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THE FEDERAL RESERVE SYSTEM

WHAT IT CANNOT DO

The Federal Reserve System has proved itself to be admirably adapted to our needs. It was fashioned after full consideration of the experience of other countries, by men with a keen realization of the peculiar needs arising out of our own territorial and temperamental make-up. No system, no device, can, of itself, accomplish anything. To attain results, the instrument must be properly worked and the Federal Reserve System has fortunately been so managed as to give to this country what its originators planned it to produce. So well indeed has it worked, that there is a tendency to ascribe to the tool, merit that rightly belongs to the workman and we find the term Federal Reserve coupled with plans for currency rehabilitation and bank reforms in other countries, where conditions, often, are so different that our requirements afford no analogy whatever to their needs. It is easier to repeat a catchword than to analyze a situation, and Federal Reserve has seemed to many a rod with which to conjure.

The Federal Reserve System was devised to meet certain definite wants and it has met them. There is, however, a tendency to ascribe to the System powers and capacities it does not possess and to place upon it, duties which it cannot in the nature of the case, perform while the mere attempt to place these duties upon the System may seriously damage its usefulness within its proper sphere.

The Federal Reserve System was founded to give to this country -

1. A sound and yet elastic currency freely convertible into gold and capable of expanding to meet the seasonal and the extraordinary needs of production, trade and transportation without, at the same time, forcing disastrous contraction in other directions.

2. To consolidate our gold reserves so as to permit their effective use for the purposes for which gold reserves are carried by banks, and

3. To assure, so far as possible, the soundness of the System's member banks.

The System thus necessarily exercises a certain degree of control over the cost and volume of credit, from which it has been hastily inferred that the Federal Reserve Board exercises or can exercise control over commodity prices.

This assumption is not without the support of eminent theoretical writers and is backed by a vast volume of newspaper patter, emphasizing these conclusions in more or less mangled form. Walter Bagehot, writing of the

London money market more than 50 years ago, explained the workings of the Bank of England and the effect of changes in the Bank Rate on the price of money and more remotely their effect on commodity prices. His book is a beautiful piece of exposition and undoubtedly applied to the London market of its time, although I have heard doubts, even as to this, expressed by a competent British authority. But, whatever may have been true of London - then -, it is quite clear that his exposition does not apply to our conditions - now.

But the mere assumption that it may so apply, carries consequence of vital importance. The trend of commodity prices determines the success or failure of the individual's business. Whether the individual manufacturer, trader or farmer is to make a profit or a loss, depends largely on the trend of commodity prices and any Board or Commission believed to possess power over commodity prices will as a matter of course be subjected to pressure, individual, social and political, with a view to influencing such prices. A manifestation of this appeared in the loud complaint that the Federal Reserve Board caused the sharp fall in commodity prices in 1921 and again in the persistent demand that a "dirt farmer" be made a member of the Federal Reserve Board; when agricultural prices improved, no more was heard of this.

The danger that this misconception as to the scope of the Federal Reserve Board's power involves, is that it is an incitement to bring political pressure to bear on the Board to influence its action and on the Executive, from time to time, to make political appointments to the Board. Thus the very foundation, the bed-rock, of our banking system runs the risk of being brought into politics.

This is a real danger and it flows, curiously and innocently enough, out of a mere economic misconception.

There is now pending in Congress an amendment to the Federal Reserve Act declaring it to be the primary function of the Federal Reserve System to stabilize the general price level by stabilizing the purchasing power of the dollar, so far as may be possible, consistent with sound economic principles, and directing the Federal Reserve Board to make a detailed and exhaustive study of all available plans, methods, devices and means known to economic science to bring about the complete stabilization of the dollar in its purchasing power and to report to Congress recommending any legislation in its judgment necessary and proper to permit the Federal Reserve Board to bring about such stabilization.

This, on its face, seems harmless enough, but it involves the assumption that the Federal Reserve Board can in some way, acquire the power to control commodity prices and so re-enforces the mischievous impression that legislative or executive action on the banks and currency can legitimately and safely influence prices.

Whether the so-called stabilization of commodity prices is desirable, if feasible, is perhaps an open question: whether it is possible, even if desirable, is certainly an open question, but there can be no doubt that nothing should be said or done to give or to confirm any impression that the Federal Reserve Board has power of life or death over commodity prices.