FEDERAL RESERVE CREDIT POLICY.

Program:

1. What object should Federal Reserve credit policy seek to accomplish and by what test may we know that it is sound?

   Discussion to be led by Messrs. Norris and Wills.

2. What relative importance should be given to the following factors in determining such policy?
   a. Federal Reserve reserves.
   b. Interest rates in the open market.
   c. Interest charged by member banks.
   d. Interest rates paid on time deposits.
   e. Balance of trade and inward or outward movement of gold.
   f. Credit conditions in, and exchanges with, leading foreign countries.
   g. Volume of bank loans and deposits.
   h. Business and industrial activity, present or prospective.
   i. Commodity price levels.
   j. Condition of security markets.

   Discussion to be led by Messrs. Jay and Seay.

3. What light does the experience of the Federal Reserve Banks throw on the value of different methods of making their credit and discount policy effective?
   a. Discount rates.
   b. Open market operations.
   c. Discretion in rediscounting.
   d. Credit examination of member banks.
   e. Credit ratings of commercial borrowers.

   Discussion to be led by Messrs. Strong and Perrin.

4. What is the most practicable method of bringing about timely and competent consideration of matters of credit policy by all of the Federal Reserve Banks and effective action to obtain the results aimed at?

   Discussion to be led by Messrs. McDougal and Curtiss.

Summary of Selected Topics:

The following summary is a selection and condensation of statements made in the papers and memoranda prepared by Governors and Chairmen, with special reference to those points on which opinion is apparently divergent. The topics considered do not follow the order of the program.

1. Relation of credit policy to commodity price levels.

"Federal Reserve credit policy should be directed to effecting steadier credit and price conditions". This object should not be confused with stabilization of prices at present levels. "No one can now predict or control the level at which prices will ultimately become stabilized. We should merely direct our policy (1) so as to prevent any serious inflation, and (2) in times of deflation and depression, so as not to impede those who wish to move forward by using more credit". Credit volume, of course, is not the only factor affecting price levels, but without more credit prices do not rise very far, and with less credit prices almost invariably fall. In agreement with this position is the statement: "Regulation of the volume of credit (which may greatly affect prices) therefore becomes our greatest responsibility".

Another paper states that "very little consideration should be given to commodity price levels. It is no part of the business of a Reserve Bank to seek to advance or depress the price of commodities". Furthermore, "the influence of changes in Federal Reserve Bank rates has been greatly exaggerated, and their power to affect the price-level or control the amount of credit is not only very limited, but very slow in producing effects". No policy, however, should be adopted that is likely to accentuate price fluctuations, and one test of the soundness of policy is whether it "tends indirectly to stabilize prices by stabilizing credit conditions, and stabilizes credit conditions by checking inflation and deflation before disaster comes". Another paper points to the limited control exercised by Federal Reserve policy over the movements and volume of credit and urges that "it is manifestly impossible in a country so large and so governed as ours to assume that the Federal Reserve Banks initiate or stop credit movements because of high or low prices, active or inactive business, etc. ". The conclusion of another writer is that "the inflation which started in 1919 and broke in 1920 was not controlled, and in my opinion could not have been controlled, by any policy which the Federal Reserve Banks could have adopted".

II. <u>Value and meaning of "discretion in rediscounting" as a method of making credit policy effective</u>.

Two papers reach similar conclusions on this question. One concludes: "Based on the experience of this bank, and giving due consideration to conditions prevailing, 'discretion' in rediscounting is more effective in controlling the credit situation than changes in discount rates". The other says that Federal Reserve Bank "credit and discount policy will be made effective through the exercise of discretion in granting rediscounts, and not through regulation by the discount rate". Among the considerations on which discretion in granting or refusing rediscounts must be based are: (1) occasion for rediscounting, (2) soundness of member bank's condition, (3) integrity and skill of its management, (4) its seasonal rediscount program, (5) general business, banking, and credit outlook.

Another paper concludes that "discretion" in granting discounts should be used merely to supplement regulation by rate, and then chiefly in sections where interest rates are high. "In special cases and districts personal 'discretion' will be inescapable, but its employment should be resisted and moderately used". "'Discretion' implies knowledge of details of member banks business. Such discretion extended to all member banks would necessitate passing upon every loan and investment of every member, causing annoyance, criticism of the system, and possibly radical legislation. 'Discretion' when required should be exercised more as to the total borrowings of a member, rather than as to any specific use of the proceeds. 'Discretionary' control over borrowings by members, except to a limited extent when rate control is ineffective, will develop the desire to exercise still greater power."

III. <u>Effectiveness of rate policy in controlling flow of credit.</u>

The opposing points of view are indicated by the following statements:

(1) "The effective method of regulation demonstrated by long experience abroad is by the discount rate."

(2) "The discount rate cannot be the major influence making the credit policy effective."

In support of the first statement:

"The rates established by the Federal Reserve Banks have been measurably effective in influencing the loaning policy of member banks." And: "The rate of discount of a reserve bank regulates in general how much member banks borrow, and consequently influences increases or decreases in the totel volume of credit."

In agreement with the second statement: "The experience of this bank has demonstrated that while increasing the discount rate may have an indirect influence in developing an attitude of caution, it will not be wholly effective in curbing a tendency toward excessive borrowing at Federal Reserve Banks."

It is recognized that the control exercised by regulation depends partly upon the condition of member banks. "It is only when the banks generally are compelled to call upon Federal Reserve Banks that the power of the Reserve Banks to exercise any control over credit begins, and it is at such times that the rates and the rate policy assume greatest importance." And: "Particularly is the influence of the discount rate slight during a period of liquidation such as began in 1920."

IV. Relation of discount policy to reserve position.

There is a marked diversity of opinion regarding the relative importance of Federal Reserve reserves in determining discount policy. The extremes are indicated by two statements:

(1) "Too much emphasis cannot be placed upon the Federal Reserve reserves in fixing discount rates."

(2) "The reserve ratio of a bank or of the system is a very easy but a very bad guide to discount policy."

In accord with the first statement: "The rate to be charged for this assistance (to member banks and the open market) shall be determined by the percentage of gold reserve at the Federal Reserve Banks, as well as its trend." The paper most insistent upon establishing a close relation between discount policy and reserves suggests a plan by which a series of rate advances are definitely related to declines in reserve ratios. This paper says: "If, when their reserves were declining, it was the plain duty of Federal Reserve Banks to protect them by raising discount rates, which resulted in a curtailment of business, why then, when reserves have become exceedingly large, is it not likewise their duty to lower their rates and thus give a stimulus to business?"

In contrast to this is the statement that "it seems probable that a Federal Reserve Bank could render to its member banks substantially its full rediscount service by establishing a moderate rate of say 5 per cent or 6 per cent, and maintaining such a rate without change".

Another paper states that "At the present time, when Federal Reserve Bank reserves are at a high ratio, and the reserves of member banks of the country are in excess of commercial demand and seeking investment in securities, it is obvious that the protection of Federal Reserve Bank reserves cannot be the primary reason for fixing rates, and that other reasons will and must naturally come to the fore." Yet, when other factors "combine to effect a drain upon the reserves, present or prospective, then the protection of Reserve Bank reserves would become the primary consideration."

V. Relation of discount rates to rates charged by member banks.

Opposing statements:

(1) "I must express the conviction that no object can be accomplished, and no policy can be effective, unless the discount rates of the Reserve Banks are generally maintained at or above rates charged to the public, particularly during periods of expansion."

(2) "Our experience thus far confirms the contention that Federal Reserve discount rates will normally not be above and usually below the lending rates for the paper rediscounted."

Another paper supports the first statement: "Federal Reserve Bank rates to their members must as a governing principle be based upon and bear a close relation to the prevailing rates for bank funds on line of credit paper current in any particular part of the country".

In general accord with the second statement: "Discount rates have ordinarily a very limited effect upon the rate made by such members to their customers and were not intended to control the rate to the customer, and do not, in fact, exercise such an influence". Another writer says: "I believe member banks should get accommodation for the necessary requirements of their customers at Reserve Bank rates; and that the rates they charge customers are of minor importance".

VI. <u>Timeliness of rate changes, and method of consideration.</u>

The opinion is expressed that "the real power of the Federal Reserve Bank would seem to be that which results from the wisdom it has exercised in taking the leadership of its members". An object which credit policy should seek to accomplish is "to give timely notice of any distinct change which is anticipated in credit conditions". Changes in rates should be of a character which would indicate "what way the current was running, how strongly it was running, and whether there was likely to be a change in its direction". In agreement with this, another paper states that "an advance in the discount rate, simply recording the accomplished fact of increased credit demand, could serve no important purpose, but an advance made as a cautionary warning of an expected trend of increased demand, should serve as a steadying influence to those engaged in industry and commerce. If it be urged that those guiding a Federal Reserve Bank's policies cannot infallibly forecast the trend of credit demand, it may be said, in the first place, that mathematical precision is not necessary, and further, that the control of the ultimate banking reserves lays upon them the responsibility to be informed of the real trend of business and industry. The discount rate would be the natural medium of expressing their judgment of the credit outlook".

Two papers present plans for bringing about timely and competent consideration of matters of credit policy:

(1) "Frequent conferences of the Governors and Chairmen of the Federal Reserve Banks with the Federal Reserve Board, or a small

committee representative of the Board and the Banks, for the express purpose of considering credit conditions."

(2) Local credit policies should be dictated, except so far as certain general principles of credit policy are concerned, by the Board of Directors of each Federal Reserve Bank. Open market operations should be handled by one or possibly two committees of Governors of certain of the Federal Reserve Banks within convenient reach. The general principles of credit policy in both cases to be laid down by the Federal Reserve Board."