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Statement of Honorable Duncan U. Fletcher, Chairman of the Senate Committee on Banking and Currency

on

THE BANKING ACT OF 1935

Since the introduction of the proposed Banking Act of 1935, (S. 1715 and H. R. 5357), a flood of letters and telegrams have been sent to Senators and Congressmen in protest against one particular section of the bill, namely, Title II. I myself have received several hundred letters which show evidences of having originated from one central office. On the face of the facts, I would say that they have been signed and mailed by persons who have neither read the provisions of the bill nor are conversant with the principles incorporated in it. For the enlightment of probably thousands of ill-advised correspondents, I am herewith reproducing one of the "form letters."

April 8, 1935.

Honorable ----------,
Senate Committee on Banking and Currency,
Senate Office Building,
Washington, D. C.

Dear Senator -------:

I hope that you will find it possible to use your influence against the Banking bill (H. R. 5357, S-1715). I believe that it endangers the development of sound banking in this country, not only because its banking principles are unsound, but because it permits political control of the Federal Reserve Board and the Federal Reserve banks.

Respectfully yours,

(Signed)

John Doe

On the other hand, a number of bankers, editors, pseudo economists and so-called financial experts have bandied the subject back and forth in the Press and through the medium of "form letter" correspondence, for something like two months. Such tactics have resulted in a wealth of misinformation. Much of this misinformation has been deliberate and willful.

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At this stage of the matter, I wish to warn the general public, and particularly the correspondents to whom I have just referred, that they must be on their guard lest they be abused as were thousands of business men by the use of similar methods against the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. To this date there are literally thousands of well intentioned but misinformed business men who do not know the facts pertaining to the prospective issuance of their own securities under these Acts. This misunderstanding is not due to defects in either of the Acts or to the administration of them. It all goes back to the campaign of vicious propaganda and misinformation.

Similar results are now evidenced with respect to the proposed Banking Act of 1935. Do not be misled. This legislation will serve a public purpose and its enactment is essential to the establishment of the financial and economic security of this Nation's domestic enterprises.

As a result of having devoted much thought and study to the numerous articles which have appeared in the Press and hundreds of letters which have come to my desk, I think it best that this attempt be made to explain more clearly to the public the issues which are in controversy and discuss the principles involved in order that a much clearer understanding may be had of the necessity for the passage of this piece of legislation.

In my opinion, the proposed Banking Act of 1935 is, in all probability, the most important piece of banking and monetary policy legislation with which this or any other Congress has dealt. This statement is based upon the importance of Title II alone; and, curiously enough, Title II of the bill is bearing the brunt of almost all the opposition made to the entire piece of legislation. Please be advised, however, that all of those who are offering concerted opposition to the bill on the basis of the incorporation of Title II are almost spontaneous in their clamor for the enactment of Titles I and III.

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Hence, I shall deal only briefly with the Ist and IIIrd Titles of the Bill. The first Title provides: for the merging of temporary funds into permanent funds; that $5,000 be designated as the maximum insurable deposit; assessments; withdrawal from the fund; buying assets of insured closed banks, and a number of other important matters. The third Title provides for: "accidental" holding company affiliates; security affiliates in liquidation, security dealers accepting deposits, employees' deposits, liquidation of assets of banks in voluntary liquidation, termination of double liability, examinations, and a number of other important matters.

Title II, on the other hand, deals almost wholly with the creation of machinery for the effective regulation of a definite monetary policy in accordance with the campaign promises of President Roosevelt based on the Democratic platform of 1932 which advocated "a sound currency to be preserved at all hazzards" and proposed to put an end to "the indefensible expansion and contraction of credit for private profit at the expense of the public".

Moreover, it is a definite attempt to accomplish the ends which the President had in mind when, on July 3, 1933, he stated to the American delegation to the London Economic Conference and again reaffirmed on October 22 in his address to the American people in which he stated that:

> "When we have restored the price level, we shall seek to establish and maintain a dollar which will not change its purchasing and debt paying power during the succeeding generation. I said that in my message to the American delegation last July and I say it now once more."

This bill among other things provides that:

(1) "The offices of Governor and Chairman of the Board of Directors of each Federal Reserve bank shall be combined." In their places a Governor and Vice Governor "shall be appointed annually by the Board of Directors, subject to the approval of the Federal Reserve Board". "The Governor shall be the chief executive officer of the bank".

Whereas, in the original Federal Reserve Act the executive head of the bank was to have been known as Chairman of the Board of Directors and at

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the same time act in the capacity of Federal reserve agent; the active head in control of purely banking operations was to function in the capacity of a bank manager. The Federal Reserve banks gave to the bank manager the high-sounding name of "Governor."

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Since that time, it has developed that the "Governor" of each Federal Reserve bank has not only superseded the Chairman and agent as the executive officer of the bank but has also become the virtual dictator of the Federal Reserve bank to the extent of practically controlling the election of directors who are presumed to be independent in the exercise of their power in the election of said "Governor". The results are obvious.

The above provision of the bill merely merges the two offices and at the same time provides for the retention of all "Governors and "Chairmen" - if they are qualified, and if, subject to the approval of the Federal Reserve Board, the various boards of directors elect them Governor and Vice Governor. At the same time, the language of the bill makes it clear for once that banks cannot evade or override the law through the creation of a high-sounding office and wrest control from the Board by creating a dictatorship within the Federal Reserve System.

The bill further provides that:

(2) Prior to July 1, 1937, the Federal Reserve Board may waive the capital requirements for the adminssion of nonmember State banks as members of the Federal Reserve System.

It is intended through such a provision to recognize the fact that small banks, that small State banks, are not mere "pawn shops". It is in recognition of the fact that smallness and bigness in a bank's capitalization, deposits, investments or loans is not an indelible evidence of either soundness or weakness. The success or failure of a bank depends primarily on its management, and not on its size.

It is a recognition of the fact that there are thousands of small State banks in this country which are worthy of membership in the Federal Reserve System. On the other hand, it absolutely does not provide a license for, or inducement to, the inclusion of unsound banks, or of under-capitalized banks, within the Federal Reserve System. Assuming an unbiased and unprejudiced administration of the Act in accordance with the intentions of Congress, there should result no unfair treatment of, or impositions on, either State banks or National banks, under the provisions of this section.

The next provision to which I wish to call your attention is: (3)

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"In selecting the six appointive members of the Federal Reserve Board the President shall choose persons well qualified by education or experience or both to participate in the formulation of national economic and monetary policies."

Moreover, each director is to receive a salary equal to that of a member of the President's Cabinet, and shall be retired at the age of seventy upon a retirement wage to be paid out of funds derived from levies on Federal Reserve banks.

Such a provision is conceived in the public interest. It provides for no favoritism between bankers, lawyers, economists, manufacturers or men from any other profession. The administrative duties of a Board member are such as to require a far broader experience and basis for the exercise of sound judgment than that derived from the narrow confines of any one profession. Please note that the section reads: "The President must choose persons well qualified by education and experience or both to participate in the formulation of national economic and monetary policies."

That is a mandate!

The next three points to which I wish to direct your attention are of the greatest vital importance. They have to do with the Federal Open Market Committee, flexibility of reserve requirements, and discounts.

They are, in order of sequence, numbered (4), (5) and (6).

(4) The creation of a Federal Open Market Committee consisting of five members, three of whom shall be members of the Federal Reserve Board, the other two to be Governors of the Federal reserve banks selected by all the Governors of said banks. Their terms of office shall expire at the end of each calander year. Said Committee shall have supervisory control over the Open Market Operations of the Federal Reserve banks.

(5) The Federal Reserve Board is empowered to change the reserve requirements of member banks as to any or all Federal reserve districts and/or any or all classes of cities and as to time and/or demand deposits.

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(6) "Subject to such requirements as to maturities and other matters as the Federal Reserve Board may prescribe, any Federal Reserve bank may discount any commercial, agricultural or industrial paper and may make advances to any such member bank on its promissory notes secured by any sound assets of such member bank."

Significance of Provisions Four, Five and Six

The first question which arises in connection with these three provisions is as to whether they involve a radical change in the present powers and functions of the Federal Reserve Board and the Federal Reserve System as it is now constituted. The second question is as to whether there will be established a political dictatorship of banking.

The unequivocal answer to the first - aside from a technical splitting of hairs - is NO. To the second, an unequivocal answer of NO must be given.

It is a fact that all of the powers which are by this bill centralized in the Federal Reserve Board have since the enactment of the original Federal Reserve Act existed within the Federal Reserve System. That is; all open market powers dealt with in Title II of this Act exist in the present law, and were so read into the original Act by the "Governors" of the Federal Reserve banks, as I shall subsequently point out. But it also must be ~~pointed out~~ mentioned that when any or all the Reserve banks, the Reserve Board, or the Treasury through its Stabilization Fund, engage in Open Market operations, they depart from and transcend the field of banking and become engaged in operations foreign to banking per se.

That is, when banks or the Board engage in open market operations, they are buying and selling money; they are expanding and contracting the total volume of money; they are laying the foundation for inflation, deflation and economic chaos if intelligence, and prudence are not exercised in accordance with the sound principles of monetary science.

Such principles are not one and the same with even those of sound banking, where private profit is predominant. On the other hand, the principles of monetary science to which I refer are the principles of national monetary policy operations which absolutely must be made to conform with a public in-

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terest which oftentimes is directly opposed to the private interest motives of bankers if they are to be administered in the interest of the general public.

DEVELOPMENT OF COORDINATIVE SYSTEM

POLICY IN OPEN MARKET OPERATIONS OF FEDERAL RESERVE BANKS

For your information, I want to give you a brief historical sketch of the development of open market operations by Federal reserve banks under the original Federal Reserve Act and the centralization of their power without any specific authorization of law.

My wish is first to narrate in terms of what might be called 'bankers' technical language'; then I wish to translate it into good 'every day English'.

Prior to 1922 the Reserve banks, having the power to invest money, made considerable investments in the open market, buying bills and buying Government securities. The holdings of United States Government securities by Federal Reserve banks gradually increased in the early years of the System to about $300,000,000 in 1920, and were slightly smaller in 1921. Their purchase and sale of bankers' acceptances were made largely in accordance with seasonal changes in the supply of acceptances and in the demand for funds.

In 1922, Federal Reserve banks, facing a decline in earning assets because of repayments of discounts by member banks, began to buy Government securities for the purpose of increasing their earnings. It was observed that the operations of Federal Reserve banks, acting independently were affecting the market for Government securities and that these operations conflicted with each other and with those of the banks as fiscal agents of the Treasury.

In May 1922, at a meeting of the Governors of the Federal Reserve banks, a committee was appointed to coordinate the buying and selling of Government securities so as to have a more orderly program under central control.

In October 1922, this Committee undertook to make recommendations to the Federal Reserve banks regarding the purchase and sale of Government securities. It was observed in this year that purchases of Government securities did not cause an increase in the earning assets of the Federal Reserve banks, nor did sales cause a decrease, but rather that they affected the volume of borrowings at member banks. As a consequence, the Conference of Governors of the Federal Reserve banks voted that "investment policy should give minor consideration to

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the question of earnings and constant consideration to the effects which open-market operations have upon the condition and the course of the money market and the volume of credit."

On April 7, 1923, the Board advised the Governors of the Federal Reserve banks formally of a resolution adopted by the Federal Reserve Board on March 22, 1923, with respect to open-market operations by Federal Reserve banks, pointing out the necessity for the coordination of open-market operations of the Federal Reserve banks with their discount operations and their general credit policy. It also announced the organization of the "Open Market Investment Committee" for the Federal Reserve System. This committee consisted of five representatives of the Reserve banks and was to be under the general supervision of the Federal Reserve Board. From this time on, open-market operations could not be engaged in by Federal Reserve banks except with the approval of the Federal Reserve Board.

In March 1930, the "Open Market Policy Conference," consisting of representatives of all the Reserve banks, replaced the "Open Market Investment Committee. Under the Banking Act of 1933 the "Federal Open Market Committee," consisting of twelve Reserve bank Governors, was established.

What I have said in the immediately preceding six paragraphs is, in technical bankers' language, a correct statement of what Federal Reserve bankers did and are now doing. But in the language of the layman, this simply means that the Federal Reserve System is already engaged in all of the operations and performing all of the functions which will be required under the proposed bill; however, there is added one factor of the greatest significance to the public. We shall, through this Act, definitely fix the responsibility for and the power to engage in open market operations, in the Federal Reserve Board. In the future when money becomes "easy" or money becomes "tight" or when we are led into a period of inflation or a period of contraction and economic demoralization, we shall be able to put our finger upon the Federal Open Market Committee and say, "YOU ARE RESPONSIBLE".

May I re-emphasize the fact that when the Federal Reserve banks back in 1921 and 1922 began their open market operations "for the purpose of increasing their earnings" and later when they appointed a Committee "to coordinate the buying and selling of securities in the open market" they were literally buying and selling dollars for profit. They were buying and selling dollars in

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just the same manner and for precisely the same purpose that hundreds of carloands of wheat were bought and sold, a hundred times over, in the Chicago wheat pit or in the street, despite the fact that the wheat was in freight cars and stood on the railroad sidings for days, weeks, even months without once having been moved, That is, the open market Committee was dealing in previously created credit obligations for profit and eventually awakening to the fact that they were shooting the price structure to pieces, upsetting the financial plans of the Government, disrupting business, and confusing the bankers. Through this Act we propose to introduce responsibility for such activities, in fact - to command that the necessary operations must be engaged in at the direction of the Federal Open Market Committee with a mandate laid down for the orderly conduct of such operations <u>in the public interest</u>.

To what extent is this the introduction of a new principle into the law? The answer is: "It is not new."

Sect on 8 of the Banking Act of 1933 provided for the insertion of a <u>new</u> section in the Federal Reserve Act, to wit:

"There is hereby created a Federal Open Market Committee . . . .", immediately followed by subsections (b), (c) and (d) which made all open market operations subject to "regulations adopted by the Federal Reserve Board". Base upon the latter fact, I insist that the porposed Title II does not in any way increase the political control over the operations of the Federal Reserve Board, the Federal Reserve banks or of member banks. On the contrary, the law remains as it has been for over twenty years. Under the above provisions of subsection (d) any Federal Reserve Bank might be <u>excused</u> from participation provided it "filed with the Chairman of the Committee within thirty days a notice of its decision, . . . not to participate". In this respect our proposal is to strike out the exception and leave the power to initiate action with the Board.

Now. What of the flexibility of Reserves provided for in the bill?

May I remind you that the same Congress which enacted the Banking Act of 1933 wrote a similar clause into Public #10 (in that part known as the Thomas Amendment), a provision for the "increase or decrease from time to time, in it discretion the reserve balances required to be maintained against either deman

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or time deposits".

On this point, the proposed Banking Act of 1935 gives recognition to the fact that there is no safety to be found in arbitrary judgment or arbitrary figures with respect to the reserves of either Federal reserve banks or of member banks. Several hundred years ago, the goldsmiths retained 100% reserves. Later they arbitrarily reduced their reserves. England has no such arbitrary reserve requirements established by law. This country has progressively found it advisable to reduce the legal reserve requirements for even commercial banks from an arbitrary figure of 50 to 40 to 25, until now they stand at 13, 10 and 7% on demand deposits of commercial banks, depending upon the size of cities in which they are located.

NO BANKING DICTATORSHIP CREATED

The powers referred to in #6 as I am designating them, cannot and should not be construed as the creation of a Federal Reserve Board dictatorship over purely banking operations of the Federal reserve banks and their member banks. In this respect the Board's directions to banks are either permissive or prohibitive as to all purely banking operations. Within these two extremes all actions with respect to purely banking matters are left to the discretion of Federal Reserve banks and their member banks. That is, bankers will decide as to whether they shall or shall not make loans or investments which lie purely within the field of banking operations, such as whether loans shall or shall not be made to an individual or coporation; or a mortgage purchased; or the calling of a loan. And it is likewise left to the Federal Reserve bank as to whether it shall or shall not rediscount any of the paper of a member bank, or make a loan to said member bank upon any of its sound assets.

The next provision to which I wish to refer is:

(7) "Federal reserve notes are to be issued by the Federal Reserve bank and retired under such rules and requirements as the Federal Reserve Board may prescribe.

From the orthodox banking point of view such a provision is sound. Banks are not opposing this feature of the bill.

The next and last provision to which I wish to make a specific reference

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is:

(8) National banks will be permitted to "make loans, secured by first liens upon approved real estate, including improved farm lands and improved business and residential properties."

This is a long established principle. Do you want it stricken out, or do you have some arbitrary limit you think should be fixed? This is definitely up to the Congress. We must choose reasonable limits. What is your suggestion?

It is because of the above provisions incorporated in Title II that the American Bankers Association, a number of the State bankers' associations, and numerous bankers and economists throughout the country are making a concerted effort to divide the bill and enact Titles I and III, alleging that said Title II effects radical changes in the banking laws of the Nation.

May I point out that, with one or two exceptions, all of the above requirements have to do with the control over the monetary policy of the country. Monetary policy operations cannot and should not be merged with purely banking operations.

The administration of a monetary policy has to do with the contraction and expansion of the credit and currency of the country and directly affects the purchasing power of money. This function transcends those of banking, farming, manufacturing or that of any other business activity. It literally controls the economic and social welfare of the whole Nation. Traditionally, to be sure, this function has been turned over to banks and bankers who have operated it without direct responsibility to anyone. We propose, as I have previously pointed out, to centralize the powers and responsibilities in the Federal Reserve Board.

There are literally thousands of bankers in this country whose heads are bowed in humiliation and shame. They are blamed for the vicious results, many of which they are not able to rationalize. They have had their lines of credit shut off or have experienced the withdrawal of huge sums of money upon demand. In turn they have been forced to try to call in loans which they oftentimes have made with the greatest of caution and deserved confidence, to be preemptorily thrown into the maelstrom of a financial panic, contraction or depression.

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Among them, however, there have been a few bankers "in the know" and also in a dominant position for laying down the rules for making money "tight" or "easy" - of literally determining the trend - yet the latter have not personally been singled out nor can they, under our present system, be called to account for the disastrous results of their acts. It is my earnest desire that the fifteen or twenty thousand bewildered bankers, who have never known and never will know what it is all about, demand that this great destabilizing and disturbing factor of monetary policy shall be separated from banking per se and placed in the hands of men who must and who shall be held responsible and accountable for their acts. Undoubtedly in this great Nation we can find at least five or eight men, depending upon the final provisions of the Act, who know what it is all about and can be trusted to administer our monetary policy intelligently and with the greatest amount of integrity and respect for the people, and act for the public welfare.

Bankers as a whole are not qualified to determine nor competent to administer our monetary policy. They have not been able to discern the difference between purely banking functions and monetary policy operations. As a whole they have known only that money was "easy" or money was "tight" without knowing the "whys" and "wherefores" and have been wholly ineffectual if not irresponsible in the administration of our monetary policy.

We have been sifting and winnowing the basic facts for the past six long years. We know the facts. We have weighed the evidence. We have made up our minds as a result of the collapses of 1920, and 1929. None of the opposition will dispute the facts. They cannot deny them. If they have not made up their minds after six years, we have little promise that they will have anything to offer after another two years.

It is common knowledge, however, that there now lies within the hands of bankers the potential makings for one of the most stupendous inflations this or any other nation has ever experienced. And experience teaches us that banker control of monetary policy will probably give us an equally devasting financial whirlwind when that bubble is pricked.

This bill is conceived as our most essential safeguard.

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