

## ***'Cheap Money, Gold, and Federal Reserve Bank Policy'***

Benjamin M. Anderson Jr., Ph. D., Economist of the Chase National Bank of the City of New York

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### ***SUMMARY***

The present glut in the money markets, with excessively cheap money and its attendant evils and dangers to the credit structure of the country, is due to the concurrence of three main causes:

1. The unprecedented flow of gold to the United States.
2. The current business reaction.
3. Excessive Federal Reserve Bank earning assets, due to a feeling on the part of the Federal Reserve authorities that they owe it to their stockholders to earn expenses and dividends at all times.

Since November 21, 1923, the Federal Reserve Banks have increased their holdings of Government securities from \$73,000,000 to \$477,000,000, while the rediscounts and commercial paper holdings of the Federal Reserve Banks have declined with the falling off of commercial demand for money. In the present state of declining trade, both incoming gold and Federal Reserve Bank investments are reflected almost entirely in an increase of member bank balances with immediate and even violent effect upon the money market.

The situation is abnormal and dangerous. The predictions that the great inflow of gold, coupled with the great expansive capacity of the Federal Reserve Banks, would lead commodity prices to rise sky-high in the United States have not been fulfilled. On the contrary, commodity prices have fallen pretty steadily for over a year, and are now close to the lowest point they reached in the depression of 1921-22. The price relation between gold and goods is still a world problem, and not a problem for the United States alone. But even if we have not blown up a price bubble, we have been blowing up a credit bubble, especially in the form of long-time debts. States, municipalities, agriculture, and other borrowers have borrowed excessively because money has been cheap. Banks have invested heavily in long-time bonds. A great volume of short-time money market funds has been diverted to capital uses.

Misled by the artificial excess of money market funds, many of us believe that investment capital is likewise abundant. With a change in the business tide, and above all with such a change in the European situation that capital could once more freely diffuse itself throughout the world, we should see this illusion dispelled. For the world as a

whole, capital is scarce after ten years of war and disorganization. Its apparent abundance is due to abnormal money market conditions, both in the United States and abroad, and to the fact that capital is unwilling to venture into many countries and great industries which badly need it, and which, with a restoration of confidence, would be effective bidders for it. Men who use money market funds at low rates for capital purposes may expect a rude awakening when the tide turns, when gold flows out, and when foreign *need* for capital becomes *effective demand* for capital.

Of the three causes of abnormally cheap money, only one is subject to immediate control. It will take time to straighten out the European situation, and it may take time to work out of the current business reaction. Federal Reserve Bank policy, however, can be immediately changed. If the Federal Reserve banks would market 100 to 200 million dollars of their Government securities, 2% call money would disappear overnight.

On July 16, 1924, member bank reserve balances with the Federal Reserve Banks stood at \$2,085,203,000. The total earning assets of the Federal Reserve Banks on the same date stood at \$810,495,000. Approximately 40% of the member bank balances, which constitute the primary supply of funds in the money market, thus rest on the earning assets of the Federal Reserve Banks. The Federal Reserve Banks, selling securities, would receive payment in checks drawn on themselves which they would debit to member bank reserve accounts. The operation would be analogous to the familiar operation of the Bank of England when it tightens up the money market by selling Consols, or more commonly, by "borrowing from the market."

The extraordinary profits of the Federal Reserve Banks during the war and post-war period have led to the accumulation of a surplus of \$220,000,000, approximately 200% of their paid-in capital. This surplus may properly be used to meet the deficits of several years, if necessary, during which the Federal Reserve Banks are holding their earning activities to the minimum demanded by industry and commerce, in averting the evils of the excessive inflow of gold.

Dividends on Federal Reserve Bank stock should be paid out of this surplus. There appears to be nothing in the law to forbid this, but there seems to be doubt as to the legality of it in Federal Reserve circles. This doubt should be removed, if necessary by Congressional action. But there should be no delay in reducing the earning assets of the Federal Reserve Banks, even if this means suspended dividends. The interests of the banks, as well as the interests of the country, both demand this. Members banks have much more to lose by continued demoralization of the rate fabric than they could lose even from suspended dividends on their Federal Reserve Bank stock. The free services which the Federal Reserve Banks perform for the Government and for the member banks, which in the aggregate cause so large a part of their overhead expenses, should no longer be free. The Federal Reserve banks should make reasonable charges to the member banks for the services which they perform for them, and the Government should make reasonable compensation to the Federal Reserve Banks for the fiscal services which they perform for it. The great overhead expenses of the Federal Reserve Banks, which grew

up as these banks expanded during the abnormal war and post-war situation, should continue to be reduced.

It should be emphasized that the Federal Reserve Bank System exists primarily for steadying the money markets and for other public services, and that the question of profits and earnings is only incidental. This is particularly true of their open market operations, which were originally designed as an especially effective instrument for steadying the money markets.

The abnormal gold and money situation calls for two lines of operation. For the long run, we must earnestly cooperate with Europe toward such a stabilization of European affairs as will restore the gold standard in the important countries of Europe, and restore European credit so that there may be a normal redistribution of capital throughout the world. We must lower our tariffs so as to permit Europe to send us more goods instead of gold in payment of debts here, we should throw into the general settlement the problem of the debts of our European Allies to our Government, and above all, we must do everything possible to effect the prompt adoption of the Dawes plan. Pending this change in the European situation, we must, for the next two or three years, be prepared to offset the evil effects of inflowing gold. The main point here is a change of Federal Reserve Bank policy. Rediscount rates should be regularly kept higher than market rates, and open market policy should be reversed as explained above.

Additional measures for taking care of the inflowing gold may be found in the elimination of part of the national bank note circulation, which would leave room for more gold or gold certificates in the general circulation medium of the country. The Treasury has already announced its intentions to retire the 4% circulation bonds, maturing in 1925, of which something like 87 millions now stand as security for national bank notes. This will make room for 87 millions of gold in circulation. The Panama 2% bonds are also callable, and if they should be retired, which could be done at once, an additional 74 millions of national bank circulation would be retired, making room for an additional 74 millions of gold or gold certificates in the circulation. If an early reduction of the tariff could be accomplished, the pressure of incoming gold would be substantially reduced. The Government might also take advantage of the present gold situation to get rid entirely of an ancient sore spot in our currency system – the Greenbacks, or United States notes. If the whole issue could be retired, it would make way for approximately \$200,000,000 (net) of gold or gold certificates in the circulation of the country.

Certain English writers have for four years been expecting us to have a violent boom and flare-up of commodity prices as a consequence of the gold which has been coming to us. As their predictions have failed they have explained the failure of the interesting but mythological theory that Federal Reserve Bank policy has prevented the gold from having its normal effect. They are quite mistaken in this. Federal Reserve policy has intensified the influence of the gold, as shown above. With changed policy, however, we can prevent even a continued flow of gold from doing us much damage for another two or three years. Our danger is real, but assuming sound policy on our part, it is neither so

grave nor so imminent as are the dangers to which Europe is exposed in the absence of sound gold money.

### ***MONEY AND CAPITAL***

After four years of war and six years of economic disorganization growing out of the war, the general level of well-being of mankind has been greatly reduced, and the volume of effective capital is much less than it will have to be when the world is set going again and a vigorous process of reconstruction and reorganization is under way. The shortage of capital manifests itself in certain parts of the world in the form of very high interest rates. Germany and Poland, for example, are offering and paying appallingly high interest rates for such meager amounts of capital as they can obtain. Weary holders of raw material resources, weary promoters with long deferred development plans would eagerly pay high rates in many cases if only they could find lenders willing to listen to their projects. On the other hand, in the money markets of London and New York, lenders are bidding eagerly for prime securities and commercial bills at exceedingly low rates of return.

In New York and London, the shortage of capital is masked by several factors. These centers, too, felt the shortage of capital very acutely as a money market phenomenon in 1919-21, at the height of the boom and in the crisis. But, in the depression which followed, in 1921 and 1922, there came an immense liquidation of the most liquid commercial credits, and temporarily idle money piled up where it was available for investment in Treasury certificates and other high-grade securities, in call loans, and in acceptances. Easy money has continued ever since in London, as British industry remained throughout in a slack condition. In New York, this condition was interrupted by a business revival, lasting from late 1922 to early 1924, but has recurred in an acute form in recent weeks.

Special circumstances have greatly accentuated the abundance of short-time liquid bank credits, both in London and in New York. London has been subject to a very heavy drain of gold, while New York has been the recipient of an unprecedented inflow of gold. The inflow of gold to New York has worked constantly toward holding down money rates in that center, and has steadily worked toward lowering the return of such securities as banks were willing to buy, or as banks were willing to accept as collateral for loans. In a measure, the inflowing gold has affected long-time interest rates even on loans which banks would not make, since the competition of banks for prime investments has driven other investors to place a larger proportion of their funds into non-liquid investments. There has been on the whole a very great diversion of "money" into long-time or "capital" use.

While the inflowing gold has caused great monetary ease in New York, the outflow of gold from London has not, as would normally have been the case, tightened money or raised rates in London. The reason is primarily that Great Britain is not, at present, on the gold standard. The money supply of Great Britain is not lessened when gold flows out of the country. Great Britain is on a paper money basis. Gold could be used in London as money only at a loss of about 10%, and is therefore not used as money.

The abnormalities, therefore, with reference to gold, have made discount rates much lower, both in London and New York, than they ought to be: in London because of the abandonment of the gold standard and substitution of superabundant paper money and bank credit; in New York because of the excessive inflow of gold.

In New York, moreover, the added complication of excessive Federal Reserve Bank earning assets has created, in conjunction with the gold, a very great artificial excess of reserve money.

How great this excess is, will best appear if we compare the position of the United States in April, 1917, with the present situation. In April, 1917, the general average of commodity prices was about 19% higher than it is today, while general business activity was very intense as against the present state of business slack. We had at that time, however, 1400 million dollars less of gold in the country than we now have, and the total earning assets of the Federal Reserve Banks were at that time about 200 million instead of the 800 to 900 million at which they have lately been standing. From the standpoint of prices and volume of business activity, we needed at that time more money and bank credit than we need today, even making allowance for the growth of population. The situation then, however, showed little strain. The volume of money and bank credit was adequate for the commercial needs of the country. It will appear, therefore, that our excess gold and the excess earning assets of the Federal Reserve Banks represent unneeded additions to the circulation and bank reserves of the country. It would appear, further, that their existence must inevitably mean lower money rates and lower long-time interests rates than would otherwise obtain, and that they are masking the underlying shortage of real capital.

Contributing factors in the apparent abundance of capital are to be found in certain abnormalities which restrict the use of capital. First, there are many countries which are bidding eagerly for capital and which would be *effective* bidders for capital if political difficulties were straightened out and confidence restored. They have idle labor or ineffectively employed labor which could become immensely productive if it had adequate tools and materials to work with, and adequate food, clothing, and shelter to bring up its efficiency. Capital in London and New York prefers the 2% or 3% it can get with safety to the 10%, 15% or 30% which it might have in these countries under existing conditions of grave risk. Second, the very high surtaxes make rich capitalists of a more venturesome type of mind unwilling to take the risks which they would normally be glad to take in foreign investments or in the development of new projects and new sources of raw material, because if these projects and investments are successful, the surtaxes will take most of the profits; whereas, if they are unsuccessful, the government will stand none of the losses. A large and important field for the use of capital to which capital ought to flow in the interest of the world at large is thus shut off by abnormal political risks, or by excessive surtaxes, or by both, leading to congestion of funds in restricted types of investment.

Many development projects, on the other hand, are being held up because of the present depressed state of manufacturing activity in Europe. There is a relative excess of raw materials in the world and it seems unwise to develop further sources of raw materials in the world, and it seems unwise to develop further sources of raw material supplies. With the revival of manufacturing in Europe, many of these raw material development projects will be effective bidders for the world's supply of capital.

With a substantial part of Europe restored to the gold standard, and with a general restoration of sound credit conditions in Europe, and with a strong revival of manufacturing activity in Europe, the relative inadequacy of the world's supply of capital will be sharply revealed. Both discount rates and long-time interest rates will go sharply higher, and the folly of those who engage in long-time plans on the assumption that cheap money is to persist indefinitely, will become clearly manifest. Meanwhile, it is imperative that everything possible be done to correct the present demoralization in the money markets, and to prevent the diversion of money market funds to long-time purposes.

### ***INFLOWING GOLD AND COMMODITY PRICES***

The Quantity Theory of Money has been much discredited by the experiences of the past four years. In 1919 and 1920, we were assured by quantity theorists that we were on a permanently higher price level, that the great volume of money and banking credit outstanding would prevent any substantial drop in prices, and that the price levels of 1919 and 1920 were permanent and safe. After prices took their headlong plunge – a drop of 49% in the United States, according to Bradstreet's index number – the quantity theory prediction took a new form. Gold began pouring in on us again, and the quantity theorists predicted that the inflowing tide would raise our prices high again. Inflowing gold was supposed to increase our Federal Reserve Bank credits in some multiple ratio, and the increase in Federal Reserve Bank credit was supposed to raise the general volume of banking credit in the United States in some multiple ratio, often stated as nine to one. Inevitably, the prediction ran, prices in the United States would rise violently, and with the rise in prices in the United States, the dollar was expected to fall in the international exchange markets, so that European exchange rates, notably sterling, would come to a parity with the dollar. For nearly four years, the great flood has poured in on us, and the prediction has not been fulfilled. Prices, after a pick-up with the business revival of 1922-23, have had a pretty steady fall for the past fourteen months, and the June, 1924, index of commodity prices, issued by the United States Bureau of Labor Statistics, stands at 144.6, within a few points of the lowest prices reached at the extreme point of the depression of 1921-22.

Ultimately, if the tide were never reversed, gold would depreciate sharply, and prices would rise violently in the United States. The problem of the value of gold, however, has not been the problem of the value of gold in the United States alone; it has remained a world problem. With gold scarce and dear in the world outside the United States, the prices of copper, wheat, live stock, and other export commodities in the United States have been held down. With these prices held down, the price of fertilizer, farm

machinery, and a good many other things dependent upon the prosperity of agriculture and other export interests, have been held down. With the resultant depression and low buying power of this large body of important interests, the efforts of producers of other commodities to raise their prices have been repeatedly cut under. One-sided booms have started, but have not been able to get far.

The price problem is not a problem of the great average of prices, taken in block, as the quantity theory school of economics supposes. It is a much more intricate problem, which involves relations of prices among themselves. Depressed prices in one industry tend to depress them in others. Rising prices in one industry tend to raise them in others. The price fabric has large independence of the credit fabric, and often is master of it. The price problem, moreover, is not a problem for one country by itself, but is still a world problem. Even countries which are not on the gold standard find their price systems adjusted indirectly to a world value of gold, through their exchange rates with gold standard countries. Gold still retains its sovereignty, and still has power to take a terrible revenge upon speculators who treat it disrespectfully.

It is conceivable that the concomitance of exceedingly cheap money, and the rising price of grain which has grown out of the disaster to the grain crop of Canada, may serve as the basis of a temporary flare-up of commodity prices in the United States. Against that possibility we must reckon with the reduced demand for steel, as arrearages in railroad buying, automobile construction, pipe line construction, and building seem to have been largely made up. We should count, too, on the speedy disappearance of exceedingly cheap money with any substantial pick-up of business. We should expect also that increased income in the agricultural districts during the next year would be applied chiefly to the liquidation of debts rather than to extravagant expenditure, and we should be reasonably confident that a boom based primarily on Canada's disaster would be cut under, both by Canada's reduced buying power for our goods while the disaster persisted, and by a decline in the price of grains when a new crop year came.

Cheap money is always dangerous, and there are always possibilities of a bad flare-up in it. By itself, however, it can accomplish little. Money rates dragged on the ground for several years following the crisis of 1893 in the United States, without precipitating a boom. But when there comes a concomitance of cheap money and general hopefulness, even though the hopefulness be based on fallacious conceptions, grave dangers always exist.

It is not necessary to prophesy the course which commodity prices actually will take. If there comes an early revival of Europe with a great expansion of European manufacturing activities, commodity prices, measured in gold, will go lower. If the present situation continues, with continued inpouring of gold and unchanged Federal Reserve bank policy, special circumstances may induce a boom of a dangerous character. If we will reverse our policies, however, we can count with confidence on our ability to stand the inflow of gold for another two or three years, during which it ought to be possible to work out such a readjustment of European affairs as to reverse the tide of gold and make the situation permanently safe.

## ***RESTORING THE GOLD STANDARD IN EUROPE***

Of all the difficulties which have hampered the restoration of sound economic conditions in Europe, the most acute and obvious has been the fluctuating, irredeemable paper money with which Europe has been trying to do business. Certain countries which have suffered worst in this respect have been obliged to resort to the desperate expedient of substituting foreign currency for their own currency, or, as in the case of Austria and Germany, of appealing to the outside world for help for gold, or for a currency anchored as securely as possible to gold. Outside intervention has secured for Austria an orderly currency which has been kept at a fixed rate in terms of gold for nearly two years. Paper money of the United States, fixed in its relation to gold by actual redemption, is eagerly sought in many parts of Europe, and great quantities are there. Idle bank deposits have been sent from countries where money was unstable to countries like Switzerland, Great Britain, and the United States, where the deviation from the gold par was relatively slight or where the gold standard was fully-maintained. Throughout Europe there is an immense "gold hunger" and an immense desire for the security in business and in contracts which gold alone can give. Certain writers in Europe have raised the question as to whether gold is, after all, the best standard, and as to whether some paper standard based on financial manipulation might not be substituted. But the real obstacle to Europe's return to the gold standard are to be found in other things.

In many countries, there have been and still are powerful debtor interests, largely speculators on borrowed money, who would welcome a further depreciation of money, since their liabilities would thus shrink, while their assets would not shrink, and who have fought the efforts to stabilize on a gold basis. Even in Great Britain there is a respectable body of opinion which hesitates to try to bring sterling to par, fearing the political consequences of the slight readjustment involved, and fearing even a temporary increase in unemployment, which such a course might bring about. There is, of course, the usual crop of economic fallacies, familiar enough in the time of John Law and at the time of the French revolution, and hoary with age when we were fighting in this country to resume gold payments on our irredeemable Greenbacks. These fallacies always appear after a paper money orgy. But the best financial thought of Europe squares with the gold hunger of the peoples of Europe. Europe wants to get back to sound money and Europe believes in gold. The early restoration of the gold standard in much of Europe, in Canada, in the Argentine, and in Japan, is perfectly possible with clear thought and courage.

- (a) As regards Germany, the matter is largely in our own hands. We can and should insist as an essential condition of our participation in the Dawes plan loan to Germany, that the proposed German bank of issue immediately begin to redeem its notes in gold or gold exchange.<sup>1</sup> We owe this to Germany, to her creditors under reparations, to investors in the loan, and to our own general interests.
- (b) France and Italy can go back speedily to the gold standard, but of course not at the old gold pars. They can do it, however, at new and much lower pars, and should be encouraged to do so. The political conditions are difficult. National pride

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<sup>1</sup> *Chase Economic Bulletin*, Vol. 4, No. 1.



stands in the way of what looks like partial repudiation. Holders of government securities look forward to being paid interest and principal in francs and lire above present values. In both countries, however, it ought to be possible to make a realistic analysis. The volume of the public debt can be measured against the total value of the national resources. The burden of interest payments on public debt can be matched against national revenue or potential revenue. Existing price levels can be compared with the price levels which would obtain, if higher or lower gold pars were established. Figures can then be worked out at which the gold standard can be established and maintained, and at which a definite stabilization of money can be accomplished on the basis of actual gold redemption.

- (c) Great Britain, especially with the reviving confidence which the carrying out of the Dawes Committee plan will bring, should be able, rather readily, to resume gold payments at par in a fairly short time. This seems to be true of various European neutral states also, notably Switzerland and The Netherlands. Sweden has already resumed gold payments. Great Britain's problem in this matter does not appear to be more difficult than was the problem which the United States faced in 1877 when working toward resumption of specie payment on the Greenbacks on January 1, 1879.

Sterling stands only at about a 10% discount. It would be possible for Britain to resume gold payments immediately, and to permit the free export of gold immediately, if she were willing to pay the price. Commodity prices in England would fall possibly 10% as a consequence of this. It would be necessary for her to have very substantially steeper discount rates than she now has. She could mitigate the rigor of this by announcing forthwith that, one year hence, she would resume gold payments and free export of gold. The tightening up process in Great Britain would involve some losses, some sacrifices, probably some bankruptcies. But the present deviation from par is not very great and the problem is perfectly manageable with courage – which Britain has never lacked. There is, moreover, evidence in current British discussion that, if Germany comes forthwith on the gold or gold exchange standard, then the British will be forced both by pride and by interest to do the same thing very speedily.

Economical living, prudent financial policy, debt reduction rather than debt creation – all these things are imperative if Europe is to be restored. And all these are consistent with a greatly improved standard of living in Europe, if real activity be set going once more. The gold standard, together with natural discount and interest rates, can supply the most solid possible foundation for such a course of events in Europe.

### ***GRESHAM'S LAW***

With the restoration of the gold standard in even two or three of the major countries in Europe, the flow of gold to the United States would stop, and some gold would very

speedily leave the United States for Europe. During recent years, gold has been coming to the United States from Europe for three main reasons:

1. Europe's great indebtedness to us on current account.
2. The desire of Europeans to place their surplus funds or temporarily idle funds in a safe place from which they could surely get them back, quickly and without loss.
3. The working of Gresham's Law.

For the past two years, it is probable that it is the operation of Gresham's Law which has been chiefly responsible for the flow of gold to our shores. This is the ancient principle that "bad money drives out good money." Gold cannot be used for monetary purposes in Europe (with the exception of Sweden), in Japan, or in Canada without loss. To take gold bullion to London, mint it, and use it in payments, is to incur a loss of approximately 10%. As a consequence, *loans to Europe under existing conditions do not send gold to Europe*. Such loans check the flow of gold from Europe to the United States, but even if made in so great a volume as to reverse the current of international indebtedness, they would not, under existing conditions, cause gold to go to Europe. The proceeds of loans made in the United States to Europe take the form, first, of dollar credits in American banks. These dollar credits are then used in buying goods directly, or in buying sterling, francs, lire, etc., which largely represents goods already exported.

If, however, the gold standard were restored in Europe, and if gold could be taken to Europe, turned in at the mints there, and converted into sterling, francs, lire, etc., without loss, then gold would flow to Europe whenever the temporary movements in the exchange rates made it profitable to ship the gold. With expanding business in Europe, calling for a greater volume of bank credits and circulating money in Europe, borrowing in the United States would readily lead to an outflow of gold from the United States to Europe. The newly mined gold would, moreover, be distributed throughout the gold standard countries once more, in accordance with their monetary and banking needs.

The restoration of the gold standard in Europe requires also, in the countries involved, the measures necessary to make it permanent, especially the creating of a fiscal balance. This has long been accomplished in England, appears recently to have been approximately accomplished in Italy, should be accomplished in Germany with the Adoption of the Dawes plan, can be accomplished in France by vigorous financial policy. Confidence must be restored, and confidence rests in large measure upon the fiscal policies of the governments. With adequate discount rates and with policies which inspire confidence, the countries of Europe can attract and hold substantial foreign balances. They need not fear that paying gold will lead to a further loss of gold; on the contrary, gold flows to those countries which are willing to pay it out again, and flows away from those countries which refuse to pay it out again.

In connection with this, Europe may assume the readiness of the bankers of the United States to cooperate in protecting a well intentioned and well managed country from raids

on its gold, by providing the necessary temporary credits to punish severely any speculators who attempt such raids. Europe may assume, too, that the bankers of the United States can and will float in this country specific gold loans to improve the reserve positions of banks of issue in Europe, in those countries which are otherwise ready to resume gold payments.

The outside world is in a position to make real demands on our gold at the moment it is ready to use the gold. There is a great volume of Federal Reserve notes in Europe, in Cuba, and in other places which could be sent in and cashed in gold on very short notice. Incidentally this would not make even a momentary ripple in our money markets, since it would not lessen in any measure the amount of money circulating in the country, or the reserve balances of member banks. We should merely exchange certain unusable assets of the Federal Reserve Banks for certain of their liabilities held in foreign countries. Further than that, I think that a good many short time securities held in this country by Europeans would be sold and the proceeds taken out partly in gold, once gold had a profitable market in Europe. This would tighten our money markets, as would, of course, the drawing down of European deposit balances with member banks, as a rule.

### ***SOME BRITISH MISCONCEPTIONS OF FEDERAL RESERVE POLICY***

There is an interesting myth current in Great Britain, and elsewhere in Europe, regarding the policy of the Federal Reserve authorities with reference to the inflowing gold. The expectation that this gold would bring about a violent advance in our commodity prices has been progressively disappointed. During the past three years, the explanation has been offered that the Federal Reserve authorities have prevented the gold from exercising its natural influence by extraordinarily subtle policy. Usually this policy receives no explanation. Mr. J. M. Keynes speaks briefly of it as a policy of "burying this gold at Washington, withdrawing it from the exercise of its full effect on prices, and thereby, in effect, demonetizing the metal."<sup>1</sup> This is pure mythology. The May-June monthly review of the Midland Bank, Ltd., of London, makes a more realistic comment as to what has actually taken place, but manifests a misunderstanding of the significance of the matter from the standpoint of our money market. The review says:

"As an auxiliary means of preventing inflation, the reserve banks have during the past year or two handed over a considerable amount of gold to the Treasury, receiving gold certificates in exchange. Inasmuch as gold certificates are backed by 100 per cent. of gold, the passing of this form of currency into circulation in place of federal reserve notes has the effect of holding down the ratio of the gold reserve to note and deposit liabilities to a figure below what it would otherwise be. In this sense gold has been put into circulation in place of paper backed by 40 per cent. of gold and 60 per cent. of commercial discounts."<sup>2</sup>

It may be observed that the actual practical effect of this operation upon our money market situation has been nil. The question of whether the Federal Reserve Banks hold in the reserves actual gold or merely gold certificates is a question of no importance. The reserve ratio is the same in either case and the gold reserve of the Federal Reserve Bank

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<sup>1</sup> *Monetary Reform*, New York, 1924. Page 211.

<sup>2</sup> Federal Reserve notes, under the Act of 1913, could be issued only against commercial paper, with a 40% gold reserve. Amendments to the Act now permit, however, the issue of Federal Reserve notes against gold alone.

is the same in either case. Gold certificates are interchangeable with gold in these calculations, and the gold certificate functions as gold for most of our domestic purposes. The paying out by the Federal Reserve Banks of gold certificates instead of Federal Reserve notes when member banks need additional cash, or when member banks turn in worn bills to be replaced by new, clean bills, does affect the reserve ratio, but does not affect the volume of money in circulation or the volume of member bank balances. It means merely a substitution of gold certificates for Federal Reserve Bank notes in the circulation. The effect on the Federal Reserve Bank balance sheet is merely a reduction of Federal Reserve notes on the liability side matched by an exactly equal reduction in gold reserves on the assets side.

If the reserve ratio were low, such a policy would probably make a practical difference by influencing the rediscount rates. Paying out gold certificates would make the reserve ratio go lower still and so might serve as a ground for an increase in rediscount rates with a resultant curtailment of rediscounts and a consequent tightening of the money market. But with the reserve ratio ranging from 75% to 83%, the paying out of gold certificates seems to have made very little practical difference in the rate policy, and apart from that, makes no difference whatsoever.

A further statement of the Midland Bank, in the same connection, is clearly erroneous. They say:

“Although the loans and investments of member banks increased in this period by \$3,300 millions, credit expansion was kept within bounds by the open market policy pursued by the reserve banks, and speculative inflation was not allowed to make headway.”

Had the Federal Reserve Banks has been trying to prevent expansion, they would, on the one hand, have kept their rediscount rates above the market, and they would, on the other hand, have contracted their open market operations in periods when commercial demand for money was falling off and rediscounts were declining. Bank of England precedents would suggest this. Their policy, however, has been exactly the reverse of this. They have systematically kept their rediscount rates below the market, and they have systematically increased their holdings of Government securities, as rediscounts have fallen off. Thus, as shown above, they have increased their purchases of Government securities from \$73,000,000 in November, 1923, to \$477,000,000 in July, 1924, at a time when rediscounts were falling off and unneeded money was piling up in the financial centers.

Our British friends are, therefore, entirely mistaken in supposing that our Federal Reserve authorities by their financial policy have interfered with what would otherwise have been the inevitable consequences of the inflow of gold. The reasoning on which their original expectations were based needs reexamination, and the mechanical quantity theory of money, especially, may be commended to them for reexamination.

## ***EMERGENCY POLICIES IN THE UNITED STATES***

So far we have had no policy designed to meet the inflow of gold. We have taken it as it has come, and we have let it work whatever consequences it would under our system. The time has clearly come when a conscious policy is needed, if we are to avert very serious financial evils. Long-run policy looking toward the ultimate reversal of the flow of gold, through the straightening out of European affairs, has been discussed above. In what follows, I shall discuss the policy that seems necessary for the next two years, if we are to continue to receive gold from Europe without suffering grave injury.

A. A reversal of Federal Reserve policy is called for.

1. Rediscount rates should be regularly kept above the market rates. The market rate means the rate charged by great city banks under lines of credit to prime borrowing customers who have deposits and lines of credit with several banks and often in several cities.<sup>1</sup>
2. There should be a drastic reversal of the open market policy of the Federal Reserve Banks. Instead of buying Government securities or open market paper when money is easy and rediscounts are falling off, they should sell under such conditions; and instead of selling open market paper or Government securities when money is tight, they may sometimes be well advised to buy under such conditions – letting out slack and taking up slack.

Under existing conditions when a member bank makes an investment or loan, it does not increase the total of money market funds.<sup>2</sup> It must pay for the investment or provide the proceeds of the loan out of its own liquid assets. When a Federal Reserve Bank makes a loan or an investment, it makes payment therefore with its own liabilities, which liabilities are accepted as final payment by other institutions, leading to a net increase in the volume of funds in the market.

One of the motives lying behind the inauguration of the Federal Reserve System was the desire to get rid of 2% call money with which "Wall Street could speculate" while farmers and others had to pay excessively high rates. The Federal Reserve System was designed to make both our currency and our bank credit elastic, leveling rates throughout the seasons, supplying seasonal elasticity to the currency, preventing the choking off of good business by a money shortage in times of otherwise sound activity, and preventing a demoralized glut of money for speculators to play with in dull times.

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<sup>1</sup> For an elaboration and defense of this definition of the market rate see *Chase Economic Bulletin*, Vol. 1, No. 5, pages 4-11. Reproduced in *A History of Currency in the United States* by A. B. Hepburn. Revised edition, 1924, pp. 500-508.

<sup>2</sup> The case stands differently in times when the whole country is simultaneously expanding. See *Chase Economic Bulletin*, Vol. 1, No. 5, pages 6, 24-25. Reproduced in *A History of Currency in the United States* by A. B. Hepburn. Revised edition, 1924, pp. 503, 523-524.

The floating supply in the money market is to be found focused in the surplus reserves of member banks, consisting of deposit balances with the Federal Reserve Bank. The total of these member bank reserves stood at \$2,085,203,000 on July 16, 1924. When this is compared with the \$810,495,000 of earning assets of the Federal Reserve Banks on the same date, it is clear that a very large proportion of member bank reserves was due to the earning activities of the Federal Reserve Banks, and that the whole of the surplus reserves would be promptly wiped out by a very moderate reduction of Federal Reserve Bank earning assets. If, for example, the Federal Reserve Banks should sell a hundred to two hundred million dollars of Government securities they would promptly cancel a large, almost exactly equivalent amount of member bank reserves. They would have to be paid out of the liquid assets of the other banks in the country, and this would be primarily by checks drawn on the Federal Reserve Banks themselves. These checks would be cancelled with corresponding debits to member bank balances, and with a corresponding reduction in the total of member bank balances. Two per cent call money would disappear over night.

This is not a matter of theory, merely. The Bank of England has long been accustomed to tighten up money by just this kind of thing, "borrowing from the market" as it called. It may do this by selling Consols or Indian Treasury bills, or it may do it by borrowing from other institutions. In either case, it receives pay in the form of checks on itself drawn by the joint stock banks. This promptly reduces the reserve funds of the joint stock banks, and tightens money immediately.

If the Federal Reserve Banks had refrained from increasing their holdings of Government securities since last November, when the figure stood at \$73,000,000, then as rediscounts declined with the falling off in commercial activity and with the liquidation of loads, while money rates would have softened, they would not have fallen to anything like present levels. Member bank reserves would have gone down also, leaving the money market at all times "comfortable", but at no time slack.

In carrying out proposals of this sort, the authorities of the Federal Reserve System would doubtless be exposed to criticism, since their earnings would thereby be reduced below their expenses. As explained above, however, when it is recognized that the primary function of the Federal Reserve Banks is to steady the money market, it must be recognized that this inevitably implies that their own earnings should be *highly variable*. They should be permitted to use the profits of active times to offset the deficits of dull times. The Federal Reserve Banks are now in the very fortunate position of having a surplus of \$220,000,000 growing out of the wholly extraordinary earnings of the war period and the post-war boom and crisis.

Their great overhead expenses, moreover, can be reduced in a variety of directions. They may properly abolish certain free services to member banks which appear to have been inaugurated only because of their desire to share, in an indirect way, their extraordinary war and post-war earnings with their stockholding banks. Others of their free services to member banks and to the Government should cease to be free. The Government should pay them the actual cost of the very valuable fiscal services they perform for the Treasury Department, and member banks should pay them the moderate fees which would be necessary to relieve them of the actual expense required for the performance of necessary services.

Dividends on Federal Reserve Bank stocks may safely be paid for several years out of the existing great surplus. There appears to be nothing in the Federal Reserve Bank Act itself which forbids such dividend payments, but there seems to be doubt in Federal Reserve circles as to the legality of it. This legal point should be cleared up, and such dividend payments should be made clearly possible, either by Federal Reserve Board ruling, or, if necessary, by Act of Congress. But there should be no delay in the reversal of Federal Reserve Bank policy even though this should mean suspended or reduced dividends on Federal Reserve bank stock. The interests of the stockholding banks, as well as the interests of the country, will be served thereby. Member banks have much more to lose by continued demoralization of the rate fabric, both in current earnings and from unsound credits, than they could lose from suspended dividends on their Federal Reserve Bank stock, or from moderate payments of their pro rata of the actual cost of Federal Reserve Bank services.

The Federal Reserve System might well consider whether it can afford to maintain all its existing branches and agencies. They constitute local convenience, but they are paid for too highly if their maintenance requires unneeded additions to the country's money and credit. The Federal Reserve Banks should continue to strive in every way to reduce the very great overhead expenses which grew up during the abnormal conditions of the war and post-war period.

- B. Room may be made for the incoming gold to replace certain existing elements in the actual circulating medium of the country. The Government has already decided to retire the 4% bonds to secure national bank circulation, which mature in 1925. Approximately 87 million dollars of national bank notes secured by them will thus be retired. This will make a gap in the actual money in circulation which the incoming gold can fill, either in its own form, or represented by gold certificates or Federal Reserve notes. There is an additional \$48,500,000 worth of national bank notes secured by the Panama two per cents of 1936, and a block of \$25,642,000 secured by the Panama two percents of 1938. These bonds also have been callable since 1916 and 1918, and the Government might very well retire them at the present time.

Advantage might also be taken of the present extraordinary gold situation to get rid of the anomalous legal tender Greenbacks as an element in our circulation. Congressional action would be required to make this possible. The volume of Greenbacks outstanding is now \$346,681,016. The gold reserve behind them is now \$152,979,025. They constitute an undesirable element in the currency and the burden on the Treasury of their complete retirement would be moderate. They constitute an undesirable form of public debt. If they were retired, the circulation could absorb an additional \$196,000,000 of the incoming gold without being increased thereby.

- C. We must reduce the tariff in such a way as to permit Europe to send us more goods and less gold. This will not only relieve the immediate pressure of incoming gold, but it is also necessary, in any case, if we are to help Europe get back on her feet and if we are to restore a sound equilibrium among our own industries.

It is clear from the foregoing that we can, if we will make use of the means at our disposal, avert further evils from the inflowing gold, for a period of two or three years, even if a great flow should continue. Those of our friends in other countries who have been looking forward with concern, not unmixed with satisfaction, to seeing us swamped and smothered by the flow of gold, may defer their fears and hopes for two or three years yet, if we handle ourselves wisely. Meanwhile, we should be able to help them and the rest of the world avert the much greater catastrophes which the failure to stabilize European conditions and European moneys on the gold standard would involve, – in the course of this, protecting ourselves also. If we allow things to drift, however, grave dangers lie ahead.