BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

OFFICE OF THE CHAIRMAN

November 12, 1936.

MEMORANDUM:

TO - THE PRESIDENT

FROM - CHAIRMAN ECCLES

The heart of the problem of stabilizing and perpetuating the recovery movement achieved by the Administration lies in centralized control over money and credit. It is impossible to have a well managed currency upon which the success of stability depends in a capitalistic economy without such central management of the supply of bank credit and currency and an adequate flow and velocity of funds. Money is the most important mechanism of our system. Failure to establish adequate control over that mechanism would be to invite another and perhaps fatal disaster. The banking system must be so organized and supervized as to encourage a maximum utilization of the productive facilities and man power of the nation. As the creator and extinguisher of money, the banking system not only is a vital mechanism, but it cannot work successfully in the future any more than it has in the past if it is to be left to its own devices. It will not operate automatically. The Board of Governors of the Federal Reserve System, as appointed under this Administration, has in cooperation with the Treasury a large share of the responsibility without the adequate mechanism for such management. The fundamental weakness is to be found in the existing banking structure of the country.

One of the greatest accomplishments of the Administration was the rehabilitation of banking and the concentration in Washington, instead of in New York, of such controls as exist over money and credit. There was no opportunity, however, in the period of emergency for a more fundamental reconstruction which is imperative for

the future of sound banking. The opportunity now exists for the Administration to supplement its distinguished work by such a broad revision based upon experience both here and in other countries and upon the pressing needs of the hour arising from drastically changed economic conditions. I assume that the Administration desires to take full advantage of this opportunity which may never again be so propitious.

There is every reason to believe that the changes needed to effect a sounder, safer and more efficient banking system adapted to proper currency management in the interest of greater economic stability can be enacted without serious opposition except from the now politically discredited forces which object to all Federal supervision in the national interest--for example, the unit bankers, exemplified by Orval Adams.

There is no field in which this Administration could make a more constructive contribution than in banking reform, and broadly, changes which need to be instituted at this time would undoubtedly stand as a landmark no less notable than the enactment of the Federal Reserve System under Woodrow Wilson's leadership.

A mere glance at the existing banking structure will suffice to show clearly why there should be fundamental revision. We have in this country forty-eight separate banking systems--forty-eight state authorities to charter banks which create money, conduct examinations and prescribe regulations. The complexity of these systems is infinite and many of them are notoriously lax. It is still possible for persons who have no competence in banking to open so-called banks, which, in the words of Senator Glass, are in reality nothing more than pawn shops. It was in these state chartered non-member banks that the greatest holocaust of bank failures occurred in the late 20's and through the depression. It was those mushroom miscalled banks which caused the greatest losses and misery among their depositors and brought a large share of discredit down upon the heads of bankers generally. Through their various associations groups of these so-called independent bankers have been the most implacable foes of this Administration.

Superimposed upon this hodgepodge of state banks is the national banking system and upon that, the Federal Reserve System which is charged with a grave responsibility for exercising its influence toward the objective of greater economic stability and the avoidance of unsound banking principles which contribute to the twin evils of inflation on the upswing and deflation on the downswing. This System cannot function efficiently or effectively in the national interest so long as half of the banks are in it and the other half out. Currency management which is inevitable in a world off the gold standard becomes almost a mockery under such a divided banking system, one-half of which is free to let nature take its course, to combat and to negative management in the national interest.

The existence of such a dual situation has produced what has long been known as a competition in laxity. Obviously it is difficult to effect proper management methods in member banks when non-member banks, free from competent supervision, are free to do about as they please. Under such circumstances regulations imposed upon member banks may often penalize those banks in competition with non-members and even drive member banks out of the System so that they may be freer of restraints.

But, beyond this the existing structure from the standpoint of the Federal Government is neither sound nor workable. At present the various Federal laws require (1) that the Comptroller of the Currency shall examine all national banks. Incidentally, the office of the Comptroller of the Currency has become obsolete except for this examining authority as well as the authority to charter new national banks. It has become obsolete because there is no longer any national bank currency such as the office of the Comptroller of the Currency was created to supervize. Moreover, another important function of the Comptroller's office, that of liquidating banks which are forced to close hereafter, is now performed by the Federal Deposit Insurance Corporation. (2) The Federal Reserve System is required to examine state member banks, and is dependent upon the Comptroller's office for the examination of all other member banks. (3) The F.D.I.C. is authorized to examine insured non-member banks and depends upon the Comptroller and the Federal Reserve System for the

examination of other insured banks. In addition, of course, there are state laws for examination of institutions within their state jurisdictions.

Manifestly, such a confusion of authorities is well designed to make for inefficiency, conflict, harassment of the banks themselves, and above all, a division of authority which is the very negation of necessary and proper management of banking in the national interest today.

At present the Comptroller has plenary power to charter a national bank. The Federal Reserve System has no choice but to accept that bank as a member, although it has no voice either in ascertaining whether that bank is necessary, whether it is properly managed, or whether it complies with what should be sound fundamentals of banking practice.

Similarly, the Federal Deposit Insurance Corporation has the right to insure banks which may then apply for membership in the Federal Reserve System. Again the System has no choice in whether such bank is a proper institution, and to refuse it membership is tantamount to repudiating it as a proper subject to be insured by the Government.

Moreover, all three Federal divisions of authority prescribe regulations and despite every effort to achieve reasonable cooperation and uniformity, conflicting impulses and purposes continually make for confusion and ineffective administration. In general, the same situation applies with respect to call reports, which all three authorities issue. By their very nature, the examining and regulatory powers of the Comptroller's office and the F. D. I. C. influence national credit policies, and it is clear from the record that the Comptroller's office has repeatedly pursued a policy of restraint when it should relax and vice versa, directly contrary to correct central bank policy.

These are but the highlights of a situation which has not unjustly been criticized as a crazy quilt that makes for inefficiency, waste and above all, bad banking. It is

an outgrowth of many years of piecemeal legislation. More than ever today, however, it is imperative to make the most of the unprecedented opportunity now presented to correct fundamental weaknesses. It is especially urgent not merely because the Government has insured bank deposits and is more than ever concerned to establish sound banking, but because there can be no effective monetary and credit policies administered in the interest of the whole nation unless the existing mechanism is first put in adequate working order.

The drafting of legislation is something that must be carefully worked out in cooperation with the Federal Deposit Insurance Corporation, whose chairman is thoroughly sympathetic with the general objectives herein set forth, and with the Treasury Department which is vitally interested, particularly in view of its own great responsibilities for currency management today. Cooperation to this end with the office of the Comptroller is, however, out of the question.

The immediate question is whether the Administration is disposed to lend encouragement and support to such a program of fundamental banking revision. If the answer is in the affirmative, then the first steps would be to collaborate with the indicated authorities in drafting a tentative measure for approval. Such a measure would broadly contemplate a consolidation and reallocation of examining, administrative and regulatory functions under one roof, specifically, under the Federal Reserve System, which is the core of the Government's medium of banking supervision and monetary management. The System's facilities are comprehensive and more than adequate; its twelve Federal reserve banks with twenty-seven branches are strategically located; the System has a highly trained and competent personnel; its supervisory body, the Board of Governors, consists of seven members whose work at the present time is not adequate for six members or their capacities, to say nothing of their inevitable dissatisfaction in attempting to administer broad powers when their jurisdiction over the banking field is so badly circumscribed and hampered by competing agencies. The Board is soon to be established in its own large, new building which is capable of housing all of the indicated activities if combined; and all of this consolidation can be accomplished with-

out cost to the Federal Government and indeed with a material saving in present expenses of the Government.

I am taking the liberty of presenting this broad problem at this time because it would be useless to go forward with a program in cooperation with the Treasury and the Federal Deposit Insurance Corporation unless the Administration feels that course to be desirable. If the revisions suggested constituted a reform such as would be disturbing to the country, or designed to create serious political difficulties, or would tend to interrupt the recovery program, I would not venture to urge it at this time. However, I believe that the program outlined would be welcomed enthusiastically by the most competent banking and business opinion throughout the nation as a contribution toward consolidating and perpetuating the recovery movement. And if carried through as I believe it can be, I am convinced that such a program will go down in history as among the outstanding achievements of this Administration.

One of the greatest causes of economic disturbance in the world today is the large-scale movement of funds among leading countries. During the past two years upwards of three billion dollars of gold, as well as other funds, have poured into this country. Stated broadly, foreigners have sent us their gold, have obtained our dollars, have used those dollars to buy our securities, have thereby greatly boomed the stock market and have accumulated a large share of the profits of our recovery. They can take these funds out of our market at any time, causing a serious disturbance, and incidentally reaping a large profit for themselves. In the meantime we have been put to the expense of storing the gold which is of no productive value to us and these foreign speculators stand to get a large cut of the profits arising from the Government's recovery expenditures.

Attempts of the Reserve System and Treasury to stabilize the dollar to offset these capital movements and prevent them from causing inflationary and speculative distortions are more or less frustrated while this condition exists. The operations of the stabilization fund, the Reserve System's raising of margin and reserve requirements and the use of other instruments of control are inadequate to cope with this major cause of disturbance. It is wholly illogical to permit these foreign speculators in effect to raid our markets, to offset the economic balance which we are trying to achieve and to reap these rewards without paying their fair share. From the standpoint of monetary management it is apparent that some curb must be imposed upon these vast and violent movements of funds. They dislocate not only our domestic economy but the repercussions are equally violent upon world conditions. There appears to be no other way to reach this situation than through power of taxation. While I am not prepared at this moment to state exactly how that power can best be exercised, the subject is one that needs thorough exploration in order to get at the root of this seriously disturbing economic factor instead of trying to deal with it through mere offsetting monetary operations.

Foreign capital has continued to move into our markets notwithstanding the stabilization agreement, and the present high level of the stock market reflects these funds and does not reflect any increase in the amount of bank or broker loans for security purchases. Should these funds move out, the stock market would sustain a correspondingly large deflation. It appears to be but ordinary prudence to institute a thorough study of this problem between the Treasury and the Federal Reserve System with a view at least to imposing a tax that will tend to discourage a continued vast inflow on the one hand and will exact from funds now in the market a fair share of the profits already derived before such funds are withdrawn to other capitals.