USE OF CREDIT IN SECURITY SPECULATION

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A close relationship has developed in this country between the stock market and the money market because of (1) the widespread practice of margin trading in securities and (2) the need, especially under a system of small unit banks, for a liquid money market where banks may employ reserves and temporary surplus funds. Wide fluctuations in the volume of street loans with changes in speculative activity have been a stabilizing influence when they offset opposite movements in volume of credit used by business customers of banks; but from 1922 to 1927 street loans increased along with other loans and investments of banks. The speculative movement was not checked by limitations on the supply of money in 1928 and 1929, and brokers obtained loans from non-banking lenders. Increase in volume and use of credit and diversion of credit into certain uses resulting from the increase in street loans affected the volume of production and trade and also the equilibrium of the economic system. Absorption of credit by the stock market was less important than creation and diversion of credit resulting from market activity. More effective control of stock-market credit is necessary for business stability. Adequate control may be exercised over supply of funds only by making stock-market activity the principal guide of credit policy. Restrictions on margin trading are needed to limit demand for brokers' loans. New restrictions on both supply and demand have been imposed by the Banking act of 1933 and the Securities Exchange act of 1934.

In this country the banking and credit system has been more closely related to security speculation than in any other country of the world. The market for stock-exchange loans has been our central money market, the place where banks and others with loanable funds may generally go and find borrowers and from which they may always readily withdraw their funds when needed. For a long period in our history this market served the function of a central bank.

Developments in this market have had considerable influence upon the operation of the general economic system. Fluctuations in security prices and in the volume of speculation, it is true, *reflect* business developments; but fluctuations in the volume of stock-market credit in turn have an important effect upon the course of these developments. Throughout the history of the country stock market activity has been recognized as an important factor in the ebb and flow of business. Attempts have been made to restrict its influence by changes in our banking structure and by restrictions upon manipulative trading in securities. The events of the past decade indicate that earlier attempts along this line did not accomplish their purpose; and within the last two years other measures have been adopted which are designed to diminish the degree of connection between the stock market and the credit system.

Development of the Street Loan Market

The development of the close relationship between stock trading and the credit system has been based in part upon the particular mechanism of stock-market trading used in this country and in part upon the peculiar nature of our banking system—the one affecting the demand for funds and the other affecting the supply.

Demand for funds. With respect to the stock-market mechanism there are two characteristics which are important:

(1) Stock-market trading is generally financed by open accounts with brokers. Since the customer is required to pay only part of the purchase price and may put that up in securities, and since commission houses have only a limited amount of capital, brokers must borrow the remainder from banks and other lenders. The broker holds title to customers' securities, and may sell them to protect his loan. This practice has concentrated the demand for funds in the central money market into the hands of a few substantial borrowers, and has thereby enhanced the quality of street loans.

(2) The system of call loans characteristic of the New York money market has grown up out of the practice of daily settlements of stock-exchange transactions. Under this system payments must be met promptly, formerly within one day and now within two days. Brokers must be able to make new loans and repay old ones every day, depending upon whether their payments exceed their receipts or *vice versa.*

In addition to these general characteristics of stock-market credit mechanism, certain other features have encouraged the free use of credit for stock-market speculation. The ease with which any individual of small or large means can open a margin account with a stock commission house is not equalled in any other market. The solicitation of brokers for trading accounts, the various means for selling and advertising their services, the tremendous amount of publicity given to stock-market developments, the facility and rapidity with which quotations may be obtained, and various other aspects of this nature facilitate stock speculation through commission houses. These practices are not followed to anything like the same extent on other markets. On the London Stock Exchange, brokers are exceedingly careful in accepting new clients, and advertising for business by members of the exchange is practically prohibited. The completeness with which transactions are reported and the rapidity with which these reports become available are both on a much smaller scale than in this country. The general public interest in stock-market activities is considerably more limited.

It is important to emphasize that in this country stockbrokers, who profit by an increase in the volume of speculative trading, are the original grantors of credit to traders, who are the original borrowers, and that these credits are in effect merely advances on open-book account. Practically the only test of borrowing ability is the adequacy of the margin; borrowers are not required to give promissory notes, and generally little or no inquiry is made into their credit standing. In London, by contrast, brokers require evidence of good credit standing and of full personal responsibility before accepting an account. London brokers are particularly cautious about carrying over speculative accounts from one term to another, preferring that purchasers take up stock and borrow from banks on their own notes.

Because of laxity in the precautions taken in this country by commission houses in accepting customers, these houses must act promptly on a falling market to require new margin or to sell out the customer for lack of margin. For the same reason on a rising market the customer can readily use his enhanced margin to increase his commitments. Because of the practice of selling out, customers' credits and brokers' loans have proved to be safe in practice, but this safety has been attained with the sacrifice of stock-market and money-market stability.

Margin trading of this sort on a large scale provides a broad market but not necessarily a stable market. In fact it probably exaggerates the effect of manipulative operations. Powerful pools by raising the prices of stocks increase unencumbered margins, thus permitting additional purchases, which in turn promote the rising tendency. Bear pools, on the other hand, by depleting margins force distress selling, which furthers the declining tendency of prices. In this manner a movement once started in either direction is likely to become cumulative.

Supply of funds. From the standpoint of supply of funds the credit structure of this country has had certain characteristics which have encouraged the free use of credit in stock-market speculation.

The New York street loan market, which supplies these funds, is a distinctive institution among money markets. Whereas in most other central money markets of the world banks place their liquid reserves and temporary surplus funds principally in the bill market, in this country demand loans on stock exchange collateral have generally in the past furnished the principal employment for temporary surplus funds and secondary reserves of banks. In other countries banks as a rule place very definite limitations upon amounts they will lend for stock-market speculation.

With our system of unit banking and resulting correspondent bank relationships and in the absence of central reserve banks, there developed early in our financial history a real need for an exceptionally liquid central market for demand loans, in which banks could employ their reserves and their temporary surplus funds and withdraw them quickly when needed. Even under the federal reserve system interior banks have found it desirable to keep balances in New York either on deposit or loaned at call; if the former, the New York correspondent banks had to have the funds obtainable on demand.

Although it is the general tradition that banks supply their customers' needs before placing funds on the street, not all street loans of banks are made from surplus funds not needed by business customers. Regardless of customers' demands, banks must keep some of their funds in readily obtainable form; furthermore, brokers may be customers, especially at city banks; and at times banks have no doubt been attracted to the market by high rates.

In addition to bank funds there have been other sources of funds for street loans. Investment trusts, insurance companies, other financial institutions and even industrial corporations with temporary surplus funds awaiting use, generally found in this market satisfactory employment for these funds. Individuals and other brokerage houses also frequently made loans on the street.

Because of certain established customs in handling commercial credits, a large bill market did not develop in this country, and the New York call money market has most effectively supplied the needed medium for the employment of liquid funds. Under normal conditions this market has provided a service that has contributed to the smooth operation of our banking and credit machinery. Through all sorts of vicissitudes, moreover, brokers' loans have proved to be remarkably safe and have always been readily callable on demand. Probably no other money market in the world could have met so smoothly the demands that have been placed upon this market. The incidental effects, however, upon the stock market and upon general business and credit conditions have not always been favorable. At times they have been disastrous.

Stock-Market Credit and Business Conditions

There have been in the past wide fluctuations in the volume of street loans. From 1921 to 1929 they increased from about a billion to over eight and one-half billions of dollars, and they subsequently decreased to less than half a billion dollars in 1932. At the same time other loans on securities increased and decreased by large amounts. Stock-market speculation was thus definitely reflected in the volume of credit. Business conditions were also influenced by these variations in speculative activity and in credit volume. The flow of goods through the channels of production and trade was stimulated by the further use of funds which speculators borrowed to buy securities and was depressed by the withdrawal of funds from business uses when loans were reduced.

An increase in brokers' loans indicates that brokers, as a group, are paying out more funds than they are receiving, while a decrease means an excess of receipts by brokers from customers and others. Brokers' loans usually increase when stock prices rise, in part because new speculators coming into the market or old ones using their profits as margins are increasing their borrowings from brokers to purchase securities from investors or from corporations issuing new shares, and in part because speculators are withdrawing their profits. During falling prices, on the other hand, holders of stocks must deposit new margin funds or sell out to investors or speculators who bring in new money. Brokers are thereby enabled to reduce their borrowings.

Effect on business. At certain times in the past the traditional practice for

banks to shift funds between customers' loans and stock-market loans has probably made the stock market something of a stabilizing influence in the general business situation. When customers of banks demanded loans for use in production and trade, funds were withdrawn by banks from stock-market loans. Liquidation of these loans exerted an influence which more or less offset and eventually was a factor in checking expansion in volume of production and trade and rising prices. Conversely, in periods of depression funds not needed by business customers found use in securities markets, with a stimulating influence on production and trade.

During the past decade, however, these traditional relationships were not maintained. From 1922 to 1927 the increase in brokers loans, occurring largely in bank loans, represented an increase in the total volume of credit, which was based not only upon a growing demand from stock-market speculators but also upon the fact that banks had an abundance of funds and were seeking borrowers, despite active business. This supply of funds came in part from gold imports, in part from a shifting of deposits from the demand to the time category, which released reserves, and in part from the fact that corporations and other business borrowers were financing their needs more largely from their own resources or from the proceeds of new capital issues than from short-term bank loans.

In 1928 and 1929, on the other hand, the supply of funds available to banks was reduced by federal reserve bank open-market operations and for a while in 1928 by gold exports; banks withdrew funds from street loans and sold some of their investments. Their loans to customers increased, representing in part large business demands and in part speculation in securities by customers. In these years the continued increase in brokers' loans was supplied by non-banking lenders, a new element in the situation. Although total bankers' loans increased substantially, there was no increase in the volume of bank deposits. Business, however, continued exceptionally active during 1928 and the first half of 1929, an activity that was reflected in increased turnover of available deposits rather than in larger volume of deposits.

Through this period, however, weaknesses were developing in lines which did not obtain funds, directly or indirectly, through stock-market channels. Mortgage money was scarce; rates on customers' paper and on customers' loans of banks increased, and rates on acceptances rose. Higher money rates in this country as well as stock-market speculation attracted funds from abroad and caused serious dislocation in foreign money markets.

From June to September, 1929, when there was the last great spurt in the stock-market boom, there is evidence that stock-market speculation was financed largely by a self-contained and self-generating supply of funds, obtained from lenders who had in turn obtained them by selling stocks to margin traders. Stock-market activity and prices rose to phenomenal

levels but with little stimulus to business. It is possible that during this period credit actually absorbed in increased deposits held by participants in the stock market was a depressing influence on trade which more than offset any stimulus arising from the increased use of other deposits in production and trade.

During the long decline in security prices from 1929 to 1932, accompanied by liquidation in brokers' loans as well as in other security loans of banks, the after-effects of the stock-market boom decreased both the volume and velocity of the money supply. In the first stages of liquidation brokers' loans by others were paid off with funds drawn from a variety of sources, in part from the sale of other assets and in part from borrowing directly from banks. Bank loans to brokers increased in 1930. Although in 1930 there was an actual increase in deposits, as there had been a decrease in 1928 and 1929, the holders of those deposits used them less actively for business purposes.

Speculation and the supply and use of money. It may be seen from this historical résumé that security speculation may affect production and trade by influencing not only the supply of credit but also the extent and nature of the use of the available supply. It is not possible here to elaborate the theoretical questions involved in these relationships. The various ways in which they are expressed may only be enumerated rather dogmatically.

1. Expansion in brokers' loans by banks means an increase in the money supply, unless other loans and investments of banks decrease; while contraction in the volume of bank credit as a result of declining brokers loans decreases the volume of purchasing power available for business uses. These results may, of course, be offset by contrary movements in other factors affecting the volume of bank credit.

2. Changes in the volume of brokers' loans by non-banking lenders do not affect the volume of money. If these loans replace or are replaced by bank loans the money supply is, of course, affected by the changes in bank loans.

3. An increase in stock market loans, *whether made by banks or by others,* is likely to result in the more active use of available deposits. Corporations issuing new securities will have funds for capital expansion, and speculators taking profits will spend more freely. This is reflected in increased velocity of deposits.

4. Absorption of credit by the stock market, meaning by absorption an increase in funds held on deposit as a result of stock-market activity and not available for use in trade and production, is generally much smaller in amount than credit created or put to more active use as a result of a stock-market boom.

5. The stock market has considerable influence in directing the flow of

credit and may divert funds from some uses into others and thus upset the equilibrium of the economic system.

6. To the extent that stock-market loans are made by corporations and others from the proceeds of securities sold to margin traders, a self-contained credit system may be set up which will have but an indirect effect upon the use of money in production and trade.

Control of Stock-Market Credit

There is no easy solution to the problem of controlling fluctuations in stock-market credit. Trading in securities is an important aspect of the operation of our economic system; security trading has no doubt been an aid in supplying the tremendous amount of capital needed for development of this country. The free and easy flow of investment funds into business use is facilitated by the existence of an active securities market. The operation of this market requires and is entitled to a certain amount of short-term credit, just as credit is required in the distribution of goods. The use of a moderate and relatively stable volume of credit in security trading cannot be seriously criticized. The dangers arising from the use of credit in stock-market speculation grow out of the extreme fluctuations that characterize these markets.

From the standpoint of the banking system, also, the street loan market is a useful institution. As long as we have a unit system of banking it will be necessary for banks to maintain correspondent relations in money centers, or to have otherwise available a supply of funds which can be immediately called upon to meet customers' demands. The street-loan market has fulfilled these requirements in an eminently satisfactory manner. From the banks' standpoint the defects in the market are not that street loans are unsafe, but that the economic consequences of these loans are undesirable.

Control of supply. Most proposed and attempted methods of controlling stock-market speculation have been directed at the supply of funds. It has been emphasized that this is a task of the federal reserve system. By open-market operations the federal reserve banks can increase or decrease the supply of reserve funds available to member banks. Since expansion and contraction of street loans by banks reflect changes in their surplus funds, it is said that control over the surplus is all that is needed. Experience shows, however, that once a speculative movement has begun, it may not be so easily checked. Withdrawal of bank funds results in an increase in money rates, and not only banks but other lenders are attracted to the market. When there are opportunities for large profits, speculators are not retarded by high money rates.

Furthermore, as previously explained, not all of the street loans by banks represent surplus funds. Brokers are also customers of banks and receive

consideration as such. Banks in New York also feel responsibility for maintaining stability in their money market; and when other funds are withdrawn quickly, in order to prevent a crisis, New York City banks will supply the demand.

For these reasons, other methods than open-market and discount-rate policy have been adopted or proposed to control expansion in street loans. The Banking act of 1933 instructs the federal reserve banks to keep informed of the character and amount of investments of member banks and under certain conditions the Board may suspend any member bank from use of the credit facilities of the system or place specified limitations on its discount privileges.

Restrictions placed by the Banking act of 1933 upon bank relations with security affiliates and with security dealers are designed to reduce the amount of direct interest that a bank may have in security markets. Limitations imposed by that Act on interest that may be paid by banks on deposits may tend to decrease the supply of funds available for lending in securities markets. Brokers' loans by non-banking lenders are now prohibited by provisions of the Banking act of 1933, the Securities Exchange act of 1934, and clearinghouse regulations.

The proposal that member bank reserves be based in part on velocity of turnover as well as on volume of deposits would also restrict the volume of funds available for lending, particularly by banks in communities where a speculative movement is centered.

The recent development of a large market for short-term Treasury bills, which now total nearly $2,000,000,000, supplementing the supply of bankers' bills, might also be an influence in detracting from the importance of street loans in the employment of liquid funds of banks.

With its previous powers and with the additional restrictions that have been imposed by certain recent legislation, the federal reserve system could probably exercise effective control over the amount of funds available for stock-market speculation. In order to accomplish this purpose, however, it would be necessary at times to make developments in the stock market the chief basis for policy. It is undesirable that the general credit policy of the country should be based upon the fickle fortunes of speculation. In order to control speculative movements pressure must be exerted early in the development of that movement and at a time when the general business situation may indicate no need for restriction. Control over supply, therefore, needs to be supplemented by control over the demand for funds and in particular control over that portion of the demand that itself arises from undue speculative activity.

Control of demand. The demand for stock-exchange loans could be diminished by placing such severe restrictions upon the stock market that all types of trading would be penalized. The same end, however, might be ob-

tained simply by restrictions on margin trading which would discourage the building up of large speculative commitments, by traders operating on credit. Both of these approaches have been adopted in the Securities Exchange act of 1934.

The margin provisions of this Act are automatically flexible and are so designed as not to discourage trading at times when security prices are low and to place increasing restrictions on margin trading as prices rise. Under the margin formula expressed in the Act and adopted by the Federal Reserve Board a broker may at any time make a loan of as much as 100 per cent of the lowest market price of a security within the preceding three years, but the loan may not exceed 75 per cent of the current market value nor is it required in any case to be less than 55 per cent of the current market value. The result of this formula is that small margins are required on securities which are relatively low in price or on those which fluctuate within narrow limits, whereas on securities which have risen considerably high margins are required. This system of requirements serves to restrict the amount that can be borrowed on securities that are likely to be speculative favorites. Another effect is to restrict the practice of pyramiding; the price of a security may rise from 133 to 182 per cent of its basic low point without any increase in the amount that can be borrowed. Similarly, the formula will lessen the necessity for forced liquidation; the price may fall from 182 to 133 without requiring that additional margin be obtained. The Board has power to change these requirements when necessary. These features should be a factor in stabilizing securities markets, the alternate expansions and contractions of credit that arise from their fluctuations, and the consequent ebb and flow of business.

It is not within the scope of this paper to discuss other features of the Securities Exchange act which place limitations upon trading and require that fuller information be provided by corporations to their stockholders. These features should also serve to restrict the volume of margin trading and to diminish extreme fluctuations in speculative activities.

Conclusion

Thomas Paine is responsible for the statement that "credit is suspicion asleep." Events in this country during the past decade indicate that a stock-market boom is a most powerful soporific to human suspicions, while a decline in the market is an equally powerful arouser of suspicions. The stock-market and money-market mechanism in this country encourage the use of credit in stock speculation. The credit thus put into use becomes an active and positive factor in determining the course of economic developments in general. Once such a movement has started, ordinary restrictions upon the bank-credit supply may prove insufficient to check it, because of the intensity of speculative enthusiasm and in part because the stock market has the

ability to create its own credit, which may not only be used to finance stock speculation but may also stimulate business turnover.

A credit structure built upon the fickle fortunes of speculation is certain to collapse because the profits of speculation depend upon liquidation. Restrictions placed upon stock speculation and upon the use of credit for this purpose are, therefore, necessary to insure stability of business and should not be considered as undue restraints upon legitimate business enterprise. The organization and operation of the stock market in this country and the close interrelationship between stock market and money market give to stock-market operations an unduly important rôle in influencing not only the rate of expansion and contraction in the volume of credit but also the channels through which that credit is put into use.[1]

It may be seriously questioned whether economic stability can be obtained in this country until this influence has been considerably restricted. Recently new measures have been adopted to control these tendencies. These various new restrictions have been placed upon securities markets and securities loans at a time when they were not strictly necessary to prevent abuses. This will permit the market to become accustomed to them without any difficult or sudden readjustments. Their effectiveness remains to be tested when the economic situation is such as to encourage a revival of speculative enthusiasm.

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[1] This view is not intended to imply that security speculation in itself is the fundamental cause of business fluctuations, but only that the close tie-up between the stock market and the money market is such as to make security speculation, for whatever reason it may have developed, an influence which increases the intensity and magnitude of fluctuations in business.