

Office Correspondence

BOARD

Date February 13, 1935.

To Governor Eccles

Subject: Arguments for changing the open market provisions of the Banking Act of 1935.

From Walter Wyatt, General Counsel.

READY TO FILE SECTION
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In accordance with your request, I am handing you herewith a memorandum containing arguments against the open market provisions of the Banking Act of 1935 and in favor of vesting the final and complete authority over this subject in the Federal Reserve Board. I dictated a rough draft of this and revised it after obtaining suggestions from Messrs. Morrill and Goldenweiser.

At first, I considered urging in the alternative that the bill should be amended either (a) by authorizing the Federal Reserve Board to initiate, adopt and enforce open market policies after conferring with an advisory committee of five Federal Reserve bank Governors, or (b) by restoring this section of the bill to the form in which it was drafted prior to February 4, 1935. On further reflection, I believe it would be better to advocate the first proposal and to compromise on the second one if the first one is not accepted. Therefore, the memorandum mentions only the first proposal.

In addition to the memorandum containing the arguments, I am handing you herewith (1) a proposed draft of a substitute for section 205 of the bill, which would authorize the Federal Reserve Board to initiate, adopt and enforce open market policies after conferring with an advisory committee of five Federal Reserve bank Governors, and (2) a print showing how the provisions of section 205 of the bill were changed on February 4, 1935, just before the bill was sent to Congress.

Respectfully,

Walter Wyatt,
General Counsel.

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ARGUMENT FOR CHANGING THE OPEN MARKET PROVISIONS
OF THE BANKING ACT OF 1935.

Section 205 of the Banking bill (H. R. 5357 and S. 1715, pages 44 and 45), which vests the final determination of the open market policies of the Federal Reserve System in a Committee consisting of three members of the Federal Reserve Board and two Governors of Federal Reserve banks is impractical, dangerous and inconsistent with the principal purposes of Title II of the bill.

It would create grave danger of serious conflicts between two different bodies having jurisdiction over different phases of the same subject -- the proposed Committee, on the one hand, which would include only a minority of the members of the Federal Reserve Board and which would have authority only over open market policies, and the Federal Reserve Board, on the other hand, which has the final determination of the discount rate policies of the Federal Reserve System, the power to increase or reduce the reserve requirements of member banks, and numerous other powers to influence strongly the credit policies of the Federal Reserve System as a whole.

Under the bill as introduced, it is possible that the two Federal Reserve bank Governors would join with one of the Board members on the Committee in adopting and putting into effect an open market policy to which the other seven members of the Federal Reserve Board, including the Governor of the Board and the Secretary of the Treasury, might be vigorously opposed. Even if the Open Market Committee should

be unanimous in its decision, there is a danger that the five members of the Board not on the Committee would favor a different policy and, by a majority vote on the Board, would exercise the Board's powers in such a way as to obstruct and possibly nullify the policy decided upon by the Open Market Committee. 10

Thus, the Open Market Committee might decide to ease credit conditions by purchasing a billion dollars of Government bonds in the open market, whereas the five members of the Board not on the Committee might vote to tighten money conditions by increasing the reserve requirements of member banks.

That such a situation is not unlikely to arise is manifest from the fact that, from February until August, 1929, the Board was divided, five to three, on the question whether or not it should rely upon direct action in curtailing the use of Federal Reserve bank credit to finance brokers' loans or whether it should approve the increase in discount rate repeatedly recommended by the Board of Directors of the Federal Reserve Bank of New York.

During the period just mentioned, the Federal Reserve Board was able to act by majority vote and its decision was final; but a similar conflict between the majority of the members of the Board and the three minority members on the proposed new Open Market Committee would result in two different bodies, with the power to make final decisions on different phases of the same problem, working at cross purposes in the same field.

Such a conflict would be fraught with the most dangerous consequences for the entire country; and a form of organization which would create the danger of such conflicts should not be adopted.

An important reason for amending the present law is to do away with possible conflicts of authority between the Open Market Committee, which initiates policies, the Federal Reserve Board, which approves them, and the Federal Reserve banks, whose consent is necessary to carry them out. The criticism of the existing arrangement is cogent and it applies with almost equal force to the proposed arrangement under which the Open Market Committee would be responsible for open market policies while the Board would have responsibility for discount rates, bill rates, changes in member bank reserve requirements and for general credit conditions and developments.

Moreover section 205 is inconsistent with other provisions of Title II of the bill, which are designed to centralize responsibility for monetary policy in one National body appointed for that purpose and to make membership on that body more attractive to persons well qualified to participate in the formulation of National economic and monetary policies. To transfer the final determination of the open market policies of the Federal Reserve System from the Federal Reserve Board to the proposed Open Market Committee would result in a diffusion, instead of a centralization, of authority and responsibility and would make positions on the Board much less attractive to persons of outstanding character and ability.

SUGGESTED SUBSTITUTE

In order to avoid the dangers pointed out above and in order to harmonize this section of the bill with the remainder of Title II, it is suggested that there be substituted a provision clearly vesting in the Federal Reserve Board full power and responsibility to initiate, adopt and enforce open market policies for the Federal Reserve System, after consulting with an advisory committee consisting of five Federal Reserve bank Governors. A suggested amendment for this purpose is attached hereto.

ADVANTAGES OF PROPOSED SUBSTITUTE

Such a provision would eliminate all danger of conflicts of jurisdiction and policy of the kind described above because the final decision as to all matters affecting the national policies of the Federal Reserve System would be vested in the same body. The participation of Federal Reserve bank governors in the deliberations leading to the adoption of open market policies would be preserved; but the responsibility for making a final decision and the power to adopt and carry out national policies of vast importance would be centered in one place and in one body, as they should be.

Moreover, the Federal Reserve Board, through the exercise of, or the mere threat to exercise, its power to remove officers and directors of Federal reserve banks from office under section 11(f) of the Federal Reserve Act, could enforce compliance by every Federal Reserve bank with its open market policy; whereas, the proposed Open Market Committee would have no such power.

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The Federal Reserve Board, consisting of the Secretary of the Treasury, the Comptroller of the Currency, and six other persons appointed by the President and confirmed by the Senate, has a National viewpoint and has long been accustomed to considering matters as they affect the country as a whole and without regard to the special interests of any particular locality or group. It was created for the purpose of supervising and coordinating the activities of the twelve Federal Reserve banks "in order that they may pursue a banking policy which shall be uniform and harmonious for the country as a whole". (Report of the Banking and Currency Committee of the House of Representatives on the original Federal Reserve Act, Report No. 69, 63d Congress, 1st Session, page 16). The Federal Reserve Board has been exercising this function for more than twenty years and is believed to be better equipped to continue to do so than would be the proposed new Federal Open Market Committee, which would include the Governors of two Federal Reserve banks, who presumably would be primarily concerned with the problems of their own Districts and their own banks and might not be likely to consider the open market policy solely in the light of its effect on the country as a whole, as distinguished from the special problems of their own banks.

Regardless of whether or not its policies have always been the wisest and best, the Federal Reserve Board has never been influenced by a desire to do anything except what it believed to be best for the country as a whole. Its actions have never been influenced by political considerations nor by any desire to favor any particular section or interest. That the proposed Open Market Committee would be equally free of such influences is not at all certain.

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There is a danger that the proposed committee would be influenced by sectional interests or at least sectional viewpoints and might not act with due regard to the welfare of the country as a whole. Since the money market is in the East and the Governors of the Eastern banks are more familiar with market conditions and more convenient to Washington, it is very likely that the two Federal Reserve bank Governors on the committee would be from Eastern Federal Reserve banks. If one of the members of the Federal Reserve Board appointed on the committee should also be from the East it is possible that the three Eastern members, being primarily interested in and principally concerned with conditions in the Eastern money market, might adopt an open market policy inimical to the best interests of the agricultural sections of the South and West.

In addition to the power to make final decisions regarding discount rates and to increase or reduce the reserves required of member banks, which have been mentioned above, the Federal Reserve Board has many powers to influence general credit conditions throughout the country.

Thus, under section 19 of the Federal Reserve Act, the Federal Reserve Board has the power to regulate the rates of interest which member banks may pay on time and savings deposits; under section 11(m), it has the power to fix from time to time for each Federal Reserve District the percentage of individual bank capital and sur-

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plus which may be represented by loans secured by stock or bond collateral made by member banks within such district; and, under section 4, it has the power to suspend from the use of the credit facilities of the Federal Reserve System any member bank which, in the judgment of the Federal Reserve Board, is making undue use of bank credit for the speculative carrying of or trading in securities, real estate or commodities or for any other purpose inconsistent with the maintenance of sound credit conditions. Furthermore, the present law gives the Federal Reserve Board the power to issue regulations governing the discounts, advances and other credit accommodations which Federal reserve banks grant to their member banks and both the present law and the proposed bill would give the Federal Reserve Board plenary authority to issue regulations governing the open market operations of the Federal Reserve banks. These powers could easily be used to obstruct, and possibly defeat, any open market policy adopted by the committee to which the Federal Reserve Board as a whole might be opposed.

There are so many powers vested in the Federal Reserve Board which could be used in such a way as to hamper and possibly defeat any open market policy to which the Board is opposed that it is absolutely impracticable to vest the power of making final decisions regarding open market policies in any body except the Federal Reserve Board.

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PROPOSED AMENDMENT TO H. R. 5357 AND S. 1715

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Strike out everything commencing with line 11 on page 44 through and including line 17 on page 45 and substitute the following:

"Sec. 12A. (a) There is hereby created an Open Market Advisory Committee (hereinafter referred to as the 'Committee'), which shall consist of five representatives of the Federal reserve banks. The members of the Committee and an alternate to serve in the absence of each of them shall be elected annually by the Governors of the twelve Federal reserve banks in accordance with procedure prescribed by regulations of the Federal Reserve Board. Vacancies shall be filled in the same manner. The terms of the members of the Committee shall expire at the end of each calendar year, and a person elected to fill a vacancy shall serve for the remainder of the term of his predecessor. The Committee shall elect its own chairman. Meetings of the Committee shall be held from time to time upon the call of the chairman or upon the call of the Governor of the Federal Reserve Board. Meetings shall be called whenever requested by a majority of members of the Committee or by a majority of the members of the Federal Reserve Board.

"(b) The Committee shall consult and advise with, and make recommendations to, the Federal Reserve Board from time to time with regard to the open market policy of the Federal Reserve System. The

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Committee shall also aid in the execution of open market policies adopted from time to time by the Federal Reserve Board and shall perform such other duties relating thereto as the Federal Reserve Board may prescribe.

"(c) After consulting with and considering the recommendations of the Committee, the Federal Reserve Board, from time to time, shall prescribe the open market policy of the Federal Reserve System. Each Federal reserve bank shall purchase or sell obligations of the United States, bankers' acceptances, bills of exchange, and other obligations of the kinds and maturities made eligible for purchase under the provisions of section 14 of this Act to such extent and in such manner as may be required by the Federal Reserve Board in order to effectuate the open market policies adopted by the Board from time to time under the provisions of this section and each Federal reserve bank shall cooperate fully, in every way, in making such policies effective.

"(d) All transactions of Federal reserve banks under authority of section 14 of this Act shall be subject to such regulations, limitations and restrictions as the Federal Reserve Board may prescribe."

HOW THE BILL WAS CHANGED.

On the day the bill was sent to Congress, section 205 was changed as follows, the canceled words being stricken out and the words in capital letters being inserted;

"Sec. 12A. There is hereby created a Federal Open Market Committee (hereinafter referred to as the Committee), which shall consist of the Governor of the Federal Reserve Board, who shall be Chairman of the Committee, two members of the Federal Reserve Board, selected by the Board, and two Governors of the Federal Reserve banks, selected by the Governors of the Federal Reserve banks in accordance with procedure prescribed by regulations of the Federal Reserve Board. The terms of the members of the Committee, other than the Governor of the Federal Reserve Board, shall expire at the end of each calendar year. Whenever a vacancy shall occur a successor shall be selected in the same manner as his predecessor was selected. Meetings of the Committee shall be held from time to time upon the call of the Governor, at the request of the Board or of any two members of the Committee, or upon his own initiative.

"The Committee from time to time shall consider, adopt, and transmit to the Federal Reserve ~~Board~~ **BANKS** resolutions setting forth policies which in the judgment of the Com-

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mittee should be followed with respect to open-market operations and discount rates of the Federal Reserve banks, and the Board shall give prompt consideration thereto. Upon notification of the Board's approval of any such resolution, the Federal Reserve banks shall conform their open-market operations to the provisions thereof, and The Committee shall aid in the execution of such policies and/or perform such other duties relating thereto as the FEDERAL RESERVE Board may prescribe. All open-market operations of the Federal Reserve banks shall be subject to regulations, limitations and restrictions prescribed by the Federal Reserve Board, which shall not be inconsistent with resolutions approved by the Board as hereinbefore provided. THE COMMITTEE FROM TIME TO TIME SHALL ALSO MAKE RECOMMENDATIONS TO THE FEDERAL RESERVE BOARD REGARDING THE DISCOUNT RATES OF THE FEDERAL RESERVE BANKS."

This section should either be restored to its previous form or there should be substituted a section clearly vesting in the Federal Reserve Board the power to initiate, adopt and enforce open market policies for the Federal Reserve System after consulting with an Advisory Committee consisting of five Federal Reserve bank governors.