Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 6, 1938.

To Chairman Eccles

Subject:

From Mr. Smead

ERA

Referring to our "Comments with respect to section 2(c) of the Patman Bill, HR 7230" dated March 29, 1938, attached to my memorandum of March 30, after further consideration and discussion with Governor Ransom it has been decided to eliminate from the memorandum any reference to the relationship between the present surplus of the Federal Reserve banks and their deposit and note liabilities. A copy of the memorandum as rewritten is attached.

It is suggested that the memorandum dated March 29 be destroyed.

Attachment.

April 6, 1938

COMMENTS WITH RESPECT TO SECTION 2(c) OF THE PATMAN BILL, HR 7230

Section 2(c) of the Patman Bill provides that "After all necessary expenses have been paid or provided for, the net earnings of the Federal Reserve banks shall be covered into the Treasury as miscellaneous receipts". Section 7 of the Federal Reserve Act as amended requires that all net earnings of the Federal Reserve banks after the payment of dividends shall be paid into the surplus funds of the banks.

The reasons for the proposed change in the Law, it is assumed, are based on the assumption that

(1) the net earnings of the Federal Reserve banks, after the payment of dividends, are substantial, and

(2) the United States Government will have no claim on such net earnings if they are not paid to the Government currently each year.

Net earnings of Federal Reserve banks. During the period of the world war and for a few years thereafter member banks were borrowing very large amounts from the Federal Reserve banks, and as a consequence the earnings of the Federal Reserve banks were exceptionally large. At that time Federal Reserve banks paid a franchise tax. The franchise tax payments for the calendar years 1920 and 1921 amounted to over $120,000,000. For the eighteen year period from the organization of the Federal Reserve banks in 1914 to the end of 1932 total franchise tax payments amounted to $149,138,300, or only $30,000,000 more than the amounts paid for the two years 1920 and 1921.

Revised

The requirement for the payment of a franchise tax was repealed by the Banking Act of 1933. The surplus accounts of the Federal Reserve banks were built up in large part during the World War and early post World War periods when the earnings of the Reserve banks were relatively large.

The Federal Reserve Act, as amended on March 3, 1919, provided that all of the net earnings of a Federal Reserve bank remaining after the payment of dividends, including those for the calendar year 1918, should be paid into a surplus fund until it amounted to 100 percent of subscribed capital and that thereafter 10 percent of such net earnings should be paid into the surplus and the remainder paid to the United States as a franchise tax. This provision of the Law was again modified by the Banking Act of 1933, to provide that all of the net earnings of a Federal Reserve bank, after payment of the 6 percent dividend provided by law, should be paid into its surplus fund. At the same time, however, Congress required the Federal Reserve banks to use one-half of their surplus to purchase stock in the Federal Deposit Insurance Corporation, on which they receive no dividends. In other words, one-half of the surplus of the Federal Reserve banks was appropriated by Congress for the purpose of furnishing the Federal Deposit Insurance Corporation with a part of its capital funds.

The net earnings of the Federal Reserve banks available for transfer to surplus during recent years have been relatively small, amounting to $2,616,352 in 1937, to $352,524 in 1936, and to $607,422 in 1935. In some years the Federal Reserve banks, after payment of dividends, have had deficits in net earnings which were charged to surplus.

Since the Federal Reserve banks were organized in 1914 their total earnings have amounted to $1,241,000,000. Of this amount $610,000,000 has been utilized to cover costs of operation, $33,000,000 has been set aside as reserves for contingencies and the balance of $598,000,000 has been used as follows:

Payment of 6 percent dividend on capital stock, as required by Section 7 of the Act	$162,000,000
Payment of franchise tax to the United States Government	149,000,000
Contribution to the capital stock of the Federal Deposit Insurance Corp.	139,000,000
Balance in surplus accounts	148,000,000

Of the net earnings of the Federal Reserve banks since their organization, 48 percent has gone to the Treasury as franchise taxes and to the Federal Deposit Insurance Corporation as a contribution to its capital funds, 27 percent has gone to member banks in payment of the 6 percent dividend required by statute, and 25 percent remains as surplus.

Since the operations of the Federal Reserve banks must under the law be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country such banks should be in a position, if necessary in the public interest, to operate over substantial periods with income insufficient to cover expenses. Furthermore, if the Federal Reserve banks are to serve the productive enterprises of the country adequately they must at times take unusual risks. In the circumstances, it is important that the surplus of the Federal Reserve banks be increased from time to time as earnings permit.

Government's right to surplus. With respect to the second assumption mentioned above, Congress has the right at any time to legislate with respect to the surplus funds of the Federal Reserve banks. If at any time Congress should consider the surplus of the Federal Reserve banks more than adequate, in the light of their liabilities and responsibilities, it could appropriate a portion thereof for such purposes as it saw fit. As stated above, Congress did in 1933 appropriate one-half of the surplus of the Federal Reserve banks to be used as a part of the capital funds of the Federal Deposit Insurance Corporation. While the Federal Reserve banks technically own stock in the Federal Deposit Insurance Corporation, they are not permitted under the law to receive any dividends on such stock.

Under present law member banks are entitled to a 6 percent cumulative dividend on their paid-in subscription to the capital stock of the Federal Reserve banks. No further distribution to member banks of the net earnings of the Federal Reserve banks is possible under existing law. In case of liquidation of a Federal Reserve bank the Law provides that its surplus shall be paid to and become the property of the United States.

The acquisition by the Government of the capital stock of the Federal Reserve banks, as provided in Section 2(a) of the Patman Bill, would necessitate an initial expenditure of Government funds in the amount of approximately $133,000,000 for the cost of such stock, and in view of the fact that the public indebtedness of the Government presumably would be increased by a corresponding amount, the net income derived by the Government from the ownership of such stock would be limited to the difference between the interest cost to the Government of money borrowed by it and the annual dividends received from the Federal Reserve banks. The annual 6 percent dividend payable to member banks in accordance with Section 7 of the Federal Reserve Act amounts to about $8,000,000, and if the cost to the Government of borrowed money be considered to be say 2-1/2 percent per annum on the basis of long term bonds the net profit which would accrue to the Government from its investment of $133,000,000 in the capital stock of the Federal Reserve banks would be less than $5,000,000 per annum. Should Congress decide to reduce the dividend on Federal Reserve bank stock this profit would be largely eliminated.

<u>Federal Reserve notes.</u> It is frequently stated that the Federal Reserve banks obtain Federal Reserve notes from the United States Treasury for the cost of printing, and that they place large volumes of such notes in circulation and thus obtain substantial profits which should belong to the Government. It is important, therefore, to review the factors that determine the volume of Federal Reserve notes in circulation, what the Federal Reserve banks have to do to get them and the costs connected with the supplying of currency to the public.

The amount of money in circulation at a given time represents what the public collectively wants, since currency always moves out of the Federal Reserve banks when the demand for it increases and returns to them when the demand subsides. This is what is meant by an elastic currency. When currency is needed, the public obtains it from the local banks, and the latter obtain it from the Federal Reserve banks. When it is not needed, the public deposits it in the local banks, and the local banks in turn redeposit it in the Federal Reserve banks. The Federal Reserve banks may be regarded as reservoirs from which additional currency is drawn when the public requires it and to which currency not required by the public is returned. The Federal Reserve banks have no way of keeping in circulation a larger amount of currency than the public requires, or reducing the amount of currency that the public needs to finance its current operations.

The demand for currency is determined by various conditions. A certain minimum is required for day-to-day cash expenditures of individuals; a certain minimum is required for payrolls. There are times when personal expenditures rise, as during holidays, and there are times when payrolls rise, as during harvest. Certain individuals, businesses, and communities have their own periods when they need more or need less cash than ordinarily. The net effect of all of these factors is a normal and regularly repeated cycle of demand for currency year after year -- slack after the first of January, when retail trade falls off following the holidays, larger during the succeeding spring months, when payrolls increase and outdoor industries become active, slack again in mid-summer,and steadily increasing during autumn and early winter to the regular peak in December.

In addition to this regular annual cycle, the amount of currency also responds to increases and decreases in the volume of retail trade and of payrolls as the amount of business done by the country increases or decreases. There have been times also when the demand for currency was greatly increased as in the period preceding the banking holiday in 1933. In the course of a few weeks at that critical time the Federal Reserve banks furnished the public with as much as $2,000,000,000 of additional currency.

For more than twenty years the Federal Reserve banks have fully met the normal demands of the country for currency; they have also fully met peak demands both in times of prosperity and in times of depression, and they have made it possible for the volume of currency to decline automatically when the public demand for it declined.

Machinery of note issue. Before a Federal Reserve bank can obtain Federal Reserve notes it must deposit as security with the local representative of the Government, known as the Federal Reserve agent, collateral at least equal in amount to the notes to be issued. This collateral, as provided by law, may consist of the following assets only: (1) promissory notes, drafts, bills of exchange, or acceptances, usually referred to as "eligible paper"; (2) gold certificates on hand or due from the United States Treasury; and (3) until June 30, 1939, United States Government securities bought in the open market. In addition to being secured by the pledge of specific collateral, Federal Reserve notes are a first lien on all the assets of the issuing Federal Reserve bank, and a 40 percent reserve in gold certificates must be maintained against them.

As of March 16, 1938, the Federal Reserve banks had obtained $4,440,000,000 of Federal Reserve notes from the Federal Reserve agents, of which $4,125,000,000 were in circulation, constituting about two-thirds of the total of $6,330,000,000 of money in circulation, and $315,000,000 were held in the vaults of the Federal Reserve banks. The collateral held against these notes was as follows:

Gold certificates on hand and due from U.S. Treasury	$4,533,000,000
United States Government securities	10,000,000
Eligible paper	7,000,000
Total	$4,550,000,000

Gold certificates are receipts which are issued to the Federal Reserve banks by the United States Treasury for gold deposited with it by the Federal Reserve banks in compliance with the Gold Reserve Act of 1934, which required all monetary gold in the United States to be delivered to the Treasury. The Federal Reserve banks do not have the right to pay out these gold certificates. As indicated, the Federal Reserve banks have pledged $4,533,000,000 of these certificates against $4,440,000,000 of their own notes in circulation. Federal Reserve notes, therefore, at present are virtually substitutes for gold held by the United States Treasury. So long as the Federal Reserve banks pledge one dollar in gold certificates against each dollar of Federal Reserve notes in circulation they cannot obtain a profit by issuing Federal Reserve notes. Moreover, all costs connected with the printing, shipping and redemption of Federal Reserve notes are borne by the Federal Reserve banks. As will be noted from page 10 of this memorandum, it cost the Federal Reserve banks nearly $6,000,000 during 1937 to obtain currency from the Treasury and supply it to member banks and through them to the general public.

Expenses of Federal Reserve banks. The expenses of the Federal Reserve banks were incurred in rendering the services and performing the functions required by the Federal Reserve Act. As stated above, they furnish the public with an adequate, safe and elastic currency; they collect large volumes of checks and other items payable upon presentation for member banks; they provide rediscount facilities for member banks; and perform fiscal agency, custodianship, and depositary services for the Treasury and other Government agencies.

In carrying out these and other important functions the Federal Reserve banks have endeavored to be of as much service to their member banks, and through them to commerce, industry, agriculture, and the public in general, and to the United States Government, as is consistent with the efficient and economical operation of the System.

All compensation provided by the boards of directors of the Federal Reserve banks for directors, officers or employees is subject to the approval of the Board of Governors. The Board of Governors requires each Federal Reserve bank to submit periodically detailed reports of its expenses and of salaries paid each officer and employee. The reports of expenses are reviewed and summaries thereof are furnished the Federal Reserve banks in order that their costs may be compared.

Shortly after the present Board took office on February 1, 1936, it instituted a survey of the organization at each Federal Reserve bank and as a result thereof many economies were effected, among which were the placing of the chairmanships at the Federal Reserve banks on an honorary basis and the fixing of the compensation of the Chairmen on the same basis as that of any other director in lieu of annual salaries of from $20,000 to $50,000, as had been the previous practice. Wherever it is found that certain operations can be handled more economically without sacrificing efficiency prompt steps are taken to effect the economies.

There has been a gradual reduction in the unit costs reported for the principal operating units of the Federal Reserve banks. For example, in the Country Checks-Outgoing unit, which is the largest single operating unit in the Federal Reserve banks, the average cost of handling a thousand items was $3.65 ten years ago as compared with $2.59 in 1936 and $2.64 in 1937. With a few exceptions, the unit cost in the Country Checks-Outgoing unit for each of the past ten years has been lower than that reported in the immediately preceding year as may be noted from the following tabulation:

Cost per thousand items in the Country Checks-Outgoing unit

1928	$3.65	1933	$3.47
1929	3.35	1934	3.05
1930	3.35	1935	2.88
1931	3.23	1936	2.59
1932	3.30	1937	2.64

The reductions in operating costs reported for the Country Checks-Outgoing unit are due principally to improved methods of procedure.

The costs of performing the various services rendered by the Federal Reserve banks during 1937 are set forth below in summary form.

EXPENSES OF FEDERAL RESERVE SYSTEM, YEAR 1937

Currency and Coin

The cost of receiving and handling 2,257,889,000 pieces of currency and 2,730,387,000 pieces of coin, including shipping charges to and from member banks was	$4,149,671	
Assessments by the Treasury Dept. to cover the cost of printing new Federal Reserve currency, the cost of issuing such currency at the Reserve banks, and the cost of redeeming Federal Reserve currency unfit for circulation, including shipping charges, amounted to	$1,787,036	
Total		$5,936,707

Check Clearing and Collection

Handling and collecting 926,792,000 checks and 6,705,413 maturing notes, drafts, coupons, etc. cost $3,802,889

Loans, Rediscounts and Investments and Safekeeping

Making discounts and advances to member banks; handling applications for advances to industry for working capital under Section 13b of the Federal Reserve Act; maintaining credit information, holding in safekeeping and servicing about $4,000,000,000 of securities for member banks and purchasing and selling Government securities for member banks cost $1,366,258

Fiscal Agency, Custodianship, and Depositary

Receiving, proving, and paying 127,823,053 Government checks and coupons, including work relief checks, and maintaining the general account of the Treasury of the United States, etc. cost $1,125,402

Fiscal Agency work for the U. S. Treasury Dept. comprising principally the issue, redemption, and exchange of 3,892,004

pieces of securities cost	$1,380,352	
Total	$2,505,754	
Reimbursed by Treasury Dept.	$1,634,363	
Net cost		$871,391

Services performed for various Government agencies such as the Reconstruction Finance Corporation, Federal Farm Mortgage Corporation, Federal Land Banks, Federal Intermediate Credit Banks, Federal Emergency Administration of Public Works, and the Federal Home Loan Banks and Home Owners' Loan Corporation cost	$2,231,142	
Reimbursed by Government Agencies ...	2,204,426	
Net cost		$26,716

Accounting

This function, which includes the maintenance of the general books, member and Federal Reserve bank accounts, etc., and the making of transfers of funds for the account of member banks, cost	$1,579,520

Banking House and Furniture and Equipment

Cost of operation of banking houses, including payment of taxes, the salaries

of janitors, elevator operators, etc., less deductions for income received from rented space, etc.	$2,612,685	
Reserves set aside for depreciation on banking houses	1,297,859	
Furniture and equipment, net cost	233,290	
Total		$4,143,834

Bank examination

Cost of examining state member banks and of analyzing condition and examination reports of National and State member banks, etc.. amounted to	$1,101,800

Expenses of the Board of Governors

Assessments for expenses of the Board of Governors of the Federal Reserve System..	$1,748,379

Statistical and Analytical

Preparing and publishing monthly reviews of credit, business and agricultural conditions; and obtaining and assembling various statistical data, etc. cost	$480,028

Bank Relations

Bank relations work; visiting member and nonmember banks, conferences, etc. cost ...	$195,004

Personnel and Service

Maintenance of filing, mailing and personnel departments; vaults and telephone service; purchasing supplies and equipment; equipment repairs; page service, etc., cost $2,294,234

Protection

Salaries of special officers and watchmen, and the cost of other protective services amounted to $964,932

Postage and Insurance

Postage on ordinary mail; insurance on equipment and supplies; premiums on employees' fidelity bonds, bankers blanket bonds, etc., cost $1,324,298

Auditing

Maintaining general audits of the Federal Reserve banks and branches cost $552,623

Legal

The employment of counsel and other legal expenses cost $190,086

General Overhead

General overhead and supervisory expenses, including directors' fees and other miscellaneous expenses, amounted to $1,685,101

Total Net Expenses $28,263,800

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

April 9, 1938.

COMMENT ON H.R.7230
Introduced by Mr. Patman

The fundamental purpose of H.R. 7230 is to establish a mechanism that would control the volume of money with a view to maintaining a fixed price level.

The mandate

In an amendment the Board of Governors is instructed to raise the all-commodity index until full employment of all persons able and willing to work shall have been achieved, and until the price level shall at least reach the all-commodity index of 100, as established by the Department of Labor, for the year 1926. The Board is further directed to maintain this price level with variations not to exceed 2 per cent. To accomplish this the Board is directed to expand and contract demand deposits by engaging in open-market operations.

The position of the Board of Governors on the problem of monetary objectives was indicated in a statement issued on August 2, 1937, in response to a Congressional inquiry. The Board is in full agreement with the ultimate objective of proposals to promote economic stability, which means the maintenance of a volume of business activity and of national income adequate to assure as full employment of labor and of the productive capacity of the country as can be continuously sustained. The Board is aware that commodity prices are an important element in the Nation's economic life and that violent fluctuations of prices have disastrous effects. It believes, however, that price stability does not necessarily lead to economic stability and, therefore, should not be the principal objective of public policy. In its opinion the objective of economic stability cannot be achieved by monetary means alone, but rather should be sought through coordination of monetary and other major policies of the Government which influence business activity.

The principal difficulty with a stable price level as the objective of economic policy is that it is not in itself a satisfactory indicator of a continuously smooth working of the economic machine. There have been periods in the past when the price level was stable and nevertheless there were developing numerous maladjustments which led to an economic collapse. For example, from the latter part of 1927 to the latter part of 1929 the index of wholesale prices showed little change, but other developments were threatening economic stability. Prices and activity on the stock market were rising rapidly, and brokers' loans grew at an unprecedented rate. Construction of office and apartment buildings was being promoted with a view to quick profits at a rate that endangered the longer-time outlook in the building industry. Loans were being made for enterprises abroad without careful investigation of credit risks, and business activity in general was increasing, partly as a result of speculative developments, to a level that could not be sustained. The use of the commodity price level as a guide to credit policy in these circumstances would have been entirely unsatisfactory.

There is no assurance that it would be satisfactory in the future.

The proposal is that the Board of Governors bring the commodity price index up to at least the 1926 level. The average for that year is about 25 per cent above the present level and an advance of that magnitude, except over an extended period, would cause speculative buying and would lead to boom conditions which would culminate in a break and a depression. Furthermore, in periods of rapid advance disparities between prices of different groups of commodities generally become more pronounced and yet, both from the point of view of justice and of economic stability, the most important thing in regard to prices is the maintenance of proper relationships between prices of different commodities that are exchanged for each other. Activity of producers depends on the relationship between their costs, including principally prices of materials, labor, taxes, and debt service, and the prices at which they can sell their products. In the last quarter of 1936 and in the first quarter of 1937, for example, building costs and prices of new houses rose so rapidly and so far as to discourage buying, and this resulted in a decline in residential building. Moreover, the rise in prices of industrial raw materials at that time was much sharper than the advance in finished goods, and this was a factor in causing speculative purchases, forward orders, and building up of inventories, all of which contributed to the subsequent collapse of business.

Present prices of individual commodities in the Bureau of Labor statistics index, compared with 1926, range from a decline of 75 per cent to an increase of 100 per cent. A restoration of the 1926 level could be achieved through an advance of all commodities, including those that are too high, as well as those that are too low, or through a rise in one or the other group of these commodities. There is nothing in monetary policy that could determine which of the commodities would rise, and yet this would be all-important from the point of view of the effects that the rise in prices would have on the economy.

In the Board's view the essential objective of monetary policy is to contribute to the maintenance of a flow of money and income through the channels of trade, industry, and agriculture that would tend to utilize to the full the country's human and material resources. This is the Board's understanding of the broad mandate stated in the Federal Reserve Act as "accommodating commerce and business". To this end and to the maintenance of sound banking conditions the Board devotes its efforts, and there is nothing in the proposed mandate that would add to the Board's desire or ability to achieve these objectives.

In directing the Board to achieve price stability and full employment through open-market operations, the proposed mandate disregards the limitations on the effectiveness of this instrument of credit policy. It assumes that open-market operations can always create or destroy deposits, and that changes in the volume of deposits in turn are immediately reflected in the price level. The fact is that open-market operations do not always create deposits, since purchases of securities from the banks do not increase deposits. Whether open-market purchases result directly in an increase in deposits or not, they do result in the creation of a corresponding amount of reserves. These reserves may or may not result in the creation of deposits, depending on whether conditions are favorable for the expansion of loans and investments by banks. The great bulk of deposits in the banks of the United States are created through such an expansion. A given volume of reserves created by Board action, therefore, might result in no increase in deposits at all, or on the other hand might result in a growth of deposits several times as large as the reserves. Which of these developments would actually occur would depend on forces that are largely, if not wholly, outside the control of the Board of Governors.

It is not true, furthermore, that the creation of deposits necessarily results in an equivalent rise in prices. We have had increases in deposits without corresponding increases in prices. The volume of deposits at the present time is greatly in excess of the amount that existed in 1929 and yet the price level is much lower. Nor is it clear that a rise in prices necessarily results in an increase in employment. An unbalanced advance in prices may, on the contrary, be an influence in decreasing employment, as was the case early in 1937.

Aside from many factors that are not under the control of the Government, there are numerous phases of Government activity other than monetary action by the Federal Reserve System that have effects on prices and on economic activity. Among such factors are the actions of the United States Treasury in relation to the inactive gold account and the stabilization account; policies in regard to taxation, exchange rates, the volume and character of Government spending; its action in regard to the capital market, to railroads and utilities; the Government's housing program, its agricultural policies, and its policies in regard to labor. All of these Government activities have a distinct bearing on the volume of business activity and on the price level. They are beyond the influence of the Federal Reserve System, and yet without them and their coordination with monetary policy the System would be powerless to achieve either an advance in prices or the restoration of full employment, as would be required under the proposed mandate.

The Board of Governors, therefore, does not favor the adoption of the proposed mandate.

Federal Reserve System operates in the public interest

In addition to prescribing a mandate for the Federal Reserve policy, the bill proposes a reorganization of the Federal Reserve System. The reasons offered for this reorganization are that the System has not been operated in the public interest; that it has been dominated by bankers; that it has been conducted in the selfish interests of a small group, and that it has made large profits at the expense of the community. The Board of Governors does not believe that any of these assertions can be sustained by the record.

Ownership of stock by member banks does not enable the bankers to control the Federal Reserve System. It is more nearly in the nature of a compulsory capital contribution than stock ownership. Although the member banks elect two-thirds of the directors of the Reserve banks, the large banks elect only two out of nine directors. The small banks elect two, the medium-sized banks elect two and the Board of Governors in Washington appoints three. Only a third of the directors can be bankers and all directors and officers are subject to removal by the Board of Governors. The Board in Washington appoints the chairman and deputy chairman of each Reserve bank, and the appointment of all presidents and first vice presidents, as well as the salaries of all officers and employees, are subject to its approval.

Complete authority over all matters of major national policy, such as the determination of discount rates, reserve requirements, margin requirements on security loans, and maximum rates of interest to be paid on time deposits, is vested in the Board of Governors. Authority over open market operations is vested in an open market committee consisting of seven members of the Board of Governors and five members elected by the Reserve banks.

It is clear, therefore, that in matters with which the bill is primarily concerned the System is dominated not by banks, but by the Board of Governors, a Governmental body whose members are appointed by the President and confirmed by the Senate.

Federal Reserve banks not operated for profit

During the twenty-three years of its existence the Federal Reserve System has earned approximately one and a quarter billions of dollars, of which about one-half has been used for operating expenses incurred largely in performing public services, such as the clearing and collection of checks, the supplying of currency to the banks and to the public, the performance of many duties for the United States Government, and in furnishing rediscount facilities for the member banks.

Earnings of the Federal Reserve banks above these expenses and reserves for contingencies amounted to $600,000,000. Of this amount approximately $150,000,000 has been paid to the Government as franchise tax, about $140,000,000 has been appropriated by Congress for the Federal Deposit Insurance Corporation as capital, $160,000,000 has been paid as the statutory dividends to member banks, and the remainder is held in a surplus account which in case of liquidation becomes the property of the Government.

Member banks contribute 3 per cent of their capital and surplus to the capital of the Reserve banks and receive 6 per cent annually on this contribution. In addition, member banks are required to keep balances with the Reserve banks amounting on the average to 16 per cent of the member banks' deposits and receive no return on these balances. For example, a member bank having a capital and surplus of $100,000 and deposits of $1,000,000 contributes $3,000 to the Reserve bank's capital and, on the average, would be required to hold $160,000 on deposit with the Reserve bank as legal reserves, on which it receives no interest. The dividends such a bank would receive on its stock in the Reserve bank would be $180 a year.

The System was established and is operated in the public interest and dominated by public officials; it performs a service that saves the people of the country far more than the cost of the System; and it makes no profits for any private interest other than the amount paid annually to stockholders at a fixed rate, which has been prescribed and can be changed by Congress.

Proposals would not improve banking system

Proposals in the bill for reorganizing the Reserve System would transfer ownership of the stock in the Federal Reserve banks to the Government and would have all the directors of the Reserve banks appointed by the President and approved by the Senate. It would enlarge the membership of the Board of Governors to fifteen, including three ex-officio members -- the Secretary of the Treasury, the Comptroller of the Currency, and the Chairman of the Federal Deposit Insurance Corporation.

A Board of Governors of fifteen members proposed in the bill would be too unwieldy to function promptly and effectively. The proposal in the bill to offer all the privileges of membership to nonmember banks so long as they choose to keep their reserves in a Federal Reserve bank would remove all incentive to become members of the System. It would enable all banks to profit by the services of the System so long as it suited them, without contributing anything to its strength or complying with its regulations, and to withdraw their reserves when to maintain them would seem to be burdensome. It would make futile the proposed enlargement of the power to increase reserve requirements. It would remove all incentive to membership and would make it impossible for the System to discharge its responsibility for maintaining sound credit conditions.

Distinction between monetary and fiscal authorities should be maintained

The primary function of the Treasury is to collect taxes, borrow money, and provide funds for the various agencies of the Government in accordance with Congressional appropriations. The primary function of the Federal Reserve System is to influence the flow of money and to contribute to the soundness of the banking situation. In a broad sense the objectives of both agencies are the same, namely, to serve the public interest, but their points of view and experience, and their approach to current problems may at times be different. The maintenance of an organization for the regulation of credit separate from the fiscal arm of the Government has been found advantageous in most countries of the world, and its abandonment, which is proposed in the bill, would, in this Board's opinion, be a backward step.

Local autonomy in local matters should be preserved

Since its establishment in 1914, the Federal Reserve System has undergone many changes in the direction of increased control by the Board of Governors. With the passage of the Banking Act of 1935 this control has been greatly strengthened in so far as national policies are concerned. In regard to local matters, the maintenance of local autonomy under general supervision and close Government regulation is advantageous in a country like the United States, consisting of various regions with diverse economic interests. The maintenance of locally elected directors on Federal Reserve bank boards is of great advantage in creating local pride and local interest in the System and in inspiring the business community with confidence in its management. This advantage would be lost if the appointments of all local directors were handled entirely from Washington. Consequently, the System's ability to render a disinterested public service to all classes of the community would be greatly diminished.

To sum up, the Board is convinced that improvement in our banking system is needed but sees nothing in this bill that would tend in this direction. The Board is convinced that the main objective of the bill is not practicable; that the evils which the reorganization features of the bill propose to correct do not exist; that the organization which it proposes to establish would result in less satisfactory service to the country; and that enactment of the bill would be a backward and not a forward step in the development of the banking system in the public interest.