

(November 24, 1919.)

## Some American Financial Problems

BY GOVERNOR W. P. G. HARDING.\*

*Mr. President and gentlemen of the Canadian Club:*—After hearing the announcement made by your president as to the speakers that you are to hear in the immediate future, and after having read the list of distinguished speakers who have preceded me, I cannot but feel that I am rather presumptuous in appearing before you to-day. But I am very glad indeed to have this opportunity of meeting the representative business men of an allied and neighboring country. We are bound together by the close ties of blood and business interests. Even before the United States entered the war, we appreciated and admired very greatly the splendid spirit shown by the Dominion of Canada in its contribution to the great contest for world freedom and civilization. Personally, a great many of us regretted that we did not take our place beside you much sooner than we did; but we hope that we came to your side in time to be of some effective help.

Our boys stood together in the trenches of France; and in the post-war problems which confront us now we feel that it is important that we should have personal contact and acquire knowledge of each other's problems, in order that we may devise as intelligently as possible the means of solving them.

I shall outline very briefly the salient points of our new banking system in the United States and then turn to some of the most vexing of the problems which now confront us, in order that we may ascertain to what extent our problems are your problems and better decide what joint action we can take in meeting them. In the first place, our banking system in the United States is radically different from your Canadian system. Up until 1913 it was realized, not only throughout the world but admitted in the United States, that we had

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perhaps the most defective banking and currency system of any civilized nation. We have always had a great admiration for your Canadian banking system. However, your system is not adapted to our American needs or American thought.

For more than eighty years there has been a strong prejudice in the United States against the branch bank system. Consequently, instead of having a limited number of strong banks whose branches radiate in every direction to supply the needs of local communities, as you have in Canada,—where I understand you have only fifteen or twenty banks,—we have in the United States a system of independent banking units. We have some large and powerful banks, and a great many of limited resources. We have, all told, about 28,000 separate and independent banks, many of them capitalized as low as \$15,000, and some as low as \$10,000. Doubtless, the idea of an independent bank having a capital as low as \$10,000 or \$15,000 may appear strange to Canadians.

Some of these banks are organized under Federal law,—about 7,800 of them. The remainder are organized under the laws of the various states; and we have forty-eight states, and the laws of no two states are exactly alike. Thus you can see that, with so large a number of units, such a thing as effective co-operation was impossible. Furthermore, each bank was required to keep its own reserves. A proportion of its legal reserve had to be kept in lawful money in its own vault.

Our old law provided for central reserve cities and reserve cities. National banks located in cities thus classified were required to carry reserves of twenty-five per cent against their net deposits. Banks in central reserve cities were obliged to keep the entire amount of the required reserve in lawful money in their own vaults, while banks in reserve cities were permitted to keep a reserve of twelve and one-half per cent in lawful money in their own vaults provided they carried at least twelve and one-half per cent additional with national banks in central reserve cities. Banks located in towns and cities which were not classified as reserve or central reserve cities were known as "country banks". They were required to carry reserves amounting to fifteen per cent of their net deposit liabilities, at least two-fifths of which had to be lawful money in their own vaults, and three-fifths of their required reserve could be kept with national banks in either reserve or central reserve cities.

The effect of that arrangement was that, whenever there was any unusual stringency in the money market or when there was an extraordinary seasonal demand for currency for use in moving crops or for other purposes, the country banks would withdraw balances from the city banks at the very time when those banks could use the country banks' balances to the best advantage; and, in addition, the country banks were accustomed to call on their city bank correspondents for credit accommodations based upon the average balance carried with the city banks.

There was no elasticity to our currency; it was inflexible and rigid, and could not be increased substantially in volume to meet seasonal needs or unexpected emergencies. The amount of United States notes, which were legal tender, was fixed by law at \$346,861,106. This amount could be neither increased nor diminished. Changes in the volume of gold or silver coinage were gradual; and, while the issue of gold and silver certificates was permitted, no increase in the volume of circulation resulted, for the gold certificates were required by law to be secured by an equivalent amount of gold coin or bullion, and the silver certificates by a like amount of silver dollars. National banks were permitted to issue circulating notes secured by Government bonds at their face value; and, prior to 1914, National bank notes, which aggregated about \$740,000,000, constituted the larger part of the currency in ordinary use. No national bank, however, was permitted to issue circulating notes in an amount exceeding its capital stock, and the volume of national bank notes in circulation depended, not so much upon the demand for currency, as upon the price of Government bonds upon which they were based.

It will be seen, therefore, that under our old system it was impracticable to augment the volume of currency to any appreciable extent, no matter how great the stress. Our system broke down on several occasions. We had notable panics in 1873, 1893 and 1907, although in none of these years was there a currency panic in Canada, due to our more elastic currency system.

On December 23, 1913, after several months deliberation by the Congress of the United States, there was enacted what is known as the "Federal Reserve Law". This law created a Federal Reserve Organization Committee consisting of the Secretary of the Treasury, the Secretary of Agriculture and the Comptroller of the Currency; and provided for the appoint-

ment of five members of the Federal Reserve Board, with the Secretary of the Treasury and the Comptroller of the Currency as members ex-officio. Twelve Federal reserve districts were established by the organization committee; members of the Federal Reserve Board took the oath of office on August 10, 1914, and the twelve Federal reserve banks were opened for business on November 16th of the same year.

Each Federal reserve bank is an independent unit, governed by a Board of nine directors, six chosen by the member banks and three appointed by the Federal Reserve Board. All national banks are required to become stockholders in and to be members of the Federal reserve bank of the district in which they are located, and all state banks which have the required amount of capital and which can comply with other conditions prescribed by law are permitted to become stockholders in and members of a Federal reserve bank. All the National banks in the United States are members of the Federal reserve system, and about 1,100 state banks have been admitted, so the twelve Federal reserve banks have now between them about 9,000 member banks, or just about one-third of the total number of banks in the United States. These member banks, however, represent approximately eighty per cent of the banking power of the country.

The Federal reserve banks have no individual stockholders. Their stock is entirely owned by the member banks. The Federal reserve banks do not receive deposits except from member banks and the United States Treasury, nor do they discount for the general public. They are bankers' banks. The capital stock of the twelve Federal reserve banks amounts now to about eighty-four millions of dollars; and the surplus fund accumulated will amount, on January 1, to about one hundred and twenty millions of dollars. The law allows the Federal reserve banks to accumulate a surplus up to two hundred per cent of their paid-in capital, only one-half of the subscribed capital being paid in.

In another year the banks will probably have, in addition to their paid-in capital, a surplus of twice the amount—say \$170,000,000. Whenever the surplus of a Federal reserve bank amounts to twice its present paid-in capital, it may retain out of net earnings, after paying dividends, only ten per cent of its annual earnings as a further addition to surplus and must pay the remaining ninety per cent to the Government of the United States as a franchise tax. No interest is paid

on deposits, and the only return to stockholders is the cumulative dividend of six per cent per annum.

Earnings have been very heavy during the last two years, owing to the financial operations of the Government. Some of the banks have earned more than one hundred per cent of their capital stock in a single year. This, of course, is an abnormal condition, and is made possible by the heavy discount operations in connection with Government financing and the demand for Federal reserve notes as currency.

The Federal reserve banks have, as fiscal agents for the Treasury of the United States, received subscriptions for, and received payment for all the twenty-one billion dollars of bonds which the Treasury has issued; and they have also handled the short term obligations of the Treasury. The certificates of indebtedness now, I understand, amount to about three billions, four hundred millions of dollars, and are being reduced at the rate of about seven hundred and fifty millions of dollars a year.

The Federal reserve banks hold the gold reserves of the country. The law has been changed so that no bank—no national bank, and no state member bank—is required to keep any specified amount of cash in its own vault. That is a matter entirely for a bank's own determination. Nor does any cash in the vault of a bank, even gold, count as reserve for that bank. The only lawful reserve for a member bank is its balance with the Federal reserve bank. That, of course, has had the effect of concentrating gold in the vaults of the Federal reserve banks. The amount of gold so held by the banks and Federal Reserve Agents is in excess of two billions of dollars. The Federal reserve banks hold, in the shape of reserve balances for their members, about one billion, seven hundred millions of dollars.

The total note issues of the Federal reserve banks are about two billions, eight hundred millions. The Federal reserve note may be issued in two ways. It may be exchanged directly for gold, dollar for dollar; or the Federal reserve bank may issue it upon a deposit with the Federal Reserve Agent at each bank of commercial paper—which the bank has discounted or acquired by purchase in the open market, or discounted for member banks—for sixty per cent of the amount of notes desired, gold being deposited in like manner for the remaining forty per cent. Federal reserve notes are redeemable in gold at the Treasury in Washington, or in gold or lawful money

at any Federal reserve bank, and these redemptions have been made steadily all during the war. In no case has a Federal reserve bank refused to redeem a note in gold.

Now, in addition, we have the Federal reserve bank note, which is very much like the old National bank note. The Federal reserve bank note is secured by bonds or obligations of the Government of the United States. They have been issued principally to take the place of the silver dollars and the silver certificates which have been retired under an Act passed in April, 1918. You will remember that at a very critical period of the war there was a crisis in India; and Lord Reading, who was then Ambassador to the United States, pointed out the necessity of rectifying the Indian situation in order to prevent paper rupees being presented in amounts in excess of the ability of the Indian Treasury to redeem them. This legislation was secured in a remarkably short time. Those of you who are familiar with American financial history will remember that we spent twenty years discussing silver coinage before the matter was finally settled. But in three days the Act was passed authorizing the retirement of silver certificates and the melting of \$350,000,000. This legislation undoubtedly saved the situation in India.

We have now outstanding two hundred million dollars of Federal reserve bank notes. The reserves against these notes are five per cent in gold, or a greater amount at the discretion of the Secretary of the Treasury. Thus, our total Federal reserve note issues are about three billions of dollars. This amount is not a fixed quantity, for we have now a flexible currency; and as the demand for currency decreases the notes will come in for redemption, and we anticipate that the maximum for this year has just about been reached. By the middle of February there may be a reduction of anywhere from two to four hundred millions of dollars.

In pointing out the good that the Federal Reserve Act has accomplished, I do not want to minimize some of the dangers that accompany too free a use of credit. There is no question, as you can see for yourselves, that the United States would have been absolutely powerless to have financed itself and to have loaned ten billions to the Allies during the war had it not been for our new system, for what could we have accomplished under the old system with 28,000 separate banks all pulling apart, with no unity, no co-operation whatever? We could not have sold and taken care of the twenty-one billions of bonds and

seven or eight billions of dollars of Treasury certificates. It would have been absolutely impossible.

The old law provided that in no circumstances should any national bank be indebted for borrowed money, either as bills payable or as rediscounts, in an amount exceeding its capital stock. With such a limitation, we could not have financed the war as we did. The Federal Reserve Act places no limitation upon the amount that a member bank can borrow from a Federal reserve bank. We have had cases where a bank has subscribed for bonds and Treasury certificates to an amount much larger than its capital. A bank may have \$500,000 capital and subscribe for \$5,000,000 of bonds, and have its Federal reserve bank discount its note secured by the bonds. Of course, the power to expand credit in war time is very necessary and very useful.

Our bonds have been fairly well distributed. We had an investing population of about 300,000 before the war. We have now a list of 20,000,000 bond subscribers. Out of twenty-one billions of dollars of war bonds which have been floated and three and a half million, approximately, of Treasury certificates outstanding, the Federal reserve banks are carrying in the shape of collateral loans about one billion, seven hundred millions on Government obligations, which indicates a pretty good distribution.

But there is one thing we have to contend with. Our people have been told that they need no longer fear a currency panic such as occurred in 1907. I think that is correct; for if there is any need for currency the Federal reserve system can provide any amount that may be required for a temporary emergency. As there is no legal limitation as to the amount a member bank may borrow, we have to watch closely any tendency to abuse the privileges of the Federal reserve system. For months past there has been evidence of a strong speculative spirit all over the United States, a spirit which is essentially dangerous. It has been over a year since the armistice; and, naturally, just after the armistice we felt like celebrating. The whole country was enthusiastic at the end of the war.

But, in a sense, we have been celebrating ever since. We have overlooked certain elements of danger. We have had in the United States a period of industrial unrest, and a succession of strikes. After the armistice, people expected prices would go down. But prices and wages have been going up in a vicious circle, chasing each other around the table.

First prices go up, then wages go up; up go prices again, and then wages. There seems to be no end to it. The cost of living is getting to be a very serious problem, and it is very necessary for us in the United States to take cognizance of the problem; and my colleagues on the Federal Reserve Board appreciate the importance of checking the tendency toward undue expansion.

We have, through force of circumstances, an abundance of money in circulation and a very large volume of bank credits; but there is no reason why we should turn with reckless abandon to unbridled speculation and unchecked extravagance. We had during the war a fine spirit of self-sacrifice. We distinguished between essentials and non-essentials. We developed a spirit of thrift such as we never had in the United States before or since. We practised thrift that we might save goods to ship abroad to our armies, and we economized in order that we might buy Government securities. We have not finished with war finance and we are still technically at war, for our treaty of peace has not yet been ratified.

We must inculcate in our people the old war-time spirit of thrift and economy. It seems to me that in order to stimulate production we must reach the people who are holding back, the people whom you might say are slackers—and that term, which was used very effectively during the war, ought to be used now. The man who can work and won't is a slacker, just as he was during the war. And capital and credit applied in the wrong direction are slackers to-day, just as during the war. We must get back to the war-time spirit and practice economy; and by refusing to pay some of the exorbitant prices demanded and by self-denial, we can point out to the great community at large the way back to a solid basis.

I shall not attempt to discuss European conditions, for I have only second-hand information. You had a speaker here last Monday, who gave you, perhaps, as dismal a view of the situation as any one will. We have heard more optimistic views and we have tried to strike an average of opinions. We frankly say that we don't know how much money will be needed for financing Europe; but we do know that it is necessary, for the rehabilitation of Europe and for the re-adjustment of permanent peace and prosperity throughout the world, to get the populations of Europe back to work, back to a point where they can support themselves and gradually pay back what they owe.

The great trouble with the world today has been the destruction of the real wealth, the liquid wealth, as represented by goods and commodities. There has been a tremendous expansion of credit and inflation of currency throughout the world, and there has been a corresponding reduction of the volume of goods. Our problem, from an economic standpoint, is to so increase the volume of goods without increasing in like degree the volume of credit that we may ultimately restore a proper relation between the volume of credit and the volume of goods.

And, gentlemen, after all is said and done, there is only one way in which we can accomplish this. We can best describe the process by these two words, "Work" and "Save". We must work in order to produce. We must save in order to liquidate Government obligations and expanded credits and get back to firm and stable ground.

We in the United States have a great responsibility and duty to the rest of the world. We have a large population. We have great productive capacity. We were not in the war as long as the rest of you. For two years we profited at the expense of others. We received great accumulations of gold. We sold our goods at a large profit. Our wealth increased enormously. I want to say to you that we of the United States realize our obligations and appreciate our duty. We are anxious to help the rest of the world. We had in Washington ten days ago, and in New York last week, one of the most interesting and delightful visitors we have ever had. He impressed us with the dignity of his bearing, with his unassuming manner, and with his pre-eminent fitness for the place he occupies. I refer to the Prince of Wales. There never was a visit of any foreign potentate or dignitary more productive of good than his.

A good deal has been said about further credits by the Government of the United States to foreign countries. As you know, the United States has already advanced ten billions of dollars to foreign countries. When we entered this war, our total national debt was around a billion of dollars. Our national indebtedness today is not far from twenty-five billions of dollars. Our pre-war budget was about eight hundred millions; our budget for 1919 is over six billions of dollars. There is only one way through which the Government of the United States could extend credits abroad; and that is by getting the money from the people; this can be done either by further increasing taxation, which we feel is already heavy

enough, or by another issue of bonds. Another issue of bonds would mean harmful inflation. We have had to resort to credit expansion to do what we have, because our normal investing capacity is not more than six or seven billion dollars a year and yet we have floated twenty-five billions of obligations in two and a half years. We have had to anticipate future savings. Our thought is that there is no possibility of further Government aid to foreign countries. I think we might all get that idea out of our minds.

But we resort to private initiative, to individual enterprise. The United States is a great agricultural and manufacturing nation. We are anxious to sell goods. We realize we cannot maintain our trade relations with the rest of the world unless we give credits. Our exports for the first ten months of this year amounted to about six billions, and our imports only to three billions. We have had to give credits for the balance, and we must extend further credits. I think Americans understand that.

There is pending in Congress, a bill known as the "Edge Bill", which bears the name of its author and sponsor, the Senator from New Jersey. It provides that corporations having a capital of not less than two millions of dollars may be organized for the purpose of financing exports, to be supervised by the Federal Reserve Board. They will buy foreign securities, and extend credits abroad as they are needed. They will be authorized to issue their own debentures, secured by foreign obligations, and sell them to American investors, in order to replenish their funds and continue the transactions.

Our information is that considerable sums of money are being remitted to Europe every week by people who are either of European birth or of European parentage. Those sums may be small in detail, but they are very large in the aggregate. After we have the Peace Treaty ratified and the tide of tourist travel sets again towards Europe, credits by Americans will undoubtedly be very heavy. That will help relieve the situation. And we in the United States are told by many of the delegations that call on us that, while they will need credits for five or ten years in order to overcome adverse exchange conditions, yet we must not think they are going to need them continuously. What they need is long time credits now; and after this winter and next spring are past, they expect to have so far advanced in Europe that they will be able to pay all current obligations thereafter.

We get particularly encouraging news from Belgium; and we all know that England is going to take care of herself. She has great problems; but her centuries of experience as the world's banker, her position as the center of the world's shipping, make her position absolutely secure. We have not the slightest doubt about that. With regard to your own situation, your Canadian exchange being at a heavy discount, in terms of our own, creates a condition which while it may be a little mortifying to you from the standpoint of civic pride, is not, I take it, without its compensations.

It is a situation which concerns us in the United States more than it affects you, for Canada for years has been the largest customer of the United States. We have sold more goods to Canada than we have to all the rest of the western hemisphere combined. We have sold you—I have not the figures before me, but my recollection is—an average for seven years past of \$750,000,000 a year; and we have bought from you \$350,000,000 or \$400,000,000 a year. You have had constantly an adverse trade balance with us of between \$300,000,000 and \$400,000,000. But you have always had balances due you from Great Britain. Ordinarily, you have settled by selling your sterling bills in New York, and but for the discount on sterling there, Canadian bills would be par.

There has been some talk of floating a Canadian loan in the United States. If Canada wants to borrow in the United States I do not think there is any doubt that our American investors would avail themselves of the opportunity to lend. We know you. We have had uninterrupted trade relations with you for more than one hundred years; we have had 3,000 miles of border during all this time, on which there never has been a cannon or a soldier, and never a warship on the Great Lakes. We have lived on terms of peace and amity with you, and a Canadian loan would appeal to Americans almost as an American loan. But it seems to me that what you want is to have us mobilize our credits with a view to relieving the situation in Europe; for, if we relieve the situation there and get Europe stabilized, your own exchange is going to take care of itself. You have a great Dominion, plenty of vacant land, and great development ahead of you. You are attracting the notice of American investors to an extent greater than ever before.

The discount on Canadian exchange makes it more difficult for American merchants and manufacturers to sell in Canada

because it adds to the cost of our goods; and, conversely, it stimulates Canadian sales in the United States. For instance, if a Canadian should buy \$100 worth of goods in Buffalo, it would cost him \$104.50 to pay for them. But the cost to him in Toronto would be \$100. And if a Buffalo man bought \$100 worth of goods in Buffalo it would cost him \$100; and, at the present rate of exchange, only \$96 if he bought the goods in Toronto. Thus, an adverse exchange rate stimulates your exports and has a tendency to restrict your imports. It gives you an opportunity for cementing your own trade relationships among yourselves and for building up industries in Canada that you did not ordinarily have. I am not here to advocate, of course, the desirability of an abnormal exchange rate as a permanent condition. I am merely pointing out that there is a compensation. No matter how mortifying the present situation may be to your civic pride, after all the remedy lies in extending credits to France, England, Italy and Belgium, and other countries in the old world, for commercial and constructive purposes.

I know you are all busy men and I must not detain you longer. Let me thank you again for the warmth of your welcome and for the very kind attention you have given to my remarks. And let me say in conclusion that we Americans believe that our problems admit of solution, and that they will be solved. While there seems to be no probability that our Government will extend further credits to Europe, I feel assured that private capital in America is ready to do its full part in the work of world rehabilitation and restoration.