Federal Reserve
Board

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OFFICE CORRESPONDENCE

December 8, 1924.

TO Governor Crissinger

FROM Mr. Goldenweiser

SUBJECT: Article in the Commercial and Financial Chronicle for November 22, 1924.

Eight pages of the Chronicle for November 22 were devoted to an article entitled "Imperfect working of Federal Reserve System - over-saturating credit and currency". In view of the wide circulation of the Chronicle among persons interested in financial problems, it is worth while to consider some of the points in this editorial.

Resolution of Bankers' Association.

The article begins with a quotation from the resolution of the American Bankers' Association last October in Chicago to the effect that the operations of the Federal reserve banks "may tend to accentuate the swings of the financial pendulum rather than to keep the swings from going too far in either direction," and that it should be carefully considered whether it would not be "wise to limit the Federal reserve banks to their primary function as banks of issue and rediscount." The writer believes that the Bankers' Association resolution "has come not a moment too soon." He thinks that "in view of the recent glutted condition of the money markets of the country no one can truthfully assert that the Federal reserve banks have functioned properly" and that "the volume of the circulating medium of the country is being kept at a level enormously above what it should be."

Causes of excessive ease in the money market.

The writer discusses the reasons usually assigned for the over - abundance of funds, namely, the trade recession and the gold inflow, but is convinced that in addition to these causes the activities of the Federal reserve banks have contributed to the excessive supply of credit. He is of the opinion that, while the member banks have gone back to normal conditions after the war, "the reserve banks have been unable or unwilling to get back and have stopped at the half way point." On this point the writer is clearly mistaken, since the total volume of member bank credit at the present time is about $2,300,000,000 larger than at the post-war peak in the autumn of 1920, while total earning assets of the reserve banks are about $2,300,000,000 less than they were at that time.

As proof of the statement that the reserve banks have increased the amount of credit in the market the writer points out that while what he calls "mercantile paper" (discounts) at the reserve banks is now only about $234,000,000, the reserve banks have bought during the year over $500,000,000 of Government securities and lately have purchased large volumes of acceptances. In this statement the writer overlooks, first, that while the reserve banks have purchased Government securities to the extent of $500,000,000 there has been an equivalent decline of discounts, and, secondly, that purchases of acceptances have been largely on the initiative of acceptance dealers who have offered their bill holdings to the reserve banks because the firmer conditions in the money market have caused the member banks to call some of their loans to these dealers. A comparison of conditions now and a year ago and an examination of the gold imports during the period indicate that for the year as a whole the increase of member bank credit approximately corresponds to the amount for which the gold imported from abroad furnished a basis. Total loans and investments of all member banks increased by about $2,000,000,000 between September 13, 1923 and October 10, 1924, and net gold imports for the period were about $375,000,000, indicating that the gold inflow alone, when added to the reserves of member banks, has been much more than sufficient to serve as a basis for the increased lending power of member banks. Earning assets of the reserve banks, on the other hand, are no higher now than they were a year ago.

Functions of the reserve banks.

The writer's views on the scope and functions of the Federal reserve system are that "the reserve banks exist only to provide surplus or excess credit" and that "in a period of pronounced ease in the money market ... not a dollar of their deposits ought to be put out in the shape of reserve notes." The question whether the reserve banks are to be merely emergency institutions operating at times of seasonal or cyclical demand for excess credit or whether they shall be continuously in the market, is a question on which there has been much difference of opinion. The Federal Reserve Board however, has from the beginning taken the position that it is important for the reserve banks at all times to remain in touch with the market and that for this reason it is necessary for these banks always to have in their possession discounts, acceptances, or securities in order not to be cut off entirely from contact with the credit situation.

The writer's views on currency.

On the subject of Federal reserve notes the writer has strong convictions based largely on a misunderstanding of the nature of the Federal reserve note. He says that when money rates are down to 3 and 3 1/2 per cent and there is no mercantile demand for reserve bank credit, this is conclusive evidence that there should be no Federal reserve notes outstanding, and that gold rather than notes should be in circulation. This view overlooks the fact that Federal reserve notes are not issued by the reserve banks, except in response to a currency demand, and that it makes no difference in the existing credit and money market situation whether the reserve banks issue Federal reserve notes or gold in response to this demand. It is true that by paying out gold the reserve banks decrease their potential lending power more than by issuing Federal reserve notes, but in view of the fact that this potential lending power is now far in excess of any probable demand for reserve bank credit, this effect of paying out gold is of only academic interest.

The saturation point.

The writer says that the only way the reserve banks can acquire gold is either by issuing Federal reserve notes or by accepting gold on deposit. From this he argues that if the note issues and the deposit liabilities of the reserve banks exceed their gold reserves, this is evidence that the reserve banks have put into use more credit than they have received from the public. This statement is fundamentally correct. It is true that to the extent that the deposits and notes exceed the reserves of the reserve banks there is more bank credit in use, as a result of the operation of the reserve banks, than there would have been if the deposits had been held by the member banks and the gold had been in circulation. The conclusion, however, that this excess, which amounts to about $1,000,000,000 represents "saturation" of credit by the reserve banks does not follow. While the excess measures the extent to which the existence of the reserve banks has added to the volume of credit in existence, it is not clear what is meant by saturation. The fact is that the larger volume of currency in circulation at the present time compared with 1914, prior to the establishment of the Federal Reserve System, is due to the higher level of prices. The level of wholesale prices is about 50 per cent above what it was in 1913 and the volume of money in circulation is about 40 per cent above its level at that time. It may be argued that it is because of the increase in currency that prices have increased, but whatever truth there may be in this argument its proper application is to the war period and not to recent activities of the reserve banks. Prices increased during the war in the United States and throughout the world, and in order to meet the requirements of business at the existing price level more currency is required than was needed in 1914.

The complete adjustment between the demand for currency and the volume of it outstanding under the present plan is one of the definite gains resulting from the establishment of the Federal Reserve System, and this adjustment is in no way affected by the policy of the reserve banks to pay out one or another kind of currency, a point which the writer fails to understand. He is entirely mistaken when he says that if the gold coming from abroad had merely displaced

Federal reserve notes in circulation there would be no such redundancy of currency and no such plethora of funds as now prevails." The fact is that the Federal reserve banks have paid out $700,000,000 of gold into circulation in the last two years, an amount somewhat in excess of gold imports for the period, and Federal reserve note circulation has declined by approximately the same amount. The Federal reserve banks have paid out more gold into circulation since the middle of 1922 than they have received from abroad, so that the total cash reserves are now smaller than they were two years ago, but this policy has had no effect on credit and currency conditions, beyond merely changing the form of money in circulation.

Expenses of the reserve banks.

The author also discusses the necessity for the reserve banks to earn their expenses, and expresses his conviction that this was the one reason why the managers of the system permitted the issuance of a large excess of reserve bank credit,- whatever ingenious arguments they may have put forth to explain their actions. In this connection he quotes B. M. Anderson to the effect that gratuitous services by the reserve banks should be discontinued, and Willis to the effect that earning assets of about $1,000,000,000 a year will be required to meet the expenses of the reserve banks and that,therefore,the banks should enter the market more actively. He does not argue with Willis, who believes that the reserve banks should at all times be a large factor in themarket, but draws from Willis' view the opinion that the free services are a great menace because they make it necessary for the reserve banks to keep $1,000,000,000 of credit constantly in use.

The discount rate.

The writer quotes Anderson to the effect that the discount rate should be regularly kept higher than the market rate, but goes farther than Anderson by saying that the rediscount rate should never be less than 5 or 6 per cent. This is in keeping with his general theory that the Federal reserve banks should function only in emergencies. Reserve bank credit, according to his view, should be used only when it is badly needed and when a difference of a few per cent would hardly be noticed.

To the writer "there is something preposterous about the attempt to thrust excess credit, the only credit at the command of the Federal reserve banks, upon the member banks when they have no need for it." He thinks that the effect of this is to force banks into speculation. He says that in view of the fact that the banks can borrow from the reserve banks at 3 and 3 1/2 per cent and can buy good investments at 4 and 5 per cent, their refraining from doing this is a sign that they have better vision than the reserve banks. The fact that member banks have at all times lent or invested funds up to the limit of their available reserves and that they have now a volume of credit far in excess of the 1920 peak is not taken into consideration in this statement. He also sees a danger in the fact that, the lower the discount rate the more the reserve banks will have to have invested in order to earn their expenses, and that this vicious circle would lead to progressive inflation.

The writer's remedies.

As a final conclusion from this discussion the writer proposes the repeal of the 1917 amendments which required that all the reserves of the member banks be kept with the reserve banks and permitted the reserve banks to issue notes directly against gold. If the writer's views on the situation were correct his remedies would not be adequate. With the present volume of reserves the reserve banks could transfer to the member banks that proportion of the reserves held by these banks prior to 1917 and still have enough funds left for any amount of credit expansion that may reasonably be anticipated. Prohibiting the reserve banks from issuing notes against gold would under the present circumstances have no effect whatever, as is indicated by the fact, already mentioned, that the reserve banks have actually paid out gold rather than notes to the extent of $700,000,000 without any effect on the credit situation.

To sum up, the author, displeased with the fact that the interest rate is what he considers abnormally low and believing that the reserve banks are at least in part responsible, has based his arguments on a misunderstanding of our system of currency issues and of the scope and limits of the power possessed by the Federal reserve banks. There may be too much bank credit in use, but the writer offers no fresh evidence on this point and proposes no remedies that would accomplish his purpose.