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BRIEF ANALYSIS

The Federal Reserve System was never designed to check or prevent speculation carried on with individual funds.

Purpose of Federal Reserve System was merely to take the bank reserves of the country out of the speculative market.

The Reserve Act transferred the required reserves to the Federal reserve banks and further provided that loans of the Federal reserve banks should never be made for the purpose of carrying speculative transactions.

The Federal Reserve Act not only did not attack speculation; it indirectly provided for it by reducing amount of required reserves and permitting member banks to continue to deposit their surplus reserve with the city banks for loan on collateral if the owners of it so desired.

The Federal Reserve Act exempted United States obligations from the prohibition against loans for carrying securities; in other words, it allowed borrowers to get funds from reserve banks for the purpose of buying and carrying United States bonds and certificates.

The reason for this exception was shown in the World War, the reserve banks being an indispensable adjunct in the placing of Government bonds.

The special interests induced Congress to permit Federal reserve banks to loan on the direct notes of member banks with Government bonds as collateral.

Administrative rulings and practice under this new provision made it almost mandatory for a reserve bank to do so.

This was a long step in advance of the permission granted in the Act to loan for the purpose of carrying United States securities.

This put the reserve banks in the position of being obliged to loan with United States bonds as collateral, without inquiring what the purpose of the loan was, - that is to say, to loan indirectly for the purpose of speculation in other securities.

Although promise was made to repeal this immediately after the war was over the same special interests sought to protect it and it has remained on the statute books.

Thus the bank reserves of the country have more than ever gone back into the market.

At a recent date the reserve banks were carrying about $720,000,000 of certificates or loans secured by such Government obligations.

The Reserve Act provided for the bankers' acceptance as a means of obtaining suitable interest bearing instruments in which the surplus reserves of the member banks could be invested should they prefer not to loan on call. It was supposed that, as in Great Britain, banks desiring to be in a liquid condition would put their surplus reserves into bankers' acceptances and then when needing funds get them by selling these acceptances to reserve banks.

The member banks have never carried any considerable amount of such acceptances but have sold them direct to the reserve banks which have to carry the entire burden of the acceptance market from the very beginning.

At a recent date member banks were holding only about $25,000,000 out of the total of $1,284,000,000 of acceptances outstanding of which the reserve banks held for their own and foreign accounts about $800,000,000.

The credit obtained by acceptance financing has admittedly in many instances gone directly into the stock market and thus the surplus reserves of the country, as well as the basic reserves themselves, have been put back into the service from which the Reserve Act had sought to draw them.

The remedy for a bad practice is always the complete cessation of that practice.

This may not be possible as an immediate step but it must be begun and systematically carried forward.

REMEDIES:

1. Reserve banks should absolutely stop supporting the market for Treasury certificates under re-purchase agreements.

2. They ought to stop lending to members on the direct notes of such members collateraled by Government obligations.

Cites recent loan to member bank of over $100,000,000 on its direct notes collateraled by Government securities.

3. The reserve banks should rid themselves of all save a very moderate holding of Government certificates.

4. They should hold no Government bonds whatever.

5. They should refuse to buy acceptances except when they represent a fractional part of a general body of paper of the sort which is being carried by the member banks as a way of investing surplus reserves and thereby keeping themselves liquid.

6. Reserve banks should do what they never have done, - resort to

direct dealings in two-name paper regardless of the endorsement of member banks, - a practice widely carried on by European central banks.

The above changes would result in re-establishing the liquidity of reserve banks and in doing what the original Act intended to do, - keep the reserve funds of the country out of the stock market.

The Federal Reserve Act never had any quarrel with legitimate speculation but on the contrary provided for the release of funds which could be used if desired to take care of it.

Speculation is a part of the industrial and financial structure of the United States and performs a useful economic service. It cannot be well dispensed with under the present economic order. It ought to be liberally financed.

It is, however, constantly tending to invade other fields. At the present time the stock market is taking the place of the banks in many particulars.

A new type of financing by the issue of stocks and bonds rather than through commercial bank loans has come into vogue.

The number of enterprises listed on the Stock Exchange has immensely increased.

The New York Stock Exchange is serving vastly more than a speculative purpose; it has become a medium of current industrial and business finance.

The excess in the use of credit for brokers' loans and collateral loans is shown by the fact that the Stock Exchange calls upon New York banks for total loans of $3,000,000,000 at a time when the entire short-term loans of the London Clearing House banks, as estimated by Mr. McKenna, are less than $750,000,000 of which probably less than half is devoted to genuinely speculative transactions.

The above, of course, is what the Federal Reserve Board had reference to in its recent statement.

The statement referred to the lack of any duty on the part of reserve banks as regards speculation; it would have been better had it referred positively to their actual duty to keep bank reserves out of speculation.

Whatever the form of expression employed, the real meaning was the same, in that an unusual share of the country's resources had become involved in supporting a kind of transaction which, even though beneficial in itself when kept within limits, may, like anything else, be exaggerated and rendered dangerous.

It does not help the present situation to point out what our banking system ought to have done several years ago, or to note the errors which were made during and after the war and to point the way to long range reform.

This situation is one of emergency, - nothing less.

It is not necessary to figure the possibility of a collapse of values or an old fashioned panic, or a series of bank failures.

As a matter of fact, these conditions may present themselves as they did after 1920.

They may not appear at all, and yet the harm of present conditions may manifest itself in other ways that are quite as serious if slower in operation and less spectacular.

It may manifest itself in one way or another, and the question is how to bring about a better situation, - a situation from which it is possible to make a start towards better conditions.

TWO REMEDIES SUGGESTED:

1. Obtain an agreement that no greater amount of credit should be used for Stock Exchange purposes than is now employed.

This is perfectly feasible. It was done during the war through the money pool and the equivalent was done many times before the war to arrest or prevent panic and disastrous changes in security values.

The effect of it would be to cut off at once the constant growth in stock market transactions which calls for an ever growing volume of credit and which permits more and more people all over the country to become involved in a speculative maelstrom.

2. To make this effective it might be accomplished by an agreement among the issuing houses of the city to slow down, or perhaps for a time suspend further new issues except where such transactions are necessary.

This was effectively resorted to during the war through the Capital Issues Committee.

In a moderate way it has been pursued at different times since then for the purpose of preventing a condition of indigestion from becoming acute in the bond market.

One reason for the constantly mounting total of brokers' loans is the vast amount of loans used to finance issue houses and syndicates and in enabling them to carry large volumes of securities that have not been sold to the public.

WHAT CAN THE RESERVE SYSTEM DO?

Let us see what it has done.

1. It has raised its acceptance rates in the effort to liquidate its portfolio of acceptances.

2. It has shown a little more reluctance towards supporting the Government security market.

3. It has slightly raised its discount rates (last summer).

4. The Board has lately issued a warning statement.

5. Certain western reserve banks have informed their members they will not rediscount for any member who sends funds out of the district for speculative purposes.

All the above are good as far as they go. They have not been applied early enough but have been used reluctantly and slowly as conditions had developed which were really beyond control.

It has been suggested that the reserve bank should refuse further credit to borrowing banks who are lending in the stock market. That would merely bring on a crash which would aggravate existing conditions.

The local reserve bank by reason of past blunders is more responsible than any other institutions for what is occurring in the market today.

It cannot stand from under by merely repudiating its responsibility, - as the Reserve System tried to do without success in 1920.

Wise and strong handling of the local reserve bank could and would produce results very much greater than any that have been obtained thus far by the policies already described.

It is too late to obtain the desired effect by the conventional methods, especially in view of the burden we have assumed in connection with our joint effort to sustain the Bank of England in maintaining the gold standard policy.

It is an unfortunate outcome of 15 years experience in central banking, - for now we must find some way of correcting conditions on old fashioned lines.