
Digest p. 33. Report p. 117.

26. The policy of the Federal Reserve banks reflected the necessity for control, restraint, and restriction.
Digest p. 17. Report p. 54.

27. The Commission finds, however, that the Federal Reserve Board and the Federal Reserve banks could not apply their policy uniformly because conditions were not uniform.

28. That it could not control the loan policies of the 20,000 banks which were not members, - representing from 25 to 40% of the banking resources of the country.
Digest p. 17. Report p. 53.

29. That it could limit loans only to member banks which were borrowing or threatening to borrow excessively.
Digest p. 17. Report p. 54.

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30. The Commission finds that a change in policy, to be effective, must necessarily mean a further extension of loans.
Digest p. 28. Report p. 86

31. That such further extension must depend on the available supply of funds. Digest p. 28. Report p. 86.

32. That when banks increase loans and discounts during a time of falling prices, the credit strain increases, as also the danger of bank failures.
Digest p. 30. Report p. 88.

33. That 1/3 of the banks were greatly over extended.
Digest p. 28. Report p. 87.

34. That the Federal Reserve Board and Federal Reserve banks felt that due regard must be had to the possible results of a change in policy. Digest p. 30. Report p. 88.

35. That they felt that a general invitation to member banks to increase loans, - through the effect of lower discount rates, - might result in bank failures.
Digest p. 30. Report p. 88.

36. That suspension of the reserve requirements would have afforded no remedy, for the tax imposed by the Federal Reserve Act must be added to the discount rate, and while such suspension would tend to increase loans, the tax would operate in the same measure to restrict loans.
Digest p. 31. Report p. 90.

37. That the remedy for overextended banks should be an increase of capital. Digest p. 29. Report p. 87.

38. That it is clear that in many cases, inadequacy of capital, and not insufficiency of bank credit was a factor restraining and limiting credit during this period.
Digest p. 29. Report p. 88.

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