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VOLUME XLI



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TWENTY YEARS OF FEDERAL RESERVE POLICY

INCLUDING AN EXTENDED DISCUSSION
OF THE MONETARY CRISIS, 1927-1933

BY

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LECTURER ON ECONOMICS, HARVARD UNIVERSITY

VOLUME I

A SURVEY OF FEDERAL RESERVE POLICY



Gokhale Institute of Politics
and Economics, Poona 4.

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To

H. H. B.

**WHO AS MY TUTOR IN HARVARD COLLEGE FIRST
INTERESTED ME IN ECONOMICS**

FOREWORD

BESET by difficult problems, badgered by dualistic supervision and the lack of any potent instruments of control, the reserve system, which has now been in operation for almost twenty years, has nevertheless functioned remarkably well. To criticize from the vantage point of the present is easy, and criticism has been persistent and intensive; but the thought that the Federal Reserve Board and the reserve banks are manned by their present personnel rather than by many of their eminent critics is comforting; and the nation need not be ashamed of their achievements in the past.

It is argued in this book that the Bank rate has not played an important part in the determination of monetary conditions, that the effectiveness of open market operations has been exaggerated, that the use of moral suasion is fraught with danger and arouses dissension within the System, and, finally, that the administration of the eligibility provisions of the Federal Reserve Act has not provided reserve banks with a significant weapon of control. Bank rate has been relegated to an unimportant place, because the enforcement of a penalty rate is not practicable, because the use of the Bank rate as a weapon of restraint has been unpopular with politicians, and because in this country the usefulness of the weapon has been impaired by the peculiar relations of member and reserve banks. Furthermore, the failure of the reserve banks to interest themselves more in the size of reserve balances of member banks, and their inability to control adequately the magnitude of these balances, has impaired the usefulness of open market operations. Moreover, in carrying through their open market policies, they have been too optimistic concerning their capacity to determine the volume of indebtedness of member banks; and the relation of indebtedness and the investment policies of member banks has not always been on approved lines: the fact is that member banks (and more important all banks and non-banking lenders) have not always reduced their credit in the face of a large (and increasing) volume of indebtedness, when large profits might be made by purchasing additional assets. The results of moral suasion, another weapon popular

with reserve authorities and particularly with the politicians and the Federal Reserve Board (the link between the System and Congress), have disappointed most disinterested students of the System. In the past the use of moral suasion has been dictated by the assumed need of discouraging the *speculative* use of bank credit, and has been popular over a large part of the country. But only where money markets are not well organized and the possibility of earning large additional profits is great (by borrowing freely from the reserve banks and lending at higher rates), may the application of moral suasion be justified.

It may seem to many observers that, peculiarly in the United States, the orthodox weapons of control have lost their edge; but in truth the trend has been general since 1914, although the sensitivity to political influences of our system and the organization of our money markets and the reserve system have tended to accentuate this development here. On the other hand, the German Reichsbank, attempting to control a market with a distinctly limited volume of trade bills, and normally restricted in the investments purchasable, has relied with much success on moral suasion: it has rationed credit during crucial periods, determining rations partially by the use to which the funds obtained from the Reichsbank were to be put. Open market operations there have been of secondary importance, and the Bank rate, especially because of the internationalization of large volumes of short-term money, has been an ineffective instrument. In England the Bank rate, as a result of the diminishing importance of the trade bill and the increased capacity of foreign countries to attract foreign funds through the use of the Bank rate, has declined in importance. The issue of Treasury bills, much more important now than trade bills, is discouraged by an increase in Bank rate not nearly so much as is the issue of trade bills: the fact is that foreign lenders may be induced to finance their needs elsewhere when the Bank rate is increased, and when the financing of foreigners through acceptance credits is, relatively speaking, of lesser importance, the effectiveness of an increase in rates is impaired. Great Britain has also been affected adversely by political pressure directed against a courageous rate policy and by the difficulty of introducing economic adjustments that are a necessary part of a successful rate policy. On the other hand, the volume of short-term funds available for movement from one center to another is larger than it was before

the War. A central bank may strengthen its currency by attracting these funds, which may sometimes be an advantage; but more often it may be embarrassed by an influx of foreign money.

In one respect, the absence of tradition and the pressure of public opinion have been advantageous to the United States. Whereas officials of the Bank of England have announced that they are unwilling to assume the responsibility of creating cash beyond the needs indicated by the condition of the money market, the reserve authorities, under pressure by Congress and the threat of extreme legislation, have undertaken open market operations in 1932 on a scale never before attempted by any central banking authority — operations which have been of signal value even if they no more than proved the point that the mere creation of balances (reserves) by central banks cannot of itself bring about business recovery.

A phase of reserve policy requiring much more study than has yet been given to it is that of the relation of policies and conditions in one district to those in other districts. The condition of a reserve bank is to a much greater extent determined by the relations of the banks and the public in its district with other districts than it is determined by the relation of the reserve banks, as a group, to foreign countries. Inter-district transfers of cash, usually exceeding 10 billions monthly, are much larger than are international transfers. Inter-district clearings, government transfers of funds, open market operations, movements of funds between banks, currency movements, and so forth, determine the cash position of reserve banks to a considerably larger extent than do relations with foreign countries. Stringency to be associated with losses of gold abroad is usually felt in New York, for the most part; but not always. Moreover, open market operations, largely consummated in New York, first affect monetary conditions there; but these purchases flood the New York market with cash, while other districts, forced to pay for their share of the purchases, lose cash.

More information is needed on the questions of the inter-relationships of districts; it is necessary to consider the reserve policies of individual reserve banks as well as those of the System. In what manner and to what extent does ease or stringency spread from New York to other districts? To what extent are policies determined by purely local conditions? To what extent does the Kansas City Reserve Bank enforce its policy as against that of the reserve

system? In what manner does the New York District defend itself against bearing an excessive share of the burden of both international and local movements? These and similar questions require answers before we can understand reserve policy. An attempt is made to study problems of this nature here. Attention is also directed to the discussion of inter-regional movements of deposits, which subject receives much space in the second volume.

If this book is written around any central philosophy, it is that central banks, in attempting to impose their policies on the country, encounter very serious obstacles. Their weapons are neither so potent nor so sharp as is commonly assumed; and for any successes, reserve banks owe much to the gullible public, which labors under misapprehensions concerning the power of reserve banks.

A word about the arrangement of this book. In a survey of Federal reserve policy for the years 1914-33 that is presented in the first volume, weapons of control used by the reserve banks are discussed from a theoretical and historical viewpoint. I have tried to use all available sources of information, including the vast collection of Government documents and Mimeographed Letters and Statements of the Federal Reserve Board, neither of which has ever been examined systematically.

Volume II is devoted to an intensive study of the monetary policies of the crucial six year period, 1927-33. This volume, or at least the first half of it, is more difficult reading than is the first volume. I have made an attempt to study the mechanism of open market operations, particularly in relation to inter-regional questions, and I have devoted much attention to the movement of cash or deposits between different parts of the country, as well as the inter-regional balance of payments. The United States is in truth a continent: there are twelve central banks and numerous money markets. A student may neglect some very important aspects of reserve policy if he proceeds on the assumption that the System policy is all that is to be considered, and that relations with foreign countries are the only aspect of the problem of the balance of payments that matters.

In the latter part of Volume II the legislation of 1933, actual and proposed, as well as the extraordinary open market episodes of 1929-32, are studied in some detail and their significance for the problems of central banking indicated. Volume II also includes a

statistical appendix in which numerous problems are discussed. It seemed desirable to collect the charts and to discuss them in an appendix although references are made at appropriate places in the text.

A bibliography, which the writer hopes is fairly complete, is presented at the end of the book. The reader may find this book easier reading if he is acquainted with the well-balanced elementary studies of Kemmerer and Day, the excellent studies of Burgess and Goldenweiser (now somewhat out of date) on the reserve system, and the very able studies of Reed and Hardy on the policies of the last ten years. The latter has appeared just in time to allow me to take some account of it. There are numerous special studies of some aspects of the problems under discussion, of which the outstanding is Riefler's remarkable study of money rates. I might also mention Watkins' able book on bankers' balances. Lest I have frightened the potential reader, I hasten to add that it is my hope and expectation that he will be able to profit from this study even though he is not acquainted with the above-mentioned books.

In this study I take into account developments, in so far as the relevant facts are available, up to the early part of 1933, and I have attempted to consider all literature appearing before November, 1932. It has been necessary to rewrite large parts of this book as a result of legislative changes and developments of 1932 and the early part of 1933, and at the last moment to add a final chapter on the crisis of February — March, 1933.

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OFFICIALS of the Federal Reserve System have been most patient in answering questions and putting material at my disposal, and I must mention in particular that excellent organization, the Division of Research and Analysis of the Federal Reserve Board, and Miss Elsie Rackstraw, the librarian of the Federal Reserve Board. It is my hope that I have repaid them in part by not being unmindful of the practical difficulties that confront a semi-public organization endowed with large powers.

This book has profited from the advice of Professors F. W. Taussig and Joseph Schumpeter, who are always interested in the work done by the young economists of Harvard. My former students, Miss Doris L. Benz and Paul Sweezy, read the entire manuscript with care, as did my colleague, Kenneth P. Kempton.

Miss Virginia Stone, who was my research assistant for several years, and Miss Katherine Hampson, of the Committee on Research in the Social Sciences (formerly in Economics), who prepared the charts and read the proofs, have contributed much to this book, as has A. P. L. Turner, Jr., to whose lot has fallen a very large part of the work required in preparing these volumes. Without his help this book would be far from completed.

The Committee on Research in the Social Sciences, by putting at my disposal the necessary funds, has enabled me to complete this work much sooner than would otherwise have been possible, and also to study some phases of the subject that otherwise would have been closed to me. Professor C. J. Bullock, the Chairman of that Committee, has been particularly helpful, and I appreciate the spirit in which its help has been extended through him.

To the Harvard University Press and in particular to Mr. J. T. Day and his excellent corps of assistants I am extremely grateful for the speed and care with which they put through a very difficult manuscript.

S. E. H.

DUNSTER HOUSE, HARVARD UNIVERSITY

March 23, 1933

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