that since April 2, 1921, there has been great decrease in the amounts owed by the city banks, while the curve for the agricultural state does not show a proportionate decline.

This examination of actual figures makes clear two points: (1) There was no discrimination against agriculture by the Chicago Reserve Bank. Member banks in cities were not favored. (2) Relative, rather than absolute, figures must be used if an accurate idea of the situation is to be had.

Popular and Unpopular Activities of the Federal Reserve Board and the Federal Reserve Banks

By WILLIAM A. SCOTT
University of Wisconsin

ON account of the extraordinary conditions under which our Federal Reserve System has been obliged to operate, public opinion towards it has taken peculiar twists and turns. Hopefulness, uncertainty and lack of enthusiasm characterized it at the start, a condition easily explainable by the party controversy which preceded its establishment, differences of opinion regarding the details of the law governing it and conflicts of interest among the people most directly affected by it. Those who had fought and bled for the Aldrich plan were naturally critical of this one and uncertain regarding the manner in which it would work. The state bankers, generally, were hostile towards it because they feared that some of their sources of profits would be jeopardized, and many national bankers did not like its coercive features. The undiscriminating public undoubtedly hoped that it would succeed and was disposed to give it a fair trial.

The outbreak of the European War, three months before the Federal Reserve Banks were ready to begin operations, cleared the atmosphere and smoothed the pathway for them so far as public opinion was concerned, though in other respects it complicated their problems. The financial difficulties which speedily followed made most people thankful for their existence and created a feeling of dependence upon them. No one was disposed to hamper them by criticism.

Before our entrance into the War, their activities do not seem to have attracted public attention to an extent sufficient to arouse either its criticism or its approval. The policy developed during this period of concentrating in their vaults as large a part of the rapidly increasing gold supply as possible by exchanging their notes with the banks for gold, important though it was in checking somewhat the rapidly expanding bank credits and in rendering this mass of the precious metal easily available for any purpose for which it might be needed, seemed to excite curiosity rather than interest.

WAR COMPULSIONS

With our entrance into the War in April, 1917, the Federal Reserve Banks were called upon to assist the Treasury in its colossal financial operations. As financial agents of the government, they performed the work of executing its plans and measures and, what is more important, so long as the War lasted and for some time thereafter, their policies were shaped primarily with reference to the government's needs and interests.

The greatest of these was the flotation of billions of bonds and short time notes, and the Reserve Banks' part in the work was to act as the government's agents in the sale of these securities and to aid in creating a market for them. To this end they established discount rates considerably below the market with a differential in favor of loans on the security of government bonds and notes, rates low enough, in fact, to make it possible, with the aid of rediscounts, for member banks to loan without loss to bond buyers at rates not higher than the bonds and notes themselves yielded.

There can be no doubt that this was a violation of the rules of sound commercial banking. It opened the doors to the inflation of bank credit and to the evils which follow in its train. Conscious though they were of this fact, the Federal Reserve Banks and the Federal Reserve Board were forced to adopt this policy. The Liberty loans could not otherwise have been floated. Without borrowing from their banks, the people could not have purchased their necessary allotment of bonds, and the banks could not have made these loans unless the Federal Reserve Banks had rediscounted for them on the security of these loans at rates which did not involve loss. Had the Reserve Banks refused to adopt this policy, public opinion would certainly have condemned them and probably Congress would have forced them to it.

Responsibility for the Rise and Fall of Prices

One of the penalties that had ultimately to be paid for this violation of sound banking principles was misunderstanding and criticism, not criticism of this policy, which had the hearty and even enthusiastic endorsement of public opinion, but criticism of the measures the Federal Reserve Banks had ultimately to adopt in order to save themselves and the credit system of the country from the consequences of this policy.

This misunderstanding and criticism resulted from the contemporaneous expansion of bank credits and the rise of prices. Both were necessary results of the same causes, namely, the readjustments in the relations between the demand and supply of important groups of commodities and the transfer on a large scale of demand operations from private individuals and corporations to the government. But the people, with the assistance of a group of economists, interpreted the causal relations differently. They insisted that the expansion of bank credits was the cause of the rising prices, and, since the discount policy of the Federal Reserve Banks was held to be chiefly if not wholly responsible for the inflation, these banks were held responsible for the high prices.

This theory aroused no widespread criticism of the Federal Reserve Banks so long as prices continued to rise and prosperity to be general, but, when the high price period came to an end and the opposite movement got under way, the belief that the Federal Reserve Banks and the Federal Reserve Board could greatly influence and perhaps control price movements subjected them to pressure from people who were being, or thought they were being, injured by the slump in prices and, when the banks did not yield to this pressure, to the severe criticism of these people.

The course of events which resulted in such pressure and criticism seems to have been about as follows: The Armistice was succeeded by about a year and a half of booming business, accompanied by extravagance, speculation and soaring prices. Bank credits, including those of the Federal Reserve System, expanded rapidly, and bank reserves rapidly declined. Towards the end of 1919 ordinary prudence and a decent regard for the safety of our credit system demanded that a halt be called. The Federal Reserve Board and the responsible officers of the Federal Reserve Banks felt and knew that good banking policy would have required them to put on the breaks much earlier, but they were stopped by the financial exigencies of the government whose need for floating large loans did not end with the Armistice. The government needed the aid of the Federal Reserve Banks quite as much as during the War.

During the year 1919 the Federal Reserve Banks and the Federal Reserve Board tried in vain to moderate the pace of the member banks by moral suasion and other indirect methods and it was not until December of that year that the financial condition of the government freed their hands to such an extent that they felt free to apply the brake of increasing discount rates.

The upward movement of prices came to an end in the early summer of 1920 and the slump that followed synchronized very closely with the period of high discount rates at the Federal Reserve Banks. The pressure upon the banks to carry people who were in trouble on account of the rapidly shrinking value of inventories, and farmers whose crops could either not be marketed at all or at prices much below the cost of production, was very great. The Federal Reserve Banks and the Federal Reserve Board urged the member banks to extend all possible assistance to these distressed people and supported them in this policy by liberal rediscounts, with the result that the total loans and discounts of the banks continued to increase for several months after the slump in prices started and did not show any tendency to decline until near the end of the year 1920. The demand for bank accommodations was so great as to keep rates at a high level and to make excessive rates possible in individual cases.

PRESSURE FOR LOWER REDISCOUNT RATES

In times of financial distress people always search for an explanation in the hope of finding some means of relief, and, in this case, the process of reasoning outlined above, running from Federal Reserve Bank discount rates through general bank credits to prices, seemed to furnish the key and also to suggest a remedy. Proof that low discount rates result in expanding bank credits and rising prices and high discount rates in contraction of credits and falling prices, seemed to be at hand in the fact, easy to establish by statistics and graphs, that prices did rise during the period of low discount rates and began to fall soon after the policy of higher discount rates was inaugurated. The remedy seemed clearly to be a radical cut in discount rates, which, it was claimed, would result in the expansion of credits or, at least, in preventing contraction and in a check on the price slump and, if continued, in an upward movement of prices.

The spokesmen of the distressed classes in the community deluged the Federal Reserve Board with appeals for this kind of relief and, upon its refusal to grant it, with criticism and, in some instances, even with abuse. The Board was clearly between the devil and the deep sea. There was no question about the necessity for high discount rates and the removal of the differential in favor of government paper-secured loans if the credit system of the country was to be kept in a sound condition; but it was equally clear on the other hand that that policy was unpopular.

Recent Criticisms of Reserve Board Policy

The old saw that misfortunes never come singly proved true in this case. At this truly critical time the Federal Reserve Board was publicly attacked in newspapers and before Congress. Beside the abolition of the progressive rates in force in four of the districts and a general cutting of discount rates, it is not easy to determine precisely what these critics wanted the Board to do, but one demand seems to have been for it to undertake the task of cleaning up all the dirty places in our banking system even to the extent of correcting the bad practices of individual bankers. Through the examinations conducted by the Controller of the Currency a number of these had been discovered or at least it was so thought. It was also demanded that the Board use its influence with the Federal Reserve Banks to force or to induce them to refuse to grant credit to member banks that were not playing the banking game in the manner in which the critics thought it ought to be played.

In the course of this campaign of criticism, a number of charges were brought against the Federal Reserve Board and the Federal Reserve Banks, especially that of New York City. The chief of these were: that the Board is suffering from "bureaumania" and is unsympathetic, governing itself by general rules which it refuses to relax in individual cases which are thought to appeal to the sympathy of its members; that it is extravagant, sanctioning too high salaries and other unnecessary expenditures; that it has permitted an inequitable distribution of credit, Wall Street being favored and the farmers pinched; that it refused to abandon the progressive rate policy or even greatly to modify it when cases of what were regarded by the critics as excessive rates were brought to its attention, and that it refused to reverse its rate policy when the harm being wrought by the slump in prices became apparent.

In support of these charges, the critics indulged in fallacious reasoning, misuse of statistics and the familiar tricks of the political stump speaker. They frequently disregarded those parts of the Federal Reserve Act which determined the distribution of powers and duties between the Federal Reserve Banks and the Federal Reserve Board, or put an interpretation upon them which varied from that made by the Board. In matters of this kind there is often room for differences of opinion, but the critical energy was moved by the assumption that the Board was wrong and refused to conform to the judgment of a superior wisdom.

Apparently the critical force had no conception of the consequences that would follow the Board's failure strictly to follow general rules of action impartially applied. Even if the laws under which it operates gave it the right so to do, the attempt to deal with the cases of individual bankers or of individual borrowers would soon swamp it with an unmanageable mass of detail and render impossible the execution of any policy however necessary or desirable.

The favorite method of proving that Wall Street was being favored and the farmers pinched was to quote statistics that show that the Federal Reserve Bank of New York was loaning at one time to one member bank, or to a few large member banks, more than certain other Reserve Banks in the agricultural sections were loaning to large numbers or to all their member banks. That it is necessary to observe the relation between the amount of the real credit needs of all the constituents of each

Federal Reserve Bank and the total amount of loans in each case before such statistical comparisons can have any significance, either never occurred to the critics or they chose to ignore the fact in order to make an effect on their audience. Moreover, these facts were not emphasized: That Reserve Banks in the farming country borrowed from other Reserve Banks, usually in the East, or that large banks in centers like Chicago ran up their indebtedness at the Federal Reserve Banks, in part if not chiefly, to help their correspondents located in agricultural sections.

Much was also made of the fact that some member banks in the New York district, rediscounting heavily at the Federal Reserve Bank, were themselves loaning heavily to speculative customers, without attempting to show what was the proportion of such loans to the total in each case or how cutting down the lines of discount of these banks at the Federal Reserve Bank would have affected their constituents as a whole; or without even debating the question whether it would be good policy for the Federal Reserve Bank in New York to refuse to rediscount good, eligible paper for a bank on the ground that it disapproves some of its loans.

The opponents of Reserve Board policy appear to believe that the Federal Reserve Bank of New York and the Federal Reserve Board are guilty of sins of omission or of commission relative to the New York call loan market. They argue that high rates on that market attract funds from other parts of the country which ought to be loaned at home and otherwise would be. Just how they would use the Federal System to prevent this they nowhere make clear. Perhaps they would have the Federal Reserve Bank of New York refuse to rediscount for a bank that loans on the call market!

With almost hysterical enthusiasm were cited the cases of a little bank in Alabama and a few others in which the application of the progressive rate rule had resulted in very high rates on a few loans. These were exploited to the limit in public addresses. The members of the Reserve Board probably disliked these extreme results of the progressive principle quite as much as anyone else, but they stubbornly thought out their own remedy. They recommended a rebate of the excessive interest payments in these cases and the deferring of final judgment on the principle itself until wider experience should give them more light. The critics had their own notions, however, and one was to play upon the feelings and prejudices of their audiences through the use of these extreme cases.

The refusal of the Board to lower discount rates when the slump in prices occurred was classed as "unpardonable." The arguments disclosed complete unconsciousness of the fact that there was room for differences of opinion regarding the best policy to pursue at that time or of the reasons for the Board's refusal. The Board's action could only be accounted for on the ground of "inertia" or "inability to comprehend the meaning of events."

DISCRIMINATION AGAINST THE FARMER

The criticism that the Federal Reserve System has discriminated against the farmers seems to have been endorsed by a good many people in agricultural sections, especially in the South and some parts of the West where farmers have been especially hard pressed by the slump in prices. The real credit needs of these farmers have been very great and their desire for credit in many cases has been in excess of their needs, since they wanted loans to enable them to hold their crops for cost-of-production-plus-profits prices for the realization of which there were no real prospects. In many cases, doubtless, these needs and desires have not been satisfied and the Federal Reserve Banks, or the Federal Reserve Board, or both, have been held responsible for the failure. Why?

The testimony of Governors Harding, Strong and others before the Joint Commission of Agricultural Inquiry clearly shows that the Federal Reserve System has not been at fault in this matter; that, on the contrary, the resources of this System have been put at the disposal of member banks in the agricultural sections without stint and that member banks have been urged to respond to the farmers' needs to the fullest extent possible. There is no evidence that rediscounts of eligible paper have been refused member banks in these sections, but, on the contrary, the evidence shows that the Federal Reserve Banks in these regions have borrowed heavily from other Federal Reserve Banks and stretched the eligibility rules to the limit in order to accommodate such banks. There is also abundant evidence that member banks have taken advantage of these privileges and as a whole have responded liberally to the farmers' needs. Their rediscounts and loans have expanded rapidly since the slump in prices began, the former passing far beyond the normal lines of credit set for them by the regulations of the Federal Reserve Banks, and in many cases member banks have gone beyond the limits set by sound practice in order to accommodate their farmer customers.

Limitations of Commercial Banking

The explanation of the farmers' criticisms must be sought in a misunderstanding of the limitations of our commercial banking system, on the one hand, and of our Federal Reserve System, on the other. These critics do not know that the chief stock-in-trade of commercial banks is short time self-liquidating paper, that the amount of any other kind of paper they should carry is strictly limited and that, if they go beyond this limit, they get themselves and everybody else into trouble. Nor do these critics realize that a large part of their own paper in normal times, and most of what they have to offer in these critical times, is not of the short term self-liquidating kind. It is unfortunate that we do not have institutions especially fitted to satisfy these credit needs, but the fact is that we have not. Our banking system is defective at this point, but from this fact it does not follow that it would be good policy, or any advantage, even to the farmer, to wreck our commercial banks in an effort to do what they are unfitted to do.

Neither do these farmer critics seem to know that a Federal Reserve Bank can serve them only through a member bank and then only by means of rediscounting eligible paper. If the member bank with which the farmer deals does not have eligible paper or is unwilling to offer it for rediscount, the Federal Reserve Bank can do nothing.

Misguided Opposition

The farmer has also misunderstood the operation of high rediscount rates, especially those of the progressive variety. He has thought that these rates have prevented rediscounts by his bank and in this way have made it impossible for his banker to accommodate him. In some cases, doubtless, he has been given this impression by the banker himself who has preferred "passing the buck" to the Federal Reserve Bank to giving his customer the true reason for his unwillingness to accommodate him. That rediscounts in agricultural sections have not been prevented by high rediscount rates is shown by the facts. The rediscount item has increased in spite of these rates. What these high rates were intended to accomplish and what they evidently did accomplish, was to force more careful discrimination between real and unreal and between greater and lesser needs and to cut down the volume of speculation.

Farmers have also been infected by the theory that the so-called deflation policy of the Federal Reserve Banks caused the slump in prices.

PUBLIC SUPPORT OR CLASS CONTROL

No one would be so rash as to claim infallibility for the Federal Reserve Board or for the responsible officers of the Federal Reserve Banks, least of all these persons themselves. It would be strange if they had not made mistakes. They have had to conduct a new institution during a period in which conditions were excessively abnormal and in which principles and rules of action, seemingly well established by experience, were clearly inapplicable. They have had to blaze new trails and to settle new problems upon which very little light was thrown by past experiences here or in other countries. But no fair-minded person can read and digest the testimony of Governors Harding, Strong, Miller and others before the Joint Commission of Agricultural Inquiry and escape the conviction that every policy they adopted was carefully thought out in the light of the actual conditions confronting them, that these policies worked on the whole extremely well and in the best interests of the country, that these men are able and conscientious and know their business and that the country was very fortunate to have the operation of the Federal Reserve System in their hands during this extremely critical period in its history.

The unfortunate thing is that few of the fair-minded people of the country can or will read that testimony. The ordinary man knows little about banking and would find it difficult to understand discussions regarding it if he did read them. Public opinion regarding such matters is not formed by careful reflection and weighing of the facts. Large numbers of people are bound to be influenced and to have their opinions determined by such criticisms as have been made. Since the charter period of the Federal Reserve Banks extends for several more years, the effect of this misguiding of the public mind and feeling is likely to be demands upon Congress for modifications of the Federal Reserve System in the direction of making it subservient to special interests and attempts to put the system in the control of men who will use it in the promotion of such interests. It is time for the friends of sound banking to be on the alert.

The Development of an Open Market for Commercial Paper

By E. E. AGGER
Columbia University

IT is the function of an open discount market to promote mobility, elasticity and maximum economy in the use of credit. Mobility is assured through the free sale and purchase of bills and paper acceptable as a basis of dealing in the market. Where pressure is felt bills are offered for sale and the result-