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FEDERAL RESERVE BOARD

STATEMENT FOR THE PRESS

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Address delivered by

Governor Roy A. Young,

before the

Indiana Bankers Association,

at its

Annual Convention

at Gary, Indiana.

September 20, 1928.

The Present Credit Situation

Representatives of Federal reserve banks have appeared before audiences so many times to describe currency, discount and other operations of the System that today I am going to digress somewhat and talk about the present credit situation. This is a large subject, but inasmuch as I am speaking to an audience that is quite familiar with banking practice, I feel I will be able to get over to you a concise story in the time that has been allotted to me.

In order to bring the picture up to date, it is necessary to review what has happened during the past eight years. Gold is the basis of our credit structure and while the gold standard, perhaps, has some faults, it is the best basis that has yet been devised and public faith in its efficiency has been demonstrated conclusively during the past five years by the willingness and eagerness with which many countries have returned to some form of gold standard. All that has happened for the past eight years, therefore, can best be reviewed by referring to gold movements.

Since September 1920 and up to December 1924, gold flowed into the United States continuously, the net import movement for the period aggregating approximately $1,660,000,000. From September 1920 to the spring of 1922, the gold received from abroad was used largely by member banks to reduce their borrowings from the Federal reserve banks and thus improve the general condition of the member banks and the reserve position of the reserve banks. Generally speaking, gold received during this period did not, therefore, become a part of the reserves of member banks and did not form the basis of credit expansion.

Between 1922 and 1924 gold imports were sufficient to meet the country's growing demand for currency, and in addition, to increase the reserves of member banks which were thus enabled to expand their loans and investments without increasing their borrowings at the Federal reserve banks. From 1924 to the spring of 1927 the gold imports just about offset gold exports, so that the total increase in gold holdings of our country between September 1920 and the spring of 1927 aggregated, as I have stated before, approximately $1,660,000,000.

With this addition to the gold basis, through the inverted pyramid principle of credit, banks were able to expand tremendously. All of this growth, however, could not go into the old-fashioned forms of credit based upon production and distribution otherwise known as eligible paper, and therefore the banks had to seek other forms of credit. Naturally they turned to the investment credit market. With this stimulus and support from the banks throughout the country, the investment bankers accepted the opportunity and financed not only new enterprise by long-time credits, but old established enterprise as well, with the result that the proportion of eligible paper diminished in the portfolios of the banks while the proportion of investment credit held by the banks increased rapidly. For all the banks of the United States as of June 30, 1928, the figures are approximately as follows:

U. S. Government bonds.	$ 6,000,000,000
Other stocks and bonds.	12,000,000,000
Loans on securities (Of which amount $3,000,000,000 is represented by so-called brokers' loans)	13,000,000,000
Loans on real estate security	5,000,000,000
Loans to customers (Of which amount it is estimated that approximately $5,000,000,000 is eligible paper held by member banks)	20,000,000,000
Total loans and investments	$56,000,000,000

There has been some complaint of late that investment and speculative credit have not received their proportion of the bank credit available, but it seems to me from these figures - when you add the total amount of bonds to the total amount lent on securities and arrive at the total of $31,000,000,000 - that these forms of credit have been treated liberally by the banks.

All of this expansion of credit, up to May 1927, was accomplished without increasing the amount of Federal reserve credit, because the figures show that except for seasonal and holiday currency requirements, the total assets of the Reserve System have continued around $1,000,000,000 since 1922.

In May of 1927, however, something happened to which the American business public and financial interests did not attach sufficient importance. This was a reversal in the direction of gold movements. From May until the early part of November the Reserve System offset the exports of gold by purchases of U. S. Government securities, feeling that the time was not opportune to disturb our own domestic situation when the regular seasonal agricultural requirements were on and stabilization plans for some of our foreign friends were not completed - and stabilization of foreign currencies, indirectly, was of great importance to our domestic situation. During November and December, when gold continued to flow from this country, the System did not offset the export movements. This should have had the effect of retarding the rapid growth of credit, but it did not, largely because any increase in Federal reserve bank credit at that time was interpreted by the banks and the public as being in response to customary seasonal requirements, even though it had gone $200,000,000 higher than the year before. The return flow of holiday currency in the latter part of December and early part of January was greater than it had been in any year for five years and therefore the System sold additional Government securities to partly offset this return flow. Gold holdings changed but little during the months of January and February but credit expanded at more than the normal rate, and certainly there was no evidence that this additional credit was required for business.

There is an impression in the minds of many people, including some bankers, that a member bank deliberately borrows from its reserve bank at a low rate to enable it to lend at a higher rate solely for the profit in the transaction. I have been associated with the System for ten years and I can say without fear of contradiction that this seldom happens. What does happen generally, however, is this:

A member bank accumulates deposits in the ordinary course of its business and, if it expects to continue its business at a profit, it must employ those funds almost instantaneously in the credit field that offers the best rates consistent with safety. Later it has a reduction in deposits and must replenish its reserve in one of two ways. One is by borrowing from the Federal reserve bank and the other is by selling some of its readily marketable assets. In the great majority of cases the member bank which has wide fluctuations in its deposits borrows from the reserve bank. By doing this the bank avoids disturbing its portfolio and uses the reserve bank for the legitimate purpose of bridging over a temporary shortage in reserves. Naturally, when the rediscount rate is low and the open market rate high, there is an incentive for the banker to continue to borrow rather than to curtail his investments. When this practice becomes simultaneously general it furnishes one reason, but only one, for raising the rediscount rates.

There was evidence of this in February, with the result that a 4% rate was initiated by the directors of the various Federal reserve banks. However, credit continued to expand and the banks continued to borrow from the Federal reserve banks on rediscounts to make up the loss in gold and the sale of Government securities. No one particular bank was in debt any great length of time; in fact, the information we have in Washington is that the bank that borrowed to cover a loss of deposits got out of debt by liquidating some of its ineligible assets.

When it did so, however, directly or indirectly, it made it necessary for some other bank to borrow and so the borrowings of member banks were passed around from one bank to another without reducing the total indebtedness of the member banks to the Federal reserve banks, but on the contrary, increasing it.

Again, in April, the directors of one of the Federal reserve banks initiated a rediscount rate of 4-1/2%. This was eventually followed by all of the other reserve banks. By June the member banks owed the System approximately $1,000,000,000 upon rediscounts and were in a position where they could not get out of debt so readily by shifting the load from one bank to another; in fact, the load centered mostly in the larger cities. There was a rapid increase in discounts in the latter part of June and also in July, some of which, of course, represented currency requirements, but the increase had the earmarks of further pyramiding of credit and not of being the old-fashioned credit based upon production and distribution, with the result that some of the Federal reserve banks, where many of their member banks were heavy borrowers, initiated a rediscount rate of 5%. This action, however, was not taken in the four strictly agricultural districts west of the Mississippi River where a 4-1/2% rate is still maintained, largely because the member banks were not heavy borrowers and because it was at the time of the year when legitimate seasonal agricultural requirements had to be met.

From June up to the present time there has been but little change in the gold holdings of the United States. The System has not sold additional Government securities since that time and has undertaken no open market operations, except of a temporary nature.

To summarize, the banking system of America built up a credit structure by resorting to the inverted pyramid principle of credit on $4,600,000,000 of gold which we held in May 1927, and today, on $4,100,000,000, it is not only supporting that credit structure but a much larger one. This is shown by the June

30 reports of member banks which indicate an increase above last year of $2,500,-000,000 in loans and investments. To support this credit structure, member banks have found it necessary to increase their borrowings at the Federal reserve banks approximately $500,000,000. From this it seems to me that the reserve banks are functioning just as the law intended that they should function. Miscalculations as to the future always have and perhaps always will occur with the banks and the business public and that is one of the reasons why we need reserve banks, in other words, institutions which enable the public to adjust their miscalculations in an orderly and systematic way. So many factors have an influence on banking that it is a mistake to arrive at the conclusion that the Federal Reserve System alone, through its policies, makes credit situations. It is reasonable to believe from what I have cited that conditions, over many of which the System has no control, form the basis of reserve bank credit policies and rates.

Many people in America seem to be more concerned about the present situation than the Federal Reserve System is. If unsound credit practices have developed, these practices will in time correct themselves, and if some of the over-indulgent get "burnt" during the period of correction, they will have to shoulder the blame themselves and not attempt to shift it to someone else. Great concern is expressed over the mystery of Federal reserve policies. Dissatisfaction is expressed because the Federal Reserve System refrains from prediction and can not always anticipate. I have stated to you that conditions, to a large extent, bring about Federal reserve policies rather than that Federal reserve policies bring about conditions. That is just the position of the System at the moment. If past experience means anything, we know that the additional reserve credit needed between now and December 31 will aggregate approximately $300,000,000. This will come from the usual seasonal requirements of agriculture and business. It is the expectation of the System that this additional credit will be secured by the member banks rediscounting without hesitancy to take care of these requirements and that they will lend to their customers at reasonable rates. It further expects that this additional reserve credit will not be used in further expanding a bank credit situation that grew up when our gold reserves were $500,000,000 larger than they are now and which has continued to grow while the reserves have been shrinking. If after January 1929 following the return flow of holiday currency, the banks still owe the System approximately $1,000,000,000 in rediscounts, I, personally, will feel that the situation has been handled admirably and I shall have no cause for concern, because with the tradition which the member banks have about borrowing continually from the Federal Reserve System, a debt to the System of $1,000,000,000 will have a more moderating effect upon the too rapid growth of bank credit than any other single condition that I know of.