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The Effect of Government Security Operations on Member Bank  
Reserves During the Period of the  $3\frac{1}{2}\%$  Rate, Namely,  
from August 4, 1927, to February 3, 1928:

The claim is often made that the reduction in the discount rate from 4 to  $3\frac{1}{2}\%$ , and the accompanying purchases of Government securities during the period in which this rate was in force, - August 4, 1927 to February 3, 1928, - caused "easy" or "Cheap" credit which was responsible for the speculative craze on the New York Stock Exchange.

For example, the New York Commercial Chronicle of August 4, 1928, stated:

"Who is responsible for the speculative folly, the ill effects of which are now visible on every side? Not the banks, no matter how their course is to be deprecated, but the Federal Reserve, every move of which during the last twelve months has been fraught with latent mischief. Did not the Federal Reserve banks last summer reduce their rates of rediscount to  $3\frac{1}{2}\%$ , even compelling one obstreperous Reserve bank in the west to make the reduction against its emphatic objection and protest? At that time, the member banks were not borrowing, as they are today, over \$1,000,000,000 at the reserve banks, but barely half that amount, and could not be induced to increase their borrowings even at the low rate of  $3\frac{1}{2}\%$ , since they had no use for the money. Did not the Reserve banks then undertake to thrust out Reserve credit on unwilling banks by purchasing several hundred million dollars of Government bonds, thereby flooding the market with Reserve funds to a corresponding amount?"

The  $3\frac{1}{2}\%$  discount rate was in force, at least at New York, from August 4, 1927, to February 3, 1928, and it will be interesting to consider just what was the course of Federal Reserve credit in the whole System during this period, and examine as to how far the above

criticism of "cheap" money through lower discount rates and Government security operations, is justified.

The essential figures are as follows:

August 4, 1927 - February 3, 1928:

Member bank reserve balances increased	107,000,000
Gold stock decreased	203,000,000
Discounts increased	61,000,000
Acceptances increased	205,000,000
United States securities decreased	2,000,000
All other Federal Reserve credit decreased	60,000,000
Total Federal Reserve credit increased	204,000,000
Treasury credit increased	8,000,000
Money in circulation decreased	105,000,000
Foreign bank deposits, etc. decreased	6,000,000

Taking this period as a whole, it is clear that, comparing the beginning and end of this period, neither discounts nor Government securities were having any inflationary effect, for discounts had increased only 61 millions, a normal seasonal increase, at the end of the period, while Government securities had actually declined 2 millions. Furthermore, the total increase of Federal Reserve credit during the period, - 204 millions, - just offset the gold exports which were 203 millions, while the decline in money in circulation, - 105 millions, - practically accounts for the increase in member bank reserves, - 107 millions - during the period.

The above figures show that the hundreds of millions of Government bonds, the purchase of which by the Federal Reserve System "flooded the market" - as claimed in the above quoted editorial, -

had been neutralized by the sale of even larger amounts of these bonds, there being at the end of the period 2 million dollars less of such holdings than at the beginning, - and all this under the  $3\frac{1}{2}\%$  rate!

It may be claimed, however, that these figures do not give a clear picture of what took place, because during the month of January, 1928, the tide turned, Federal Reserve credit declining 373 millions and member bank reserve balances declining 113 millions. Let us then consider the period from August 4, 1927, to December 31, 1927, excluding the month of January 1928 when credit conditions were reversed. The following table shows the situation:

August 4, 1927 to December 31, 1927:

Member bank reserve balances increased	220,000,000
Gold stock decreased	200,000,000
Discounts increased	173,000,000
Acceptances increased	222,000,000
United States securities increased	205,000,000
All other Federal Reserve credit decreased	23,000,000
Total Federal Reserve credit increased	577,000,000
Treasury credit increased	20,000,000
Money in circulation increased	175,000,000
Foreign bank deposits decreased	3,000,000
Other items increased	5,000,000

The above figures show that during that period there were gold exports to the amount of \$200,000,000, while the purchase of Government securities increased \$205,000,000. It would seem to me fair to set off the one against the other. So also the increase in money in circulation was \$175,000,000, and this was practically offset by the

increase in discounts of \$173,000,000.

It would seem clear that the gold exports of \$200,000,000 during this period, if not offset in some manner, would have forced a deflation of member bank deposits amounting to at least ten times the amount, or about 2 billions of dollars, and the worst that can be said as to Government security operations during this period is that they prevented a radical deflation caused by gold exports. They certainly, taking the period as a whole, brought about no inflation of deposits.

It may be claimed, however, that while these figures are correct, taking the whole period, yet that there were particular times during this period when the purchase of Government securities placed money in the market which went directly into member bank reserves, thus making additional deposits growing out of loans, possible. Let us then consider the two quarterly periods of the latter part of 1927, during which the 3 $\frac{1}{2}$ % rate was in force.

Let us take the quarter beginning in July and ending in September, during all of which period, except July, the 3 $\frac{1}{2}$ % rate was in effect. The figures for this period are as follows:

Member bank reserve balances increased	44,000,000
Gold stock decreased	16,000,000
Discounts decreased	6,000,000
Acceptances increased	39,000,000
Government securities increased	136,000,000
All other Federal Reserve credit decreased	20,000,000
Total Federal Reserve credit increased	149,000,000
Treasury credit increased	9,000,000
Money in circulation increased	97,000,000
Foreign bank deposits decreased	5,000,000

The increase in member bank reserves during this period was very moderate, - only 44 millions, - and taking the quarter as a whole could be covered by acceptances, - 39 millions, - and foreign bank deposits, - 5 millions, while the Government security operations, - showing an increase of 136 millions, - would, as to all but 17 millions, have offset the gold exports 16 millions, the decline in discounts, 6 millions, and money in circulation, which latter increased 97 millions.

Let us now consider the quarter, October through December, 1927.

The figures for this quarter are as follows:

Member bank reserve deposits increased	194,000,000
Gold stock decreased	192,000,000
Discounts increased	145,000,000
Acceptances increased	142,000,000
United States securities increased	111,000,000
All other Federal Reserve credit increased	26,000,000
Total Federal Reserve credit increased	424,000,000
Treasury credit increased	13,000,000
Money in circulation increased	55,000,000
Foreign bank deposits decreased	3,000,000
Other items decreased	1,000,000

From the above figures, it appears that gold exports had increased 192 millions, and money in circulation had increased 55 millions, which was offset by Government security purchases, - 111 millions, and discounts, - 145 millions. On the other hand, the member bank reserves at the end of this period had increased 194 millions, which increase was practically furnished from the increase in acceptances, - 142 millions, other Federal Reserve credit + 26

millions, and Treasury credit, +13 millions.

An examination of the above table seems to show that neither the discounts under the  $3\frac{1}{2}\%$  rate, nor the Government security operations were, on the whole, primarily or necessarily responsible for the increase in member banks reserves upon which the pending speculation on the New York Stock Exchange rests.

While it is often claimed, as shown above, that the lowering of the discount rate to  $3\frac{1}{2}\%$  produced "easy" or "cheap" credit, it should not be forgotten that credit was easy or cheap, if you so wish to call it, before the rate reduction of August 4, 1927, from 4 to  $3\frac{1}{2}\%$ .

For example, on March 31, 1927, as compared with the previous December 31, 1926, gold imports had increased 105 millions, money in circulation had decreased 233 millions, discounts had decreased 186 millions, and acceptances had decreased 142 millions, the total Federal Reserve credit decrease being 308 millions.

Similarly, comparing June 30, 1927, with March 31, 1927, we find that discounts had decreased 8 millions, acceptances decreased 28 millions, money in circulation decreased 11 millions, and that while Government securities increased 22 millions, the total Federal Reserve credit increase was only 9 millions.

The above gives a fair picture of the easy money conditions existing before the rate was reduced from 4 to  $3\frac{1}{2}\%$ .

The purpose of the reduction of the rate from 4 to  $3\frac{1}{2}\%$  was primarily to prevent a continuance of gold imports into the United States, which, in the absence of any large volume of discounts which could have been paid off, would certainly have tended to inflate the credit structure. Another reason was to give, if possible, some relief to business, commerce, and agriculture, which had been in a state of recession but was just beginning to improve. It is fair to state that this lowering of the rate did accomplish both of the above purposes in more or less degree.

The conclusion I reach from these figures is that while psychologically an easier feeling was created, the increase in member bank reserves can be explained without reference to lower discount rates or Government security operations.

Turning now to the so-called brokers' loans, a study of the charts will fail to reveal any material difference in the increase of such loans, either prior to, during, or subsequent to the  $3\frac{1}{2}\%$  discount rate, except that the New York banks have shown a tendency to reduce these loans, more or less overcome by an increase on the part of out-of-town banks, while the loans made "for others" have steadily increased from the middle of 1926 to date, this increase being practically the same, whether during low rate or high rate periods.

As regards Government security operations, I am inclined to

believe that Federal Reserve credit conditions would have been substantially the same had there been no such operations during the  $3\frac{1}{2}\%$  period, as discounts would have taken their place.

In conclusion, it seems to me that the claim that the  $3\frac{1}{2}\%$  discount rate and Government security operations during the period running from August 4, 1927, to February 3, 1928, created cheap money, and flooded the member bank reserve account, thus exciting speculation on the New York Stock Exchange, is a myth which has no foundation in reality.

Taking the whole period during which the  $3\frac{1}{2}\%$  rate was in effect, - August 4, 1927 to February 3, 1928, - while Government security purchases moved up and down, being 2 millions less at the end than at the beginning, the growth of acceptance holdings was steady and was 205 millions more at the end than at the beginning.

The acceptance growth seems more responsible for the increase in member bank reserves than Government securities.

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