

ADMINISTRATION OF CREDIT
UNDER
THE FEDERAL RESERVE SYSTEM
OF
THE UNITED STATES
Present Criticisms.

(By William A. Shaw, Litt. D.)

(EDITOR'S NOTE -

"In the following article our contributor discusses the power of control which the Federal Reserve System possesses by virtue of its federal nature, and his conclusion is that we have everything to gain by imitating the system.

Certain other aspects of the system which make for inflation and danger we do not need to fear.")

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(By WM. A. SHAW, Litt. D.)

"For the second time in its brief existence the Federal Reserve system is encountering heated criticism and denunciation. The charges now raised are a replica of those which were levelled against it in 1921. In the main, these were twofold, firstly, that in breaking the boom of 1920 the Federal Reserve Board had acted much too late, and that when it finally did act its measures were so abrupt and savage that for the moment it smashed the industrial machine to pieces.

The facts are still within the memory of us all. The level of wholesale prices, which in 1919 had been 206 in the United States, rose to 226 in 1920 and fell to 147 in 1921. In England the movement was completely parallel, for within the same period the price level was from 205 to 251, and then fell to 155. In 1920 the bankruptcies in the States numbered 716 per month. In 1921 they numbered 1,668 per month, and the average since has increased rather than diminished. The figures for Great Britain are even more pronounced and striking. In 1920 the bankruptcies with us were 137 per month. From and including 1921, they have averaged over 400 per month. Very seldom have economists had so plain a lesson in the sequence of cause and effect.

Mercifully the lesson has been understood, and the banker statesman both in New York and London now realises that if the machinery of credit control must operate at all it must begin its work imperceptibly during the upward curve of a boom, and must follow that upward curve with imperceptibly increasing grip until the curve bends down again, and as the curve falls so that grip must be relaxed just as gradually and imperceptibly as before until equilibrium is again reached. Throughout this cycle of operations the one guide or finger-post to the banker is the index of domestic prices.

SCOTCHED.

It is rather disconcerting to find that the present wave of recrimination against the Federal Reserve system has been raised by an almost perfect instance of such regulative action. The United States recovered from the slump of 1921 with amazing rapidity. By the middle of 1922 she was again in the saddle and from then onwards to February of the present year there was a progressive movement of industrial activity and rising prices. By February the capital flotations had surpassed all records, and the figures of Stock Exchange loans, approached the highest previous figures. Everything portended another boom, such as, if realised, would inevitably have been followed by another violent slump. But in February last the banker took hold of the situation, that is, before the development had become so strong as to be uncontrollable. By the end of February, or the first week in March, all the twelve Federal Reserve Banks had fallen into line, and had

increased their re-discount rate from 4 to 4-1/2 per cent. It seems almost incredible that so slight an increase should have been effectual. Yet so it proved. The incipient boom was scotched, and the scotching was effected without any violent slump, without any dislocation of the industrial machine. By the end of April the position had become normalised, and prices were back at the level of December, 1922.

OBSTINACY.

Theoretically, the moment that normal had been reached the grip of the Federal Reserve rate should have been loosened and the steed should have been allowed to run with slackened rein. But this was not done. The enhanced discount rate of February was maintained. It is still unaltered at the moment of writing. The inference, therefore, seems clear that the subsequent downward movement is attributable to this obstinacy. The reaction since May of the present year has been strongly felt, industrial activity has slackened off and wholesale prices have fallen from 156 to 150. The situation certainly appears now to call for converse action at the hands of the Federal Reserve Board, and it is not without significance that an important session of officers of the Federal Reserve Banks was called at Washington for November, 12th instant, to consider the question of the Federal Reserve discount rates. The decision of the meeting has so far not been divulged. But quite plainly the ideal for any governing banking authority to aim at (whether it be the Federal Reserve Board or the Bank of England) is to adjust banking credits to the rise and fall of business (as indicated by prices), and thereby to diminish the undulations of the business cycle. The moment the wisdom of this simple rule is grasped and the technique of its manipulation is acquired the battle cries of inflation and deflation will become empty words.

A RE-ECHO

The second ground on which the Federal Reserve system is now being assailed is quite different. It is a re-echo of the violent charges which were brought against the system by John Skelton Williams, late Comptroller of Currency. He attacked it from the point of view of corruption, conceiving that it concentrated credits at the burning spots -- the centres of speculation, mainly, of course, New York, and that through dishonest manipulations the Stock Exchange gamblers in New York were deluged with credit while the agricultural and industrial industries in the provinces were being starved of credit. He had the courage of his conviction and hit out with both hands, and he has met an undeserved reward. His name is possibly one of the most unpopular in the United States today. But though the controversy has shifted from this more personal ground, the principle involved remains essentially the same. The Federal Reserve system does concentrate credit at the burning spots. Its mechanism for pumping credit back to the extremities is not nearly so efficient as its mechanism for concentrating credits from the extremities, and the best informed opinion in the States is beginning to realise the danger. In the opinion of the "Chronicle" "it would be a distinct advantage if the Reserve Banks did not control so much of the reserves of the country, for their inflationary

tendency would then be lessened." Underlying the controversy which is at present agitating the banking world in the United States, the controversy, namely, as to branch banking, there subsists this fundamental problem and discussion as to the administration of credit by the Federal Reserve Board and the Federal Reserve banks. The extraordinary feature of this controversy is that the American bankers themselves do not seem to realise from what source the danger comes. The real source of danger lies in the re-discount provisions of the Federal Reserve system itself. Those provisions permit, or rather prescribe for, an increase of the monetary circulation of the country pari passu with an increase in the item of discounted bills. The idea, of course, is to obtain an elastic currency. And it is well known that the late Sir Edward Holden pinned his faith to this form of an elastic currency.

AUTOMATIC

The point is worthy of most careful examination, for it is exactly in this article that our English system parts company with the Federal Reserve system, and it is exactly in this article that the Federal Reserve system is fraught with gravest danger.

It is admitted on all hands that during periods of boom all forms of circulating media increase in amount or bulk. The volume of cheques goes up, the volume of bills of exchange goes up, the circulating medium (hand-to-hand currency) goes up or increases the velocity of its circulation. Equally, it is admitted on all hands that the increase of cheques and bills is absolutely and entirely automatic -- as expressive of the forms of interchange which are liquidated by such media. Ergo, the increase of hand-to-hand currency ought to be in the same way wholly automatic as expressive of the needs of small change or hand-to-hand interchange transactions.

Under our British system we have attained perfection. In the one sphere cheques and bills expand (or contract) automatically, and Treasury notes expand (or contract) equally automatically in the other domain. Each being automatic does not affect the other, but reacts only to its own governing conditions.

DUPLICATION

But in America the system is quite different. They have no provisions for automatic rise or fall of currency, and therefore, being led astray by the search for an elastic currency, they prescribe for the expansion of the currency on the basis of the expansion of bills. By this means they are duplicating the exponent of inflation. If we had the equivalent of this in the British system we should have, in addition to our normal Treasury note circulation, an issue of £700,000,000 of Treasury notes reposing on the basis of £700,000,000 of Treasury Bills. And if we had that, who could measure the violent inflation we should be subject to? The mistake of the American system is that it does not visualise the fact that automatically increasing bills and cheques are the completest expression of an elastic currency, and that, to complete the mechanism, all that is necessary is an arrangement for a concurrent, but quite independent, automatic increase in hand-to-hand currency, the increase in each case operating

under the influence of its own factors or conditions. These factors are enormously different in the case of bills and in the case of hand-to-hand currency. Bills and cheques increase of necessity in direct ratio to the increase of business, whereas a comparatively slight increase of hand-to-hand currency is capable of carrying an immensely increased volume of hand-to-hand interchange. In the case of the British Treasury note, which is completely automatic, the fluctuation between 1917 (£212,000,000) and maximum (£367,000,000 in 1920) and minimum since (£279,000,000 in February, 1923) is under £150,000,000, or about 40 per cent. In the case of the United States the figures for the same period are \$1,928,000,000 for 1917, \$4,264,000,000 for 1920 maximum, and \$2,905,000,000 for July last minimum. The variation here is over 200 per cent.

IMITATION

This item alone of false and unscientific increase of hand-to-hand currency is capable of explaining the enormous inflationary power of the Federal Reserve system, quite apart from the parallel phenomenon of the concentration of credit at the burning spots (speculation centres like New York), and the corresponding starving of the extremities in matter of credit.

It is easy to strike a balance as between those two opposing phases of the Federal Reserve system. The power of control which the system possesses by virtue of its federal nature is in itself wholly beneficial, and certainly will be so in effect from the moment the system is purged of all connection with American politics. And from that aspect of it we have everything to gain by imitating the system, viz. by federalising our own banking world on the same or similar lines. The other aspects of the system which make for inflation and danger we do not need to fear. Under our branch bank system there is no denuding of the provinces for the sake of London. Our system is in close organic touch with the needs of industry to the remotest parts of the kingdom, and at the same time our Treasury note system is a safeguard against inflation. All the vices of the American system are per se excluded from our system, and all that we need to do in order to achieve a perfect credit control mechanism is to graft on to our system the federalised form or principle of the American system. 1"
