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THE DISCOUNT RATE CONTROVERSY
BETWEEN
THE FEDERAL RESERVE BOARD
and
THE FEDERAL RESERVE BANK OF NEW YORK

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21st (approx)

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November, 1930.

The Federal Reserve Bank of New York, in its Annual Report for the year 1929, stated: -

> "For a number of weeks from February to May, 1929, the Directors of the Federal Reserve Bank of New York voted an increase in the discount rate from 5% to 6%. This increase was not approved by the Board."

Annual Report, Page 6.

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The above statement makes clear the error of the prevailing view that the discount rate controversy lasted from February 14, 1929, - the date of the first application for increase in discount rates, - to August 9, 1929, the date of the Board's approval of the increase from 5% to 6%.

The controversy began on February 14, 1929, but practically ended on May 31, 1929.

On May 22, 1929, Governor Harrison and Chairman McGarrah told the Board that while they still desired an increase to 6%, they found that the member banks, under direct pressure, feared to increase their borrowings, and that they wanted to encourage them to borrow to meet the growing demand for commercial loans.

16 Diary 76 (69).

Furthermore, on May 31, 1929, Chairman McGarrah wrote to the Federal Reserve Board that the control of credit without increasing discount rates

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(direct pressure) had created uncertainty; that agreement upon a program to remove uncertainty was far more important than the discount rate; that in view of recent changes in the business and credit situation, his directors believed that a rate change now without a mutually satisfactory program, might only aggravate existing tendencies; that it may soon be necessary to establish a less restricted discount policy in order that the member banks may more freely borrow for the proper conduct of their business; that the Federal reserve bank should be prepared to increase its portfolio if and when any real need of doing so becomes apparent.

195 - 65.

On June 5, 1929, Mr. Mitchell came before the Board and urged a more liberal discount policy and an easing of conditions by purchase of bills and Government securities, leaving the discount rate at 5%, to be increased only if speculation should revive.

16 Diary 99, 100 (198).

The Federal Reserve Board, as hereinafter pointed out, on June 12, 1929, expressed a willingness to suspend direct action in view of the need of more Federal reserve credit, the 5% rate, however, to be continued for the present, at least.

16 Diary 108, 109 (76).

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It is the purpose of this article to examine into the facts connected with this controversy, and the divergence of opinion between the Board and the Federal Reserve Bank of New York as to the proper Federal reserve policy.

The annexed table shows the discount and acceptance buying rates of the Federal Reserve Bank of New York prior to and since the controversy:

Discount Rates		Acceptance Buying Rates 60 to 90 days	
1927		1927	
August 5	3½%	August 5	3¼%
1928		1928	
		January 27	3-3/8%
February 3	4%	February 3	3½%
		March 30	3-5/8%
		April 13	3-3/4%
May 18	4½%	May 18	4%
July 13	5%	July 13	4¼%
		July 20	4½%
1929		1929	
		January 4	4¾%
		January 21	5%
		February 15	5-1/8%
		March 21	5-3/8%
		March 25	5½%
		July 12	5¼%
August 9	6%	August 9	5-1/8%
		October 25	5%
November 1	5%	November 1	4¾%
November 15	4½%	November 15	4¼%
		November 22	4%
1930		1930	
February 7	4%		
		February 11	3-7/8%
		February 24	3¾%
		March 5	3-5/8%
		March 6	3½%
		March 11	3-3/8%
March 14	3½%	March 14	3¼%
		March 19	3-1/8%
		March 20	3%
		May 1	2-7/8%
May 2	3%	May 2	2¾%
		May 8	2-5/8%
		May 19	2½%
		June 5	2¼%
June 20	2½%	June 20	2%
		July 21	1-7/8 to 2%

The following shows the important dates in connection with the controversy:

1928.

September 28:

The Federal Advisory Council opposed any increase in rates.

November 22:

The Federal Advisory Council opposed any increase in rates because of injury to business.

1929.

January 19:

Dr. Miller told Board the Federal Reserve System was drifting and that rate increase was necessary to effect a curbing of speculation; that the really courageous way would be a public announcement that credit in the future would be available at reasonable rates for agriculture and business, but that the Board would watch the rise in discounts and prevent seepage into Wall Street.

15 Diary 129, 130 (152).

January 21:

Dr. Miller introduced a draft of a letter to all Federal reserve banks suggesting direct pressure on the member banks.

15 Diary 130 (152).

January 25:

Chairman McGarrah informed the Board that his directors were considering issuing a public warning to corporations which were loaning in Wall Street that they were injuring the Federal Reserve System, and in this warning to include an intimation that the collateral behind these loans might prove not to be liquid.

15 Diary 134 (152).

January 25:

Chairman McGarrah objected to the proposed letter to the Federal reserve banks on ground that it would be construed as a blow at the stock market.

15 Diary 134 (153).

February 2:

Dr. Miller's motion was passed, some changes having been made in the letter.

15 Diary 143, 144 (154).

1929 (Cont'd.).

February 2:

The executive officers of the Federal Reserve Bank of New York favored an increase in discount rates but there was objection in the Board of Directors.

15 Diary 143 (44).

February 5:

The Board sent letters to all Federal reserve banks pointing out the seepage of Federal reserve credit into speculative channels and asked how they kept informed of the use made of the proceeds of rediscounts, the methods employed to regulate the abuse and how effective the methods had been.

187 - 107.

February 5:

Governor Harrison informs the Board that an increase in discount rates is necessary; that direct action as to banks "out of line" had proved a failure.

15 Diary 149, 150, 151, 154 (46).

February 7:

Public warning of Federal Reserve Board released to press. This will be referred to in some detail later.

187 - 113.

Governor Harrison informs Board that his directors are considering an increase in discount rates.

15 Diary 160 (47).

February 11:

The New York directors met but took no action as to increasing discount rates.

15 Diary 166 (48).

February 14:

The Federal Reserve Bank of New York applied for approval of an increase to 6% on condition that the Board immediately act on the same.

This was the first application for an increase.

It was disapproved by the Board, as also were similar applications made March 3, March 21, March 28, April 4, April 18, April 25, May 9, May 16, and May 23.

1929. (Cont'd.)

February 15:

The Federal Advisory Council met and approved the Board's warning published February 7, but advised the Board to go further and obtain the cooperation of member banks to prevent the diversion of Federal reserve credit to "loans on securities" generally, - meaning customers security loans.

15 Diary 173, 174 (51).

The Federal Advisory Council further advised the Board not to approve any increase of discount rates until the Board's efforts along the lines of direct pressure had been exhausted. The Council, when making its recommendations, did not know of the action of the Federal Reserve Bank of New York in recommending an increase in discount rates the day before.

15 Diary 175, 176 (52).

March 21:

Governor Young suggests a conference as to discount rates with the New York directors. Governor Harrison replied Yes but discount rates must first be increased.

April 4:

The Governors Conference, accepting the desire of Boston, New York, and Chicago for an increase to 6%, favored a rate not less than 5% for the other Federal reserve banks.

16 Diary 15 (58).

April 19:

The Federal Advisory Council reverses its recommendation of February 15 and advises an increase at New York to 6%.

May 1:

Report of Committee on recent economic changes. Rather "bullish" in its optimism. Nothing much to worry about. The degree of progress in recent years inspires us with high hope.

May 17:

The Federal Reserve Bank of Cleveland passes a resolution favoring an increase in the New York discount rate to 6% to curb speculation.

16 Diary 64 (97).

1929. (Cont'd.)

May 21:

The Federal Advisory Council recommends an increase to 6%.

16 Diary 15 (58).
16 Diary 25 (91).

May 22:

Governor Young points out that Federal Reserve Bank of New York has not mentioned an increase in buying rates for acceptances in connection with an increase of discount rates; that with a 6% discount rate, acceptance rates remaining at 5½%, acceptances would flow into the Federal Reserve Bank.

May 29:

New York suggests a conference of all Federal reserve banks as national questions are involved.

16 Diary 91 (92).

May 31:

Chairman McGarrah writes Board asking it to take up a program for encouraging member banks to increase their borrowings.

195 - 81.

June 3:

Director Mitchell of New York told the Board that the market should be eased by buying bills or Government securities; that the discount rate should remain at 5% and that a more liberal discount policy should be adopted.

16 Diary 100 (74).

June 12:

The Federal Reserve Board, after a conference between its Committee and the directors of the Federal Reserve Bank of New York, sent a letter to Chairman McGarrah indicating a willingness to suspend direct pressure, except as to a few flagrant cases of continuous borrowing,

1929. (Cont'd.)

June 12: (Cont'd).

the 5% rate, however, to continue for the present.
16 Diary 108, 109 (54).

July 16:

Director Mitchell told Dr. Miller that an easing policy was absolutely necessary, although he said that Governor Harrison still favored an increase in the discount rate.
16 Diary 132 (199).

August 2:

Governor Harrison came before the Board and favored an easing policy through purchases of bills, Government securities, or both if necessary.

While he also asked for an increase in discount rates to 6%, he stated that this would merely act as a barrage which would make the acceptance buying rate (then $5\frac{1}{4}$%) lower than the discount rate, thus increasing the flow of acceptances into the Federal reserve bank and would, at the same time, induce the member banks to use part, at least, of the money received from the sale of acceptances for reduction of their rediscounts.
16 Diary 149 (80).

August 7:

The Governors, in conference, favored an easing policy as recommended by Governor Harrison, but through purchase of acceptances rather than Government securities, and approved his suggestion of an increase to 6% at New York but on the understanding and their assurance that the 5% rate would be maintained at the other Federal reserve banks.
16 Diary 152, 153 (81).

August 8:

The Board approved the policy as outlined by the Governors.
16 Diary 153 (81).

August 8:

The Board approved a reduction of the buying rate on acceptances from $5\frac{1}{4}$ to 5-1/8%.

Having outlined the important dates involved, we can now consider the difference as to discount policy which arose between the Federal Reserve Board and the Federal Reserve Bank of New York.

The Board had anxiously observed the wave of security speculation sweeping over the country, and during the year 1928 three increases of discount rates and three increases of acceptance buying rates had been approved, viz: - in discount rates, to 4% on February 3, to 4½% on May 18, and 5% on July 13, while acceptance buying rates had been several times increased, being 4½% on July 26, 1928.

In 1929 acceptance buying rates were increased from 4¾% on January 4, to 5½% on March 25.

Between February 15, 1928 and February 13, 1929, the System had sold 231 millions, net, of Government securities, and money in circulation had been reduced 16 millions.

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Between July 13, 1928, - the date of the establishment of the 5% rate at New York, - and February 14, 1929, - the date of the first application of New York for an increase to 6%, a period of seven months, no change in the discount rate was suggested by the Federal Reserve Bank of New York.

It will be interesting to consider the course of Federal reserve credit during this period of seven months.

As above pointed out, between January 1 and July 13, 1929, there had been three increases in discount rates, and the System had sold about 400 millions of Government securities, under a Federal reserve policy of firming conditions, approved by the Federal Advisory Council, the Open Market Committee, and by the Board.

On August 16, 1929, the Federal Reserve Bank of New York represented to the Board that seasonal requirements might produce some credit strain which might react on business and commerce, and the Board stated that in such event it would permit easing of the market by bill purchases, and that it would further, if absolutely necessary, permit the purchase of Government securities up to the limit of 100 millions.

The Federal Reserve Bank of New York met the seasonal credit demand, as authorized by the Federal Reserve Board, by the purchase of acceptances, substantially no Government securities being bought. It was clearly understood, however, that Federal reserve policy permitted these acceptance purchases merely for the purpose of meeting credit strain, should such strain arise.

As a fact, however, the Federal Reserve Bank of New York acting for the other banks as well, between July and November, 1928, increased their holdings of acceptances by 286 million dollars. That this amount was far beyond any possible need of increased credit, is shown by the fact that largely out of the proceeds of these sales the member banks not only met all seasonal credit demands, but actually paid off about 193 millions of their rediscounts. As a result of these purchases, helped in small degree by gold imports rates on bills and on commercial paper, as well as customers rates, actually declined, contrary to the usual seasonal trend. Member bank reserve balances increased 28 millions, and loans on securities of reporting member banks increased 127 millions.

There would seem to be no possible doubt but that this liberal purchase of bills in excess of credit needs was a factor in the revival of speculation and in the growth of brokers loans. As a fact, the purchase of acceptances had been on such a liberal scale that the Federal reserve banks held for their own account, and for account of their foreign correspondents, about two-thirds of the total volume of outstanding acceptances. The above facts are brought out clearly in the Annual Report of the Board for 1928.

Further, during this period from June to November, 1928, stock prices increased from an average based on 1926 figures, of 150.5 to 192.1; stock sales increased from 11.6 millions to 23.3 millions; brokers loans of the New York banks increased: (a) for own account 176 millions, (b) for other banks 206 millions; (c) "for others" increased 488 millions, the total increase of all these loans being 870 millions.

There is annexed hereto a table showing the course of Federal reserve credit from July to November, 1928, giving both its composition and the relative factors for increase and decrease:

Federal Reserve Credit.

July to November, 1928.

Composition				Total Increase
Discounts		- 193		
Acceptances	+ 286			
U. S. Securities	+ 25			
Other F.R. credit	+ 4			
	+ 315	- 193	=	+ 122

Factors

For increase		For decrease	
Money in circulation	+ 114	Treasury funds	+ 5
Unemployed capital funds	+ 21	Monetary gold	+ 38
Non-member bank deposits	+ 2		
Member bank reserves	+ 28		
	+ 165	-	+ 43 = 122

Increases

F. R. credit increase	122
Monetary gold "	38
Treasury currency	5
	165

Deductions

Member bank reserve balances	28
	137
Money in circulation	114
	23
Unemployed capital funds	21
	2
Non-member bank deposits	2
	0

The effect of these acceptance purchases was to nullify the effect of the increase of the discount rate to 5% made on July 13, 1928, and to change Federal reserve policy from one of firming to one of easing the market.

The above is confirmed by Deputy Governor Burgess of the Federal Reserve Bank of New York, who stated in an address before the American Acceptance Council, December 11, 1928:

> "The Taking by the Federal reserve banks of bills offered involved putting into the money market something like 100 millions of dollars more than seasonal credit needs required, which was used by the member banks to liquidate part of their indebtedness, and this tended, in conjunction with gold imports, to ease slightly the money situation."

It is interesting to note that on December 15, 1928, Dr. Miller introduced a resolution favoring higher acceptance buying rates. This resolution, however, failed, but was voted for by Dr. Miller, Platt, and C.S.H.

15 Diary 115 (149).

Such was the situation confronting the Federal Reserve Board at the beginning of January, 1929. It found that its firming policy, agreed upon by the Federal Advisory Council and the Open Market Committee, had in fact been changed by the Federal Reserve Bank of New York into an easing policy.

Federal reserve credit outstanding in January, 1929, was some 226 millions greater than in January, 1928. There was danger that the customary liquidation after the first of the year might not take place and that Federal reserve credit outstanding would increase in 1929 rather than decrease, just as it increased between January and May, 1928.

In this connection it should be pointed out that for the year ending June 30, 1929, 1,114 banks were borrowing for 80% or more of the time.

195 - 143.

The problem confronting the Board was how to bring about a reasonable liquidation of Federal reserve credit without, at the same time, injuring agriculture and business.

After most careful consideration, the Federal Reserve Board determined to keep the present 5% rate unchanged but to try to reduce outstanding Federal reserve credit by bringing direct pressure, through the Federal reserve banks, upon the member banks to bring about a reasonable liquidation of their speculative loans, or at least not to increase them, and to this end reduce, or at least not increase, their borrowings from the Federal reserve bank to support their required reserves against deposits arising out of these speculative loans.

On February 2, 1929, the Board sent a letter to all Federal reserve banks calling attention to the seepage of Federal reserve credit into the security markets and also released for February 7, 1929, a public statement known as the Board's "warning", which will be considered in detail later.

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Before considering the results obtained from the exercise of direct pressure, with a stable 5% discount rate, it will be advisable to consider the grounds upon which the Federal Reserve Bank of New York based its repeated requests for an increase of the discount rate, and the reasons prompting the Board to disapprove the increase.

The Federal Reserve Bank of New York, as above shown, first asked for an increase to 6% on February 14, 1929, and the Board disapproved the increase as also nine other applications for a similar increase, the last refusal being on May 23, 1929.

In considering the first application, the Board was hampered by the fact that the Federal Reserve Bank had given the Board no official explanation of the reasons prompting it to ask the increase.

It should be remembered that, on October 5, 1928, the Board asked the Federal reserve banks when forwarding applications for changes in rates, to give the reasons for such changes, but that on October 26, 1928, Chairman McGarrah replied that the Bank would be glad to furnish the Board with the main facts presented to the directors at the time of a change in the rediscount rate, but beyond this it would be impracticable to go, owing to the difficulties of attempting to express the reasons which have actuated the different directors in voting to change the rate.

The application of February 14, 1929, was made over the telephone by Governor Harrison, and the Board voted to table it pending an answer of the Bank to the Board's warning letter released February 7.

Finally the Board reconsidered its vote and advised Governor Harrison that it would take the application under review and take no action on that day.

Governor Harrison then told Governor Young that he had not given him the actual vote; that it was in fact conditional on action by the Board on that day; and that his directors could not leave until the Board rendered its decision.

Finally the Board unanimously voted to disapprove the application.
15 Diary 168 to 170 (50).

The disapproval was based as well on the condition imposed by the Federal Reserve Bank of immediate decision by the Board as upon the merits of the application.

The Board felt that it would not be possible to exercise its duty of review and determination upon a telephonic request, giving no official reasons for the change and conditioned on immediate decision of the Board.

Governor Young, however, explained to Governor Harrison that the application involved national as well as local considerations; that if the New York rate was increased to 6%, every Federal reserve bank east of the Mississippi River and very possibly the other Federal reserve banks also would have to make a similar increase, and that a majority of the Board felt that such action might seriously affect agriculture and commerce, and further, that the Board could not decide this important question off hand, on the day of the application, in the absence of any official statement of reasons.

15 Diary 168 (248).

On February 27, 1929, Governor Young in response to a request of the Board on February 14th filed with the Board a memorandum stating the reasons given by the Board to the Federal Reserve Bank of New York, for disapproval of the application, which memorandum was given by him to Director Mitchell of the Federal Reserve Bank of New York.

These reasons in substance were:

1. Sufficient time has not elapsed to determine the effect of the Board's warning published Feb. 7, 1929.

2. The replies received from nearby Federal reserve banks indicate that rate increases should not be begun now.

3. The danger of increased rates encouraging gold imports.

4. The Federal Reserve Bank of New York has furnished the Board with statistics, but has given it no reasons for wishing the increase, and the Board desires reasons.

5. Before consenting to an increase, the Board desires to know to what limits the Federal reserve banks are prepared to go in the event of the increase to 6% not being effective.

6. The Board desires the advice of the Federal Advisory Council now in session, before proceeding on a rate increase program.

This memorandum was placed in the Minutes of February 14th, which were not approved until February 27th.

The second application for increase was an informal one, Governor Young advising the writer on Sunday, March 3rd, that Governor Harrison had told him that his directors earnestly hoped for authority to increase to 6% the next day, as they feared a runaway market.

This application also failed but the "runaway market" did not appear!

15 Diary 184, 185 (54).

The third application was filed on March 21, 1929. It imposed the same condition of immediate action by the Board.

It was pointed out in the Board that the figures revealed a general decline of Federal reserve credit, which, apart from the prevailing speculation would point to the desirability of lower rather than higher discount rates.

The Board disapproved the application with only one dissenting vote.
15 Diary 196, 197 (56).

The fourth application for increase was made on March 28, 1929. The Board disapproved by a vote of 7 to 1.
16 Diary 4 (57).

The fifth application was made on April 4, 1929, and was disapproved by the Board.

On April 9, 1929, Governor Harrison in a letter to the Board, gave for the first time an official statement of the reasons of his Bank for desiring an increase.

The reasons given in substance were that speculative activity had increased interest rates generally in the United States to the injury of business and especially of building construction; that these high rates had prevented the flotation of foreign securities in this country; that they were reducing the purchasing power of Europe and threatening our export trade, and that the high call loan rates were drawing gold from Europe to be invested in the call loan market.

The sixth application was made on April 18, 1929.

It was pointed out in the Board that some of the reasons given for the increase, - necessity for the easing of interest rates, difficulty of placing foreign loans in the United States, the consequent falling off in our export trade, etc., were the very reasons advanced in 1917 for lowering discount rates.

It was also pointed out that the New York Bank apparently felt that higher discount rates would bring about lower call loan rates, but the opinion was expressed that higher discount rates would constitute a firm foundation for higher rather than lower call loan rates.

The Board disapproved the application.

16 Diary 22, 23 (60).

The seventh application was made on April 25, 1929, and the Board disapproved. 16 Diary 38 (63).

The eighth application was made on May 9, 1929, the chief reason given by the New York Bank being a desire to bring the Federal reserve rates into proper relation with market rates.

It was pointed out that a 6% rate was not needed to restore the former relation of rates, - that a rate of 5½% would accomplish this. The Board disapproved.

16 Diary 51 (63).

The ninth application was made on May 16, 1929.

It was pointed out in the Board that Federal reserve credit outstanding was rapidly falling; that a rate of 5½% would be sufficient to restore the old relation of rates.

The Board disapproved.

16 Diary 56 (64).

The tenth and last application for increased rates was made on May 23, 1929.

Federal reserve credit outstanding had been reduced so materially that there was some evidence that an additional amount, perhaps a hundred million dollars, was needed for the purposes of agriculture and business.

While the Board disapproved the application, there was some discussion of a possible compromise, - a lowering of acceptance rates coupled with a 6% discount rate to act as a kind of "Lombard" rate.

16 Diary 78 (69).

From this time on, the necessity of an increased rate was practically dropped from consideration, and on May 31, 1929, Chairman McGarrah, as above pointed out, advised the Board that his directors desired to take up a program of encouraging the banks to borrow.

195 - 85.

The advance in the discount rate to 6% on August 9, was, as already pointed out, a part of a program for easing the money market through lower acceptance rates.

16 Diary 149 (80).

During the discussions above outlined, in which Governor Harrison gave reasons for increasing discount rates, the conditions were rapidly changing. Federal reserve credit outstanding, as shown by total bills and securities of the New York Bank were steadily decreasing, while its reserve ratio was as steadily increasing, as shown in the following table:

Federal Reserve Bank of New York.

Total Bills and Securities		Reserve Ratio	
1929.		1929.	
January 2.	709.8	January	70.4%
February 6	325	February	78.6
March 6	349.9	March	79.
April 3	238	April	79.2
May 1	328.3	May	81.1
June 5	253.6	June	79.1

The Board was thus asked to increase discount rates under conditions of falling Federal reserve credit and increasing reserve ratios which, according to the canons of banking practice called for lower rather than higher rates!!

It has been generally supposed by the public that the issue between the Federal Reserve Board and the Federal Reserve Bank of New York was simply whether the discount rate should or should not be increased from 5% to 6%.

This supposition is absolutely erroneous.

No one was bold enough to predict with any confidence that a mere increase to 6% would suffice.

The real issue was whether the 5% rate should be maintained coupled with direct pressure on the member banks to liquidate reasonably, or at least not to increase their speculative loans, or, on the other hand, as claimed by the New York Bank, whether the Board should approve a policy of repeated increase of rates, beginning only at 6% and continuing to increase until the "situation should be corrected", that is, until the New York Stock market should be radically deflated.

An appreciation of this fact is necessary to a complete understanding of the real issue between the Board and the Federal Reserve Bank of New York.

That such was the real issue will be apparent from reading the letter sent by Governor Harrison to the Federal Reserve Board dated April 9, 1929, in which he used the following language in justifying the desire of his directors for increased rates:

> "The rate increase would have the further result of giving definite public notice to the country that the Reserve System is ready to supplement and support all its other efforts by an affirmative rate policy.
>
> "Public realization that the discount rate would be employed incisively and repeatedly, if necessary, would

greatly strengthen the effectiveness of the System's policy, and in itself hasten the time when the System might lend its influence towards easier money conditions." (Italics mine).
195 - 45.

Governor Harrison several times told the Board that if the 6% rate did not "correct the situation" recourse must be had to further increases.
February 5, 1929. 15 Diary 149 to 151 (45). May 22, 1929. 16 Diary 74, 75 (68).

Chairman McGarrah also told the Board that if 6% did not "correct the situation" he would favor an increase to 7%, 8% or even higher.
April 24, 1929, 16 Diary 37 (62).
May 23, 1929, 16 Diary 74, 75 (68).

Mr. Warburg, in his book, "The Federal Reserve System," entertained the same views.
1 - 513.
16 Diary 66 to 70 (257).

It is interesting in this connection to note the editorial in the Manchester Guardian Commercial on March 4, 1929: -

"There appeared to be some slender hope that the Federal Reserve authorities were meditating action drastic enough to precipitate the crisis in Wall Street, which, in the opinion of most monetary students, must come sooner or later."

189 - 155 (5).

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Such was the issue between the Federal Reserve Board and the Federal Reserve Bank of New York.

The New York Bank wanted quick, radical deflation of the stock market, through rapid increases in discount rates.

Chairman McGarrah admitted that if the policy of incisive, repeated increases did not quickly "correct the situation" the result would be fraught with serious danger to agriculture and commerce.

The Federal Reserve Board felt that the way to solve the problem was to keep the discount rate stable at 5% as a protection to business, but to cut off Federal reserve credit from seeping into Wall Street by direct pressure upon the member banks to reduce, or at least not increase, speculative loans.

If the Board had yielded to the desire of the New York directors and had entered upon a policy of repeated increases of discount rates, the crash in the New York stock market which took place in October, 1929, might have taken place in May or June, 1929, but the resultant injury to business would have been, in all probability, disastrous in the extreme.

The majority of the Board felt, however, as above stated, that the present fever of speculation could not be curbed through the discount rate by any increase short of such extremes as would produce a cataclysm in the market, which, as above stated, would injure business as much as or even more than it would injure the stock market.

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That the discount rate is ineffective in curbing a speculative mania when once underway, is the opinion of many bankers and economists.

For example:

Mr. James Alexander, at a meeting of the Federal Advisory Council on September 28, 1928, stated that speculation could not effectively be controlled by discount rates, and favored a reduction of rates to 4½%.

15 Diary 33, 34, 35 (5).

Professor Hawtry, of London, told the writer the same, adding that in his opinion our discount rates were too high, and were merely injuring business.

January 22, 1929, 15 Diary 131 (43).

Mr. Harry A. Wheeler, a prominent Chicago banker, telegraphed the Board on April 2, 1929, opposing further increase in discount rates, and stating that any increase would add to the heavy burden imposed on the commercial loan group whose rates have been increased in full proportion to rediscount increases, without exercising any permanent restraining influence upon market operations.

190 - 31.

On March 23, 1929, the London Statist criticised Governor Young's address before the Commercial Club, Cincinnati, on March 16, 1929, stating that it revealed a complete bankruptcy of ideas on the subject of credit control; that the obvious remedy for the unhealthy credit situation in the United States would be to lower money rates so as to cause a reflex in the international movement of short-term funds and to encourage lending abroad on the largest scale compatible with safety and profit.

On May 3, 1929, the United States Chamber of Commerce opposed an increase of discount rates solely for the purpose of curbing speculation.

191 - 32.

On May 11, 1929, the London Economist stated:

> "The final lesson is perhaps the most important. It is that when stock prices are rapidly rising, high money rates are only an ineffective deterrent which penalizes the innocent without troubling the guilty.
> "The only remedy against rampant speculation is to cut off funds altogether."

193 - 79 (3) (221).

On May 14, 1929, the New York Journal of Commerce stated that the Federal Reserve System has no right to try to curb speculation through drastic increases of discount rates; that all that has been required of it at any time has been that it should keep its own funds, the reserves of the deposit banks, out of the speculative market.

191 - 113.

On May 23, 1929, the Manchester Guardian Commercial expressed the belief that increased discount rates would not curb speculation.

192 - 147 (2).

On May 25, 1929, the London Statist stated that the banking authorities in the United States apparently want a business depression to curb speculation.

192 - 147.

The writer believes that the speculators would have heaved a sigh of relief at an increase in the discount rate to 6%, in the hope that then the direct pressure, so embarrassing to their movements, would be removed, and that they would be enabled to obtain all the money they desired under the 6% Federal reserve rate. To these speculators a 6% rate, the writer believes, would have been "easy money" as compared with the 5% rate and its stringent direct pressure.

The Board acted on the above theory with the object of cutting off, by direct pressure, the seepage of Federal reserve funds into the securities market, as will be shown later. That the speculative mania, in spite of the Board's efforts, was fed from "loans for others" was a fact over which the Federal Reserve Board had no effective control.

It must not be forgotten that the Federal Reserve System in trying to curb speculation through discount rates, can act only by increasing discount rates on commercial paper; it can not discount paper secured by stock collateral.

Suppose the authorities of a town were to announce that they had determined to put an end to the loss of life by reckless automobile driving by incisive and rapid increases in the price of gasoline!

Or suppose a Father were to chastise his only son because an intoxicated man was carousing in the street!

The reply would certainly be made that nothing short of direct action against the automobiles or against the intoxicated man in the street would suffice to correct the evil!

The majority of the Board took the position that agriculture and business were entitled to lower rather than higher rates; that the rates paid by them had been materially increased already by diversion of funds into speculative channels, and that to impose upon agricultural and commercial paper further crushing blows in the shape of rapid increases of discount rates would be a serious injury to them and a fruitless method of attempting to curb speculative loans, and especially the bank loans "for others", - which had become the chief cause of the trouble.

-12-

The Board having reached the conclusion that the 5% rate should be kept stable for the protection of business, and that seepage of Federal reserve credit into speculative channels should be prevented by other means, on February 7, 1929 issued a public statement which came to be known as the Board's "warning" and action taken under it as "direct action".

This warning and the use of direct pressure was by no means a new idea. It was discussed in the Board in October 1922 when Chairman Perrin of the Federal Reserve Bank of San Francisco explained how the

Federal Reserve Banks of Cleveland and San Francisco during the war period had successfully employed it, keeping the discount rate stable at 6% while the Federal Reserve Bank of New York had a 7% rate.
194 - 97.

It was used also by the Federal Reserve Bank of New York in October, 1925 but in a different manner, as will later be shown, from that now advocated by the Federal Reserve Board.
194 - 97 (2).

The Federal Reserve Bank of Philadelphia used it also in 1925.
194 - 97 (2).

Dr. Miller pointed out the danger from the seepage of Federal reserve credit into speculative channels in an address at Boston in November, 1925.
194 - 103.

On July 27, 1927, the Governors Conference recommended direct action to prevent speculative excess following the rate reduction to 3½%.
14 Diary 16, 17 (59).

The danger was frequently pointed out by the Board in its Annual Reports from 1925 to 1928, and in the Federal Reserve Bulletins.
194 - 103.

The necessity for its present use was emphasized by the fact that, early in 1928, certain New York member banks had borrowed from the Federal Reserve Bank, on their collateral notes, many millions of dollars which they loaned on the stock exchange with great profit to themselves.
194 - 97 (3).

On November 22, 1928, the Federal Advisory Council recommended it to prevent seepage of Federal reserve credit into the call loan market.
186 - 21

On February 14, 1929, the Federal Advisory Council advised its extension to loans of member banks to their customers.
188 - 60, 67, 70, 78.

It is true that on April 5, 1929, and again on May 21, 1929, the Federal Advisory Council reversed its recommendation of February 14, 1929, and advised an increase of discount rates to 6% as asked for by New York, on the ground that direct pressure had not succeeded in curbing speculative loans.

16 Diary 15 (58).
16 Diary 25 (91).

As a fact, however, on May 31, 1929, just ten days after this last recommendation of the Federal Advisory Council, Chairman McGarrah advised the Federal Reserve Board that the New York directors wished to consider a program for easing money conditions and encouraging banks to borrow! 195 - 85.

If the Federal Advisory Council had delayed its recommendation for a 6% rate for ten days, it in all human probability would never have made it!

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The Board, in its public warning of February 7, 1929, pointed out that during the year 1928 the System had encountered interference because of the absorption of Federal reserve credit in speculative security loans; that the volume of speculative credit was still growing and that this effect, coupled with gold exports, had brought about an advance of from 1% to 1½% in the cost of commercial credit; that it became the duty of the Board to inquire into these conditions and to take suitable measures to correct them, which in the immediate situation meant to restrain the use, either directly or indirectly, of Federal reserve credit facilities in aid of the growth of speculative credit.

The reference in this warning to the Board's letter of February 2, 1929, to the Federal reserve banks, led many to believe, including the Federal Reserve Bank of New York (16 Diary 93 (72)), - that the Board's warning meant that as a matter of law, under the Federal Reserve Act, no member bank at any time could lawfully rediscount eligible paper in order to replenish its reserves to sustain deposits arising out of speculative loans.

The writer believes no such ruling of law was intended but merely a rule of sound banking practice under the rabid speculation then rampant. This would seem to be clear from the following quotation from the warning:

> "....which, *in the immediate situation*, means to *restrain* the use, directly or indirectly, of Federal reserve credit facilities in aid of the growth of speculative credit." (Italics mine)

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We can now consider the effect of direct pressure, which lasted, as above pointed out, from February 7, 1929, to about June 9, 1929.

To understand its effect it will be advisable to consider the periods just before it went into effect, and the later periods ending with the stock market collapse of October, 1929.

These periods may be divided as follows:

1. January, 1928 to January, 1929.
2. February, 1928 to February, 1929.

3. February 9, 1929, to June 8, 1929. (This is the period of direct pressure.)

4. June 8, 1929 to August 9, 1929.

5. August, 1929 to October, 1929.
This includes the increase in discount rates to 6%, approved August 9, 1929.

FEDERAL RESERVE SYSTEM

The Federal Reserve figures are weekly averages.
The Member bank figures are for weekly statement dates.

F.R. credit	Dis-counts	Accep-tances	U.S. se-curities	Mem. bk. reserves	Sec. loans	Comm. loans	Invest-ments	Gold Im-ports	Gold Ex-ports	Curr. in circulation
1. January, 1928 - January, 1929.										
+239	+503	+104	-364	-37	+796	+333	-24		251	-19
2. February, 1928 - February, 1929.										
+245	+391	+42	-208	-12	+924	+82	-45		246	-33
3. Direct Action. February 9, 1929 - June 8, 1929.										
-193	+140	-300	- 44	- 68	-361	+444	-262	173		+29
4. June 8, 1929. - August 10, 1929.										
+ 62	+ 81	- 24	+ 5	+ 31	+518	+189	-242	42		+65
5. August, 1929. - October, 1929.										
+ 41	-186	+234	- 20	+ 10	- 28	+253	-134	31		+53

(From figures furnished by Dr. Goldenweiser)

199 - 57.

Let us now comment on these periods and examine the course of Federal reserve credit for the Federal Reserve System.

Period 1. January 1928 to January 1929.

Federal reserve credit outstanding increased 239 millions caused largely by gold exports of 250 millions net. During this period security loans increased 796 millions of dollars, in spite of the gold exports and the decline of 19 millions in money in circulation.

Period 2. February, 1928 to February, 1929.

Federal reserve credit increased 245 millions largely through gold exports, while security loans increased 924 millions.

Period 3. February 9, 1929 to June 8, 1929.

This was the period of direct action, also of a series of increases in buying rates on acceptances at the Federal Reserve Bank of New York, and of increases in discount rates by four Western Federal reserve banks to bring them into line with the 5% rate at the other banks. During this period there was a falling-off of $300,000,000 in the acceptance holdings of Federal reserve banks and of $44,000,000 in holdings of United States securities, while discounts of member banks increased $144,000,000, so that total reserve bank credit outstanding declined by $193,000,000. This decrease in reserve bank credit, despite an increase of $29,000,000 in the amount of money in circulation, accompanied an importation of $173,000,000 of gold and a decline of $68,000,000 in member bank reserve balances. During this period there was a reduction of $361,000,000 in security loans and of $262,000,000 in investments of reporting member banks accompanied by an increase of $444,000,000 in all other, largely commercial, loans.

During this period, however, loans "for others" increased 313 millions.

It may be contended that these decreases in reserve bank credit were brought about more largely by the decrease in acceptance holdings of 300 millions which more than offset the increase in gold imports of 173 millions.

It should be remembered, however, that the shutting off of the flow of acceptances by increased purchasing rates had been in effect before direct pressure was put in effect by the Federal Reserve Board.

On January 4, 1929, the Federal Reserve Bank of New York increased its buying rates on acceptances from $4\frac{1}{2}\%$ to $4\frac{3}{4}\%$ without even asking authority from the Federal Reserve Board, and on January 21st it increased these rates to 5%.

This action in shutting off the flow of acceptances threw a greatly increased strain for rediscounts on the Federal reserve banks.

The Federal Reserve Board, by direct pressure, headed off this increased demand for rediscounts and kept it down to 140 millions, notwithstanding a 344 million decline in the System's holdings of acceptances and Government securities.

Had it not been for the direct pressure, it is fair to assume that under the rampant speculative mania, the member banks would have rediscounted very much more than this increase of 140 millions, and that the gold imports of 173 millions would have also served in material degree to support further expansion.

It should be remembered also that while member bank reserves decreased 68 millions, commercial loans increased 444 millions against an increase of only 82 millions in the preceding period.

Period 4. June 8, 1929 to August 9, 1929.

> Early in June the application of direct action was suspended, largely because it was felt that the heavy credit and currency requirements around the end of the fiscal year should be met by the banks without hesitation and without a feeling that they were going contrary to Federal reserve

policy. That the System had decided upon a policy of relative ease became generally known, and this led to a revival of speculative activity. Between June 5 and August 7 there was a growth of $518,000,000 in security loans of reporting member banks, and of $736,000,000 in brokers' loans. Security prices advanced about 14 per cent. The growth in Federal reserve bank credit, however, during the period was limited to $62,000,000, owing in part to the fact that there was an inflow of $42,000,000 of gold from abroad. A part of this increase in reserve funds was incident to the issuance of the new-size currency, money in circulation increasing by $65,000,000 during the period. Member bank reserve balances also showed a growth of $31,000,000.

Period 5. August 10, 1929, to October 12, 1929.

On August 9 the discount rate at the Federal Reserve Bank of New York was increased from 5 to 6 per cent and at the same time the buying rate on acceptances was reduced from 5-1/4 to 5-1/8 per cent. This resulted in a reversal of earlier conditions by making it cheaper for the banks to obtain reserve bank credit by the sale of acceptances rather than by the discount of eligible paper. By the second week in October borrowings of the Federal reserve banks had declined $186,000,000, while acceptance holdings of the Federal reserve banks had increased $234,000,000, the net change in Federal reserve bank credit outstanding being an increase of $41,000,000. The decline in member bank indebtedness resulted in a distinct easing of conditions in the money market. Security loans of member banks declined somewhat during this period, but there was a very rapid increase in speculative activity and in brokers' loans, supplied mostly by non-banking lenders.

A similar comparison for the Federal Reserve Bank of New York follows:

(In millions of dollars)

Federal reserve figures are weekly averages. Member bank figures are for weekly statement dates.

F. R. bank credit	Bills dis- counted	Accep- tances	U. S. securi- ties	Member bank re- serve bal- ances	Reporting member banks in New York City		
					Security loans	Commercial loans	Invest- ments
Period 1, January 7, 1928 to January 5, 1929.							
+ 226	+ 243	+ 64	- 80	- 23	+ 344	+ 90	+ 37
Period 2. February 11, 1928 to February 9, 1929.							
+ 39	+ 78	+ 10	- 51	+ 2	+ 320	+ 16	+ 21
Period 3. Direct Action, February 9, 1929 to June 8, 1929.							
- 78	+ 1	- 89	+ 2	- 7	- 179	+ 267	- 78
Period 4. June 8, 1929 to August 10, 1929.							
+ 198	+ 168	+ 19	+ 12	- 9	+ 283	+ 82	- 90
Period 5. August 10, 1929 to October 12, 1929.							
- 161	- 216	+ 60	- 19	+ 15	- 125	+ 108	- 29

An inspection of the above tables satisfies the writer that the direct pressure imposed during the 3rd period was successful in preventing the seepage of Federal reserve credit into speculative channels.

This is borne out by the fact that on May 22, 1929, Chairman McGarrah and Governor Harrison told the Board that direct pressure had made the banks afraid to borrow at all and that they wanted to encourage the banks to borrow to meet the necessary demand soon to come for commercial needs.

16 Diary 75, 76, 77 (179).

The Manchester Guardian, on May 25, 1929, stated that direct action had reduced Federal reserve credit used for speculation, but not the amount of credit absorbed in speculative loans, the latter evidently referring to loans "for others".

192 - 147 (2).

It would appear also that even in the two succeeding periods ending in the collapse of October, 1929, the cause of the rampant speculative activity was largely attributable to the flow of funds into the call loan market from corporations using the banks to place their loans.

The following table will bring this out graphically:

Brokers' Loans

Reporting Member Banks, New York City.

	Own Account and Out of Town Banks	"For Others"	Total
1929			
February 5	3048	2621	5669
June 5	2350	2934	5284
August 14	2775	3178	5952
October 9	2772	3941	6713

Comparing February 5 with October 9, we find that the loans by New York banks for their own account and that of out of town banks declined 270 millions, while the New York banks loans "for others" increased 1320 millions.

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While during the period of direct pressure there was a very satisfactory decrease in total speculative (including brokers) loans, yet the security loans to customers as distinct from brokers did not decrease, but on the contrary increased, as the following table will show:

All Weekly Reporting Member Banks.

Loans on Securities.

	To Brokers and Dealers		To Customers
	In New York City	Outside of New York City	
1929			
February 6	1771	816	4971
June 5	1122	808	5267
	-649	- 8	+296

-16-

Out of this increase in customers loans, there arose another difference between the Federal Reserve Board and the Federal Reserve Bank of New York, - wholly apart from the difference as to discount rates.

16 Diary p. 1.

On May 1, 1929, the Federal Reserve Board wrote Chairman McGarrah enclosing a list of certain banks in New York City which had been frequent or continuous borrowers and which were still carrying a considerable volume of security loans, and asked him to inquire of these banks why they had not adjusted their position.

195 - 67 (5).

On May 10, Mr. McGarrah replied stating that the Board was laying down a new test of abuse of Federal reserve credit by this letter; that the Federal reserve bank can not determine whether member banks security loans to customers are speculative or not; that the Federal reserve bank has no lawful right to refuse to discount eligible paper on the ground that the proceeds are to be used to sustain such security loans; that such refusal would be a rationing of credit and bring about a condition the Federal reserve bank could not afford to risk, and in conclusion he reiterated his belief that such loans could be treated only through the use of the discount rate.

195 - 63.

Governor Harrison had previously, on February 6, 1929, taken the same position.

15 Diary 158 (115).

This position of the Federal Reserve Bank of New York was not in accord with the recommendation of the Federal Advisory Council on February 15, 1929, as shown above.

Nor does it accord with the position taken by Mr. George M. Reynolds, a prominent banker of Chicago, who, in a letter to Governor McDougal dated March 2, 1929, said:

> "I shall insist upon our people doing more than trying to sit on the lid to prevent further expansion, because I am now of the opinion that nothing short of a vigorous effort forcing liquidation of many large lines of credit will accomplish our purpose.....
>
> "The people seem to have lost their heads over stock gambling, and the time has come when those who are in responible positions will have to take the bull by the horns and force them to do something which they will not like. With sales of over six million shares of stock yesterday, it is clearly shown that the public has not profited by the advice of the Federal Reserve Board, and I think we have now reached the point where it is a matter for each individual bank to get into the game vigorously and do whatever is necessary to at least force a reduction in the amount of money that is borrowed against stock exchange collateral."

As opposed to the above views of the Federal Advisory Council and Mr. Reynolds, the Federal Reserve Bank of New York from the first took the position not only that direct pressure should be strictly confined to banks which were borrowing more than the mass of banks of their general class, but also that customers loans could not be considered by Federal reserve banks in passing upon applications for rediscounts.

On February 5, 1929, Governor Harrison squarely made such a statement.

15 Diary 154 (114).

On February 21, 1929, Chairman McGarrah repeated the statement.
195 - 67.

On May 29, 1929, both Governor Harrison and Chairman McGarrah took the position that direct pressure should not be used to curb customers speculative loans.

16 Diary 76 (53).

On June 5, 1929, Governor Harrison repeated the statement, correcting Mr. Mitchell, one of his directors, who went further in his view of the power of the Federal reserve bank.

16 Diary 101, 102 (155).

It is unnecessary to state that the Board never advised the direct refusal of rediscounts to any bank, although it clearly is within the power of the Federal reserve bank to do so, as our General Counsel, Mr. Wyatt, and Hon. Newton Baker, our Special Counsel, have advised the Board. What the Board intended was to have the Federal reserve bank examine into the security loans being made by a member bank which is a frequent or continuous borrower from the Federal reserve bank, and if it considered such loans out of line with its commercial loans or excessive generally under present conditions, to warn the bank that it must protect the interests of its depositors and of the public by exercising a more reasonable use of Federal reserve credit obtained by rediscounting.

The majority of the Board believed that a mere suggestion along these lines would, in the vast majority of cases, be sufficient without the necessity of the Federal reserve bank using its reserved power of refusing rediscounts altogether.

The position of the Federal Reserve Bank of New York in the matter is in accord with the feeling of many bankers that a good customer, keeping a good balance, is entitled to all the money he may desire if he is willing to pay the discount rate fixed by the bank, and that the use of the discount rate is the only method of curbing the good customers desire for money.

In ordinary times the above rule of practice might pass without criticism, but in extraordinary times of speculative mania it must be pointed out that the rule is not consistent with sound Federal reserve banking principles.

The reply is constantly made that if a bank refused a loan under such circumstances the customer will withdraw his account and get the money he desires from some competing bank not so solicitous for the interest of its depositors or of the public.

This may be true in individual cases but could be guarded against by agreement among the principal banks of the city, or of the country, to join in curbing wild speculation, and then the customer would find that all the competing banks are following the same rule and that he can gain nothing by withdrawing his account.

Such a conference was repeatedly urged upon the officers of the Federal Reserve Bank of New York by the writer.

The suggestion was later approved by Mr. Potter, of the Guaranty Trust Company of New York, but so far as the writer knows, was never carried out. Feb. 14, 1929. 15 Diary 172 (97).

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An interesting light was thrown on the responsibility of bankers in times of speculative manias, by Governor Young, in an address delivered at Old Point Comfort, Va., on May 7, 1930, in which the Governor said:

> "We bankers have a responsibility beyond our own balance sheets for the general course of events."
>
> "We must look beyond the safety of the collateral offered us for a loan to the safety of the aggregate volume of collateral that we know is being offered for loans at all the banks."
>
> "When we see an unhealthy development getting under way we must not only protect our own immediate institution, but must take a broader view with reference to the interests of the entire community."
>
> "In other countries, where banking development has been longer, and banking concentration has proceeded farther, certain methods of control have been developed."
>
> "A customer in England is not granted unlimited credit on the basis of security offered as collateral; he is granted a line of credit in accordance with his credit standing and the requirements of his business, and he can not easily exceed that line no matter how much collateral he may be able to offer."
>
> "I am not prepared to recommend to you this or any other specific course of action, but I do feel justified in calling your attention to our joint responsibilities and to suggest that what we need is cooperative action in the development of sound banking traditions, which alone will give assurance to the country of a lasting stability of its financial organization."

"To such cooperation I pledge my wholehearted support."

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The writer believes that the action of the Federal Reserve Board in requesting the Federal reserve banks during this period of mad speculation to take up with member banks applying for rediscounts the matter of their customers speculative security loans, is not only in accordance with law, but also is in accord with the principles of sound banking, and that if this inquiry had been more generally made, conditions might not have been as bad in the Fall of 1929 as they in fact were.

Although Chairman McGarrah and Governor Harrison characterized such a procedure as "credit rationing" likely to result in appalling consequences, the writer believes that sufficient evidence has already been disclosed of the appalling consequences of lack of such inquiry as would warrant the conclusion that such inquiry, whether characterized as credit rationing or by some other name, would have been for the greatest good of the greatest number of our people.

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Before closing this article it may be well to consider the attitude of bankers, economists, and the press, towards the Board's warning and the operations conducted under it from time to time as it progressed.

The following are among those who expressed approval:

American Bankers Association	
	April 29, 1929. 193 - 67 (3).
Anderson, B. M.	Feb. 13, 1929. 188 - 48.
	Mar. 22, 1929. 190 - 69.

The following are among those who expressed **approval (Cont'd.)**

Ayres, Leonard	Feb. 16, 1929.	188 - 68.
Becker and Co.	Feb. 13, 1929.	188 - 51 (2).
Bendell, E. C.	Feb. 13, 1929.	188 - 51 (2).
Boston Transcript Financial column	Feb. 7, 1929.	187 - 125.
	April 5, 1929.	190 - 50.
	May 16,	191 - 144.
	May 23,	192 - 34.
	June 28,	193 - 65, 70.

On May 23, it stated that direct pressure had proved as effective as discount rate increases.

Brookmeyer Economic Service
July 9, 1929. 193 - 120.

Dulles, John Foster — April 30, 1929, 191 - 20.

Equitable Trust Co. Mr. Austin
Dec. 13, 1929. 199 - 25.

Lawrence, David

Direct pressure has succeeded and Federal Reserve Board will now suspend it.
June 3, 1929. 192 - 92.

Explains warning.
June 5, 1929. 192 - 102.

Lisman Digest

Points out that low discount rates do not necessarily mean easily available money.
July, 1930. 205 - 65.

London Economist

The events of the past year have seen the beginnings of a new technique, which, if maintained and developed, may succeed in rationing the speculator without injuring the trader.
May 11, 1929. 193 - 77.

New Republic	Feb. 20, 1929.	188 - 112.
	April 9, 1929.	190 - 63.

The following are among those who expressed approval (Cont'd.)

New York Post — Feb. 8, 1929. 188 - 5.

New York Herald-Tribune — Feb. 8, 1929. 187 - 134.
188 - 5 (2).

New York Telegram — Nov. 25, 1929. 198 - 88.

New York Times — Feb. 8, 1929. 187 - 152.
Feb. 11, 1929. 188 - 10 Financial column.
Mar. 20, 1929. 189 - 88.
Mar. 28, 1929. 189 - 142.
Apr. 6, 1929. 190 - 48.
May 20, 1929. 192 - 12 Financial column.
Sept. 13, 1929.
The 6% rate has failed to direct funds from the stock market. The Board may have to resume direct pressure.
195 - 118.

See also infra - Criticisms

New York World — Feb. 7, 1929. 187 - 118, 129, 130.
Feb. 8, 1929. 188 - 5 (5).
Feb. 9, 1929. 188 - 1.
Apr. 13, 1929:
Publishes interviews mostly approving.
190 - 80.
May 23, 1929:
The Board hesitates to penalize business but seeks to check diversion of credit into speculative channels.
192 - 36.
May 26, 1929:
People who once attacked the Board for its tight money policy, now attack it for its disapproval of increased discount rates.
192 - 70.
July 31, 1929. 194 - 14.
Aug. 12, 1929. 194 - 98.
Nov. 19, 1929. 198 - 56.

See also - Criticisms

Newark News — Nov. 24, 1929. 198 - 46.

Philadelphia Evening Bulletin
A great victory for the Federal Reserve Board.
June 7, 1929. 192 - 122.

The following are among those who expressed approval (Cont'd.)

Rogers, Will
Suggests that the people may discover that the Federal Reserve Board may be working in the interest of the millions.
May 24, 1929. 192 - 34.

Rukeyser (New York American)
Feb. 11, 1929. 188 - 37 (2).
Oct. 7, 1929:
Board has mitigated violence of trade cycle.
196 - 100.
July 31, 1930:
Praises Gov. Young's address at Old Point Comfort, Va., pointing out to member banks their duty and responsibility for controlling speculative loans.
206 - 30.

Sprague, F. K.
Approves but dilatory.
Feb. 13, 1929. 188 - 51 (2).

Stern — Feb. 18, 1929. 188 - 87.

Temple, A. H. — Mar. 27, 1929. 190 - 69.
Apr. 24, 1929. 190 - 27.

Trust Companies — Feb. 1929. 189 - 89.

United States Chamber of Commerce
May 4, 1929. 191 - 39, 91.

Vanderpoel — May 16, 1929. 191 - 150.

Walmseley — April 7, 1929. 190 - 52.

Washington Post — Feb. 9, 1929. 188 - 4.
April 6, 1929. 190 - 47.

Washington Star — Feb. 16, 1929. 188 - 76.

Whaley-Eaton Service — Mar. 26, 1929. 189 - 130.
Successful in most districts but not in all.
June 29, 1929. 193 - 10 (3).

Wheeler, H. A. — April 2, 1929. 190 - 31.

There follow some critical comments or articles which appeared from time to time:-

Ayres, Leonard
Board defeated in its struggle to control the credit situation.
July 16, 1929. 193 - 145.

Boston Herald
Board failed.
Aug. 10, 1929. 194 - 65.

Boston News Bureau
Adverse comment.
April 6, 1929. 190 - 56.

Commons, Prof.
Federal Reserve Board may have gone after the stock market too hard.
Feb. 14, 1929. 188 - 57.

Durant, W. C.
Attacks Federal Reserve Board.
Feb. 28, 1929. 189 - 4.
Apr. 2, 1929. 190 - 30.
Aug. 10, 1929. 194 - 68.

Harvard Economic Service
Predicts the warning will fail unless coupled with higher discount rates, which, however, it admits will injure business.
Feb. 19, 1929. 188 - 105.

Lawrence, David
Uncertainty of Board's policy criticised by many.
June 11, 1929. 192 - 141.

London Times
Adverse comment. May 25, 1929. 192 - 147.
Savors of politics.

Manchester Guardian Commercial
Adverse comment. Mar. 28, 1929. 193 - 67.

New York Herald-Tribune
The 6% rate substituted for vacillation, threats, and cajollery.
Aug. 9, 1929. 194 - 90.

Critical articles which appeared from time to time (Cont'd.)

New York Herald-Tribune (Cont'd.)

Defense by Federal Reserve Board in its Annual Report for 1929 agreed to by few.

April 24, 1930. 202 - 130.

Gov. Young not responsible for direct pressure.

Aug. 28, 1930. 206 - 88.

New York Journal of Commerce

Adverse criticism Feb. 8, 1929. 187 - 140.

Feb. 9, 1929. 188 - 3, 5.

Apr. 6, 1929. 190 - 44.

See - Willis, H. P.

Board guided by political fears.

May 24, 1929. 192 - 45.

May 25, 1929. 192 - 147.

By approving 6% rate the Board has changed its policy.

Aug. 5, 1929. 194 - 30.

The Board's defense of direct action puts it in a ridiculous position.

April 28, 1929. 202 - 140.

The Board's credit control in 1929 was a mockery.

Aug. 29, 1930. 206 - 90.

New York Post

The pre-panic action of the Board was ineffective because of the Board's personnel.

Sept. 5, 1930. 206 - 114.

New York Sun

Charges politics. Feb. 14, 1929. 188 - 87.

Criticises. Aug. 29, 1929. 195 - 19.

Board tried to shut off credit altogether. The Federal Reserve Bank of New York saved the country from panic.

April 24, 1930. 202 - 130.

The Board has learned from experience the importance of following sound banking principle and the need of respecting the decisions of the regional banks.

Sept. 2, 1930. 206 - 104.

Critical articles which appeared from time to time (Cont'd.)

See - Schneider, F.

New York Times

Criticises Board for not following advice of Federal Advisory Council to approve increase to 6%.
May 23, 1929. 192 - 31.

Criticises Board's reluctance to penalize business, which, it says, has already been penalized.
June 6, 1929. 192 - 110.

Financial column says that Board's approval of the 6% rate represents a change of policy.
Aug. 12, 1929. 192 - 110.

A matter of dispute how far Board fell short of the needs of the occasion. Purpose and action to safeguard the credit structure was correct.

Board did not act with sufficient promptness or decisiveness.

Allowed internal division to betray itself.

Relied on persuasion or reasoning when past experience indicated that the time had passed for anything but peremptory action or, at least, definite warning which could not be misunderstood.

Lack of effective leadership.
Sept. 6, 1930. 206 - 110.

New York World.

Right but tardy. Feb. 8, 1929. 188 - 5.

Delayed firming policy too long.
Board has lost control of money market.
April 3, 1929. 190 - 32.

Right, but not determined enough.
April 15, 1929. 190 - 72.

Prestige of Board injured by its vacillating course.
Aug. 12, 1929. 194 - 98.

Richmond Press

Criticizes. 187 - 151.

Critical articles which appeared from time to time (Cont'd.)

Rukeyser (New York American)
Has proved fruitless.
Feb. 11, 1929. 188 - 37 (2).

Schneider, F. Jr. (New York Sun)
In July, 1929, Mr. Schneider, after praising the easy money policy of the System in 1927, criticized severely the firming policy of 1928 and 1929, stating that the extent of the security speculation had been exaggerated, and that the System should not be unduly distracted by emotional reactions raised by the stock market and brokers loans controversies.
194 - 73.

On December 31, 1929, Mr. Schneider took the position that the Federal Reserve Bank of New York was right, and the Federal Reserve Board wrong in the discount controversy. He evidently assumed that the issue was between a 5 or a 6% discount rate, for in the article above mentioned he specifically condemned any attempt to break the stock market by rapid increases in discount rates, not knowing evidently that that was the then policy of the Federal Reserve Bank of New York.
199 - 70.

Seligman, Prof.
Holds Board partly responsible for the crash of October, 1929, because of refusal to approve increase of discount rates.
Nov. 26, 1929. 198 - 96.

Shiveley, E. A.
Criticizes. Feb. 8, 1929. 188 - 51 (2).

Simmons, E. W. W.
Criticizes
Address. Chicago Stock Exchange.
May 14, 1929. 191 - 112.

Sprague, F. K.
Dilatory. Feb. 13, 1929. 188 - 51 (2).

Rates should have been increased long ago.
Mar. 12, 1929. 189 - 79.

Critical articles which appeared from time to time (Cont'd.)

Sprague, Prof. O. M. W.
Warning had but little effect.
May, 1929. 193 - 31.

Stern
Board has failed. Feb. 28, 1929. 189 - 6.
Mar. 1, 1929. 189 - 19.

Stokes, E. C.
Attacks. Mar. 23, 1929. 189 - 104.
June 18, 1929. 193 - 32.

Sullivan, Mark
Washington believes Board has not succeeded.
Aug. 16, 1929. 194 - 102.

Truth
Criticises. April 17, 1929. 193 - 41.

Wall Street Journal
Criticises. May 8, 1929. 191 - 58.
Aug. 29, 1930. 206 - 90.

Williams, Langbourne
Attacks April, 1929. 190 - 28.
May 10, 1929. 191 - 118

Willis, H. P.
Criticises
North American Review
April, 1929. 190 - 107
192 - 49.

Withers, Hartley
Mr. Withers believes that discount rates should have been increased and quotes from Mr. Burgess's book to the effect that the Federal Reserve System deals with credit quantitatively and not qualitatively; that its influence is upon the total amount of credit in use, not in its employment, and that it can not restrict loans on the Stock Exchange.

Let us examine the above quotation from Mr. Burgess's book. Is it true that the Federal Reserve System's power over discounts is <u>quantitative</u> only and not <u>qualitative</u>? Is it further true that the quantitative power can be exercised only through changes in discount rates?

In one sense, certainly, the Federal Reserve System is the most qualitative system in the world, for the reason that until at least the amendment of 1917, the Federal reserve banks could discount only a certain quality of paper, - that is, self-liquidating agricultural and commercial paper.

So also the amendment of 1917 was a qualitative amendment for it permitted advances to member banks on their notes collateraled by Government bonds.

Mr. Burgess, in his book, however, must mean that once the paper offered has passed the qualitative test, the Federal Reserve System can only control the amount, and that only through changes in the discount rate, no matter to what uses the bank may apply the proceeds of the rediscount.

If this position is correct, it must follow that in a time of rampant speculation, whether in commodities, real estate, or securities, the Federal reserve bank can exercise no control in the public interest except through changes in the discount rate, and that a bank offering eligible paper has an absolute right to discount it, regardless of the amount or of the use which it expects to make of the proceeds, providing it is willing to pay the official discount rate.

To take such a position, however, is to ignore the Federal Reserve Act, which states that a Federal reserve bank may discount, and not that it <u>shall</u> discount.

It is clear that a Federal reserve bank in its discretion may decline to discount altogether.

Such a position, moreover, would be at variance with the practice of the Federal Reserve Bank of New York which has always claimed and exercised the right of inquiry into the loan practices of banks borrowing more than other banks of their class, and of warning them that a continuation of such practice may result in a refusal to rediscount their paper. (See letter of Chairman McGarrah to the Board dated February 21, 1929. 195 - 67.)

While the Federal reserve bank, to be sure, exercises here a <u>quantitative</u> power, it is certainly based on <u>qualitative</u> considerations. The bank is directed to reduce the amount of its borrowings, and in order to do this, it may determine the particular means by which this reduction is brought about, whether by reduction of investments, or security or other loans.

Can it be, however, that when all banks of a given class are engaged in feeding the speculative movement to the injury of agriculture and business, the Federal reserve bank has no power to examine into their loan practices and direct a reduction of their borrowings?

If the answer is in the negative, it will place the Federal reserve banks in a position of impotence never intended by the framers of the Federal Reserve Act.

Let us suppose that a town were to erect a reservoir to hold water for irrigation purposes, with a right granted by the legislature to sell the water at its discretion and to fix the price. Let us further suppose that the owners of farms taking this water were diverting it for wasteful purposes other than irrigation.

Let us further suppose that the town has notified these owners that this practice must be stopped, and that the reply was made that in the case of one owner diverting more water for such wasteful purposes than the general class of owners, the town would have power as regards that one owner, but in a case where all the owners are improperly diverting the water, the town would be powerless. Certainly scant attention would be given to such a claim, and similarly scant consideration should be given to a similar claim of impotence in the Federal reserve banks.

It would not be necessary for the Federal reserve banks to pick out any particular speculative loan and order it to be liquidated. The Federal reserve bank could simply warn the bank that the amount of its borrowing was excessive because of its loan practices, leaving to the bank the task of adjusting its position.

Although this power of the Federal reserve bank primarily is a quantitative power, yet the decision may be based largely on qualitative considerations, and this would seem to be clearly within the power of the Federal Reserve System.

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The gist of the above criticisms seems to be that the Board persisted in its policy of direct pressure not only from February 7, 1929, to June, 1929, but farther until August 9, 1929, when it reversed itself and approved a 6% discount rate asked for by the Federal Reserve Bank of New York; that this reversal of policy was reached only after long delay and indecision; and finally that the failure to approve the increased rates asked for by the Federal Reserve Bank of New York earlier, places upon the Board some responsibility, at least, for the market crash of October, 1929.

The answer to these criticisms has already been pointed out but can be repeated:

1. The direct pressure policy was suspended early in June, 1929, when the Board and the Federal Reserve Bank of New York agreed that because of changes in the business and credit situation the problem had been changed into one providing for an increase of Federal reserve credit, and increased borrowings by the banks.

This change of policy was not publicly announced either by the Board or by the Federal Reserve Bank of New York for fear of its effect on the stock market. It did, however, leak out and was mentioned by Mr. David Lawrence in an article published on June 3, 1929. From what source Mr. Lawrence derived this information, the writer has no knowledge.

2. The increase in discount rates to 6% approved by the Board on August 9, 1929, had nothing to do with the Board's policy of direct pressure, which, as above stated, had been suspended early in June.

On the contrary, this increase, as explained by Governor Harrison, and pointed out earlier in this article, was merely a "barrage", to use

Governor Harrison's exact language, in connection with a program for easing money conditions.

3. So far from being timid and vacillating in its policy of direct action, the Board on February 7, 1929, acted decisively and boldly and kept direct action in force until the object sought by it, - prevention of diversion of Federal reserve credit into speculative channels, - had been accomplished, Federal reserve credit outstanding having been reduced under direct pressure, about 193 millions of dollars.

4. So successful was this policy that, as before pointed out, Governor Harrison and Chairman McGarrah informed the Board on May 22, 1929, that under the influence of direct pressure the member banks were afraid to increase their borrowings and that it had become necessary to encourage them to borrow from the Federal reserve banks to supply the growing demand for commercial credits!

16 Diary 76 (69).

5. The further charge of responsibility for the crash in the stock market in October, 1929, because of refusal to approve increases in discount rates asked for by the Federal Reserve Bank between February 14 and May 23, 1929, seems to me, as hereinafter stated, tantamount to a statement that the stock market crash which came in October could have been <u>averted</u> by an incisive discount rate policy in April or May, which, however, would have <u>produced</u> the crash at that earlier period.

Looking back to the period between February 4 and May 23, 1929, the Board had before it the demonstrated fact that its policy of direct action had kept Federal reserve credit away from the speculative market; that commercial loans were increasing, while security loans were decreasing.

It also had before it the report of the Committee on recent economic changes which was generally interpreted as a "bullish" report. It stated generally that there was nothing much to worry about, and that in attacking the problems before the Committee the degree of progress in recent years inspired it with high hope.

Can it be contended that under such conditions a public Board would deliberately have attempted to smash the stock market by cataclysmic increases of rates on commercial paper?

I do not believe any public board in the United States, whether composed of bankers or economists would, under these circumstances, whatever its courage and wisdom, have made such an attempt.

Mr. Edie has pointed out in an address before the Academy of Political Science January, 1930, that the ordinary law of supply and demand does not apply in time of rampant speculation; that in such times higher prices do not check demand but act as an alcoholic stimulant to further extremes of demand.

The writer believes this is as true of money or credit as of commodities, and that increase in discount rates during such periods loses its force as a regulator of demand for money; that the only way to regulate demand in such cases would be such incisive and extreme advances in discount rates that money or credit would practically cease to be obtainable at any price.

Mr. Edie admits that a gradual slow process of increasing rates would have a stunting effect on business, but that a sharp and swift advance in rates would check false inflation in security markets without paralyzing business. This is tantamount to saying that if the Federal Reserve System, in May or June, had suddenly and incisively and repeatedly raised rates high enough to smash the stock market, business would not have been injured. We all know the effect on business of the crash in October. If the Federal Reserve System had deliberately brought about this crash in May or June, by startling increases in discount rates, there would seem to be little ground, in the writer's opinion, for belief that business would have taken it any differently in May or June than it did in fact in October.

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Mr. Warburg, in his book entitled "The Federal Reserve System" gives a review of the discount rate controversy.

Vol. 1, pages 500 to 517.

He says that the Board's warning was bravely expressed in the beginning, but that it had only a temporary effect, as the Board became inarticulate; that the Board agreed to advance rates to 6% only in August, at least half a year, if not a year, too late; that the Board's attempt at loan contraction without adequate increase of discount rates, proved an impracticable and wasteful experiment.

Mr. Warburg states that loans "for other" are beyond the direct control of the Federal Reserve System, but states that he made a suggestion which would tend to bring down these loans, namely: The New York Clearing House Committee, acting under the auspices of the Federal Reserve System, could have sent for a stock exchange Committee, and have invited them to ask every stock exchange firm within a given time to reduce its borrowings, - whatever they might be, - by a given small percentage; that if this had been done, the top of the market would have been reached then and there, and liquidation gradually would have set in; that if the Federal Reserve System and the Clearing House banks had definitely agreed on such a plan, the stock exchanges would have been forced to fall into line, for no matter how large a volume of funds stock exchange firms were receiving from "others" they would have realized that, in the final analysis, they were depending upon the strength and good will of the New York banks.

Mr. Warburg says he definitely urged this in the first days of April, 1929, but that while everybody seemed to agree on its desirability and practicability, it proved impossible to carry it into effect; that the

Reserve System feared to expose itself to the charge of dealing, even indirectly, with the stock exchanges, and the clearing house banks were loath to undertake so unpopular a step, so long as Federal reserve discount rates were not increased to 6%. Mr. Warburg further states that with the Board unwilling at that time to permit the increase to which four months later it agreed, it is not surprising that the proposal fell through.

No such suggestion was ever made to the Federal Reserve Board, and it must have been made, if at all, to the Federal Reserve Bank of New York. Governor Harrison once referred to such a suggestion without revealing its source and he stated that he personally was opposed to it.
March 22, 1929. 15 Diary 199 (57).

Mr. Warburg criticizes the Board for its disinclination to injure business by increasing discount rates, and adds that with quick and determined increases, incisive enough to bring about liquidation, the period of high money rates would probably have been so brief that business might hardly have been affected by it.

Mr. Warburg concludes by this interesting statement:

> "This does not mean, however, that a Federal Reserve bank should not be free to act according to its own discretion if a member bank were to use Federal reserve credit excessively or too continuously, or in a manner harmful to the country's interest."

Mr. Warburg falls into the prevailing error by assuming that this controversy lasted from February 7th, the date of the issue of the warning, to August 9th, the date of the approval of the 6% discount rate. As above shown, from the early days of June to August 9, the problem before the Board and the New York Bank was how to induce the member banks to increase their borrowings, and not by means of discount rates to reduce these borrowings.

He further approves the position of the New York Bank that incisive, repeated increases of discount rates should be used to "correct the situation", that is, to liquidate radically the New York stock exchange loans. This, as before stated, is tantamount to saying that the stock market crash which came in October could have been <u>averted</u> by an incisive discount rate policy in April or May which would have <u>produced</u> the crash at that earlier period, - as pointed out above by the Manchester Guardian.

The Federal Reserve Board, however, felt that under direct pressure a gradual liquidation could have been secured without the necessity of the Board's going out of its way to smash the stock market. Such gradual liquidation took place during the period of direct pressure, but was interfered with by an increasing demand for commercial credit.

The writer believes that if the Federal Reserve Board had smashed the stock market by incisive discount rate increases, it would certainly have put an end to any increased demand for commercial credit, and that such action would have been an impetus to the slow decline even then apparent in commerce and business, terminating in the present business depression.

Mr. Warburg's statement that direct action was a wasteful experiment, would seem to be answered by the course of Federal reserve credit during the period when direct pressure was being applied. His suggestion of cooperation between the New York Stock Exchange and the Federal Reserve System was, as above stated, never presented to the Federal Reserve Board. Assuming, however, that he presented it to the Federal Reserve Bank of New York, and the reference, above quoted, to Governor Harrison's statement would seem to indicate that he may have, it is easy to see how the officials would have regarded it as credit rationing, to which, as above shown, they were absolutely opposed.

It should be remembered that Mr. Potter of the Guaranty Trust Company, and also the writer, suggested cooperation between the Federal reserve bank and the leading banks, with a view to exercising control over the speculative customers' loans of these banks. It is believed that such cooperation might have brought about the results Mr. Warburg hoped for from a conference between the System and the New York Stock Exchange. His final statement of approval of action by the Federal reserve bank in the case of banks using Federal reserve credit excessively or too continuously, or in a manner harmful to the country's interest, can only be accepted as an approval of the Board's position taken in its warning against frequent or continuous borrowing.

Hon. Russell Leffingwell, formerly Assistant Secretary of the Treasury, in a recent review of Mr. Warburg's book, criticises the Federal Reserve Board for attempting by direct action to make money dear for the speculator, and, at the same time, cheap for the business man. He repeats the statement in Mr. Burgess's book that the Federal Reserve System can control the amount but not the distribution of

Federal reserve credit. This statement I have already answered in this article.

Mr. Leffingwell further holds the Board responsible for the frenzied "bull" market in the first eight or nine months of 1929, and also for the stock market crash in October, 1929.

Here he falls into the prevailing error that the Board's controversy with the New York Bank lasted from February to August, while, as a matter of fact, as above shown, the Federal Reserve Board policy after June 1st was a common policy subscribed to both by the Federal Reserve Board and the Federal Reserve Bank of New York.

He states that direct action was a failure, but I feel that he has not critically examined the facts, and has not discovered that during the short period of from February 14 to June 1, in which direct action was in force, commercial loans greatly increased, while security loans greatly diminished, and Federal reserve credit was reduced about 193 millions of dollars.

He holds the Board responsible for the frenzied "bull" market during this period.

Direct action unquestionably did have a profound effect on the call loan market, but what would have been the effect on this market if the Board in February had entered upon a cataclysmic increase in discount rates which would have practically made it impossible to obtain money or credit at any rate, and which would have smashed the stock market? Mr. Leffingwell presumably would have favored smashing the stock market in February, 1924, as he is on record in this article as favoring the New York Bank's policy, but the effect on the call loan market of such an operation, as I have said, he fails to point out.

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In conclusion, it may be asked whether the majority of the Board, in supporting a stable 5% rate with direct pressure, intended to lay down this as a permanent policy to the exclusion of increased discount rates hereafter to curb speculative activity.

To such an inquiry, an unqualifiedly negative answer must be given. The Board always has and always will feel free to use the discount rate to protect agriculture and commerce from injury from any speculative excess, either in the stock market or in the commodity or real estate market. For example, discount rates were increased to curb speculative activity in the early months of 1923, in the fall of 1924, in the beginning of 1925, in the autumn of 1925, in the summer and fall of 1926, in the fall of 1927, and in 1928.

189 - 127
191 - 63.

When, however, it appears, as in the concrete case, that a speculative orgy has set in, it may be necessary to revive direct action and pressure upon all speculative loans, with or without increases of discount rates, whether to brokers or customers, or both.

Direct action or pressure, in short, is a <u>means</u> and not an <u>end in itself</u>, to be used in connection with or independently of increased discount rates, as the best judgment of the Federal Reserve System shall determine.