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Office Correspondence

FEDERAL RESERVE BOARD

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Date May 7, 1935

GOVERNOR ECCLES

From MR. WYATT

Subject: Quotations from court opinion re open market operations and discount rates.

In reading over, last night, the opinion of the United States Circuit Court of Appeals in the case of Raichle v. Federal Reserve Bank of New York, I ran across some very interesting passages regarding the power of the Federal Reserve banks and the Federal Reserve Board over rediscount rates and open market operations, which I believe will be quite helpful to us in connection with the debates on the Banking Act of 1935.

A memorandum on the subject is attached for your information. I shall send copies to Congressmen Steagall and Riley, along with the memorandum about the constitutionality of the open market provisions of the bill.

Respectfully,

Walter Wyatt

Walter Wyatt,
General Counsel.

Attachment.

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COURT OPINION RE DISCOUNT RATES AND OPEN MARKET POWERS.

In the case of Raichle v. Federal Reserve Bank of New York, 34 Fed. (2nd) 910, the plaintiff brought suit on August 6, 1928 to enjoin the Federal Reserve Bank of New York from (a) spreading propaganda concerning an alleged money shortage and increasing volume of collateral loans, (b) setting about to restrict the supply of credit available for investment purposes by engaging in open market transactions through the sale of its securities, (c) raising the rediscount rate for its member banks in order to reduce the volume of security loans, and (d) coercing member banks to call collateral loans by declining to rediscount eligible commercial paper for such member banks.

The United States District Court dismissed the bill for want of equity and an appeal was taken to the United States Circuit Court of Appeals for the Second Circuit, which affirmed the decision of the District Court and rendered an opinion throwing much light upon the purposes of discount rates and open market operations.

After reviewing the history of the Independent Treasury Bill of 1846, the National Bank Act, and the Federal Reserve Act and outlining the powers of the Federal Reserve banks, the Federal Reserve Board, and the Federal Advisory Council, the court, through Judge Augustus N. Hand, quoted from Mr. Glass's report to the House of Representatives on behalf of the Banking and Currency Committee the following statement of the objects of the original Federal Reserve Act:

"1. Establishment of a more nearly uniform rate of discount throughout the United States, and thereby the furnishing of a certain kind of preventive against overexpansion of credit which should be similar in all parts of the country.

"2. General economy of reserves in order that such reserves might be held ready for use in protecting the banks of any section of the country and for enabling them to go on meeting their obligations instead of suspending payments, as so often in the past.

"3. Furnishing of an elastic currency by the abolition of the existing bond-secured note issue in whole or in part, and the substitution of a freely issued and adequately protected system of bank notes which should be available to all institutions which had the proper class of paper for presentation.

"4. Management and commercial use of the funds of the Government which are now isolated in the Treasury and subtreasuries in large amounts.

"5. General supervision of the banking business and furnishing of stringent and careful oversight.

"6. Creation of market for commercial paper."

After reviewing in more detail the open market powers of the Federal Reserve banks, the court said:

"The foregoing provisions enable the Federal Reserve Banks without waiting for applications from their member banks for loans or re-discounts to adjust the general credit situation by purchasing and selling in the open market the class of securities that they are permitted to deal in. The power 'to establish from time to time, subject to review and determination by the Federal Reserve Board, rates of discount to be charged by the Federal Reserve Bank' appears in the Act with the open market powers. The two powers are correlative and enable the Federal Reserve Banks to make their rediscount rates effective. The sale of securities does not lessen the total amount of credit available but, by necessitating payment to the Federal Reserve Banks, increases available credit in their hands 'with a view of accommodating commerce and business' as provided by the Act. (U.S.C.A. Title 12, Ch. 3, Sec. 357.)"

As to the constitutionality of such a grant of power, the court said:

> "It is not contended that the provision for fixing rates of discount is unconstitutional, nor would it seem even reasonable to argue that it is after such decisions as First National Bank v. Union Trust Co., 244 U. S. 416 and Westfall v. United States, 274 U. S. 256, as well as The Legal Tender Case, 110 U. S. 421; Farmers' & Mechanics National Bank v. Deering, 91 U. S. 29, and McCulloch v. Maryland, 4 Wheat, 316.
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> "The Act being constitutional, we are asked to hold that the bank may not sell its own securities and fix the rates at which it will discount or rediscount paper when it is given the power by the specific terms of the Federal Reserve Act to do all of these things."

As to the right of the courts to review the policies respecting discount rates and open market operations adopted by the Federal Reserve System, the court said:

> "It would be an unthinkable burden upon any banking system if its open market sales and discount rates were to be subject to judicial review. Indeed, the correction of discount rates by judicial decree seems almost grotesque when we remember that conditions in the money market often change from hour to hour and the disease would ordinarily be over long before a judicial diagnosis could be made. * * * * The remedy sought would make the courts, rather than the Federal Reserve Board, the supervisors of the Federal Reserve System and would involve a cure worse than the malady. The Bank, under the supervision of the Board, must determine whether there is danger of financial stringency and whether the credit available for 'commerce and business' is sufficient or insufficient. If it proceeds in good faith through open market operations and control of discount rates to bring about a reduction of brokers' loans, it commits no legal wrong. A reduction of brokers' loans may best accommodate 'commerce and business'. (U. S. C. A. Title 12, Ch. 3, Sec. 357.)"

In discussing whether the Federal Reserve Board was an indispensable party to the litigation, the court said:

> "It is specifically empowered to regulate open market transactions, to review and determine rates of discount and to make reports as to conditions in the Federal Reserve System. In such circumstances, the Bank is, as to the matters complained of here, a governmental agency under the direction of the Federal Reserve Board. If the plaintiff prevailed in his contention the Bank would be enjoined from fixing a discount rate which the Board had presumptively directed. Such a situation under familiar principles renders the Federal Reserve Board an indispensable party to the suit. Alcohol Warehouse Corp. v. Canfield, 11 Fed. (2d) 214."