Form No. 131

Office Correspondence

FEDERAL RESERVE BOARD

111. 2-40

Date April 1, 1935.

To Governor Eccles

From Lauchlin Currie

L.C.

Subject: The relation of Government to monetary control

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As the main line of criticism of our bill appears to be the political one I thought it might be worth while to do some more work on this angle. Some of the points in the accompanying memorandum you have already made. Some, such as the short discussion of the typical banker mentality, could not be made publicly, but might be used in private conversations. Others, however, are a bit new. Personally I would be in favor of your taking up the political argument in your opening statement to the Senate Committee. I think we have everything to gain by frankness as much of the appeal of our opponents lies in the vague, sinister and undefined nature of their objections.

Data Supporting Bkg Bill

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THE RELATION OF GOVERNMENT TO MONETARY CONTROL

1. Control versus laissez faire. Nobody has ever denied that a policy of laissez faire in banking results in an expansion of deposit currency, or money, when business activity is expanding and the demand for loans increases, and a contraction of money when business activity is declining and the demand for loans decreases. In the absence of control the behavior of the banking system will intensify rather than ameliorate business fluctuations.

2. Automatic control versus discretionary control. The gold standard at one time provided a crude automatic control in so far as it fixed limits beyond which expansion could not proceed. It did not prevent large upward and downward swings in business activity but it did insure in a rough way that all the countries on the gold standard had to keep more or less in step in expansion or contraction. Since the war the gold standard has broken down as an automatic control. In the first place, due to our elastic monetary system, the degree of expansion and contraction of money permitted by the gold standard is too great to be endured. From 1921 on we have had gold reserves far in excess of legal requirements and yet almost nobody has criticized the reserve administration for declining to permit expansion of deposits to the limits allowed by our excess gold. Likewise, the gold standard does not provide any effective check to deflation. Not only were we on the gold standard from 1929 to 1933, but we actually gained over $700 million of gold during 1930 and the first half of 1931 while deposit currency declined over 11%. The present size of our stocks

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of gold renders their use as an automatic guide to monetary policy out of the question.

The fatal objection to automatic controls is that the combination of factors that bring about a business situation is never the same. Each new business situation with which we are confronted is in a large and significant measure a situation which we have never confronted before and will never confront again. It would appear outside the realm of possibilities that any simple rule of thumb, such as, for example, an unvarying rate of expansion of money, could supply the correct solution of an infinite succession of different problems. I think we would all agree that a given expansion of money in 1929 would have had quite different effects than would the same expansion in 1930, although it is quite possible that a much greater expansion of money in 1930 might have have somewhat similar effects.

It appears evident, therefore, that control must be discretionary. The objectives of control may, and we think should be, mandatory, but the management, or the handling of the instruments of control, must be discretionary.

3. Centralized versus decentralized control. Decentralized control is almost a contradiction in terms. The more decentralization the less possibility there is of control. Even though the Federal Reserve Act provided for a very limited degree of centralized control, the system itself by virtue of necessity was forced to develop a more centralized control of open market operations. The degree of centralization achieved by 1933, however, was highly inefficient from an adminis-

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trative point of view. There are fourteen bodies composed of 128 men who either initiate policy or share in varying degrees in the responsibility for policy. These bodies are the twelve Boards of Directors of the Federal Reserve banks, the Governors of the Federal Reserve banks in the Open Market Committee, and the Federal Reserve Board. With such an organization it is almost impossible to place definite responsibility anywhere. The layman is completely bewildered by all the officers, banks and boards. Even the outside experts know only the legal forms. They must guess and infer as to the actual degrees of powers and responsibility exercised by these various boards and individuals. Only the people on the inside really know who exercises the power. Such a system of checks and balances is calculated to encourage irresponsibility, conflict, friction, and political manuevering. Anybody who secures a predominating influence must concentrate on handling men rather than thinking about policies. There are many occasions in monetary policy when a vigorous policy is called for, and a compromise policy is fatal. Our present system, however, fosters compromise. One of the most unfortunate consequences of the diffusion of authority has been that it has detracted from he prestige of the Federal Reserve Board, and the attractiveness of a position on that Board.

Assuming, therefore, that it is desirable to have discretionary control, and that control must be centralized and exercised by a body which has both authority and responsibility, the issue becomes:

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4. Government versus private control. One point may be disposed of very briefly. The Constitution gives Congress the power to coin money and to regulate the volume thereof. This cannot be interpreted to mean that Congress has not the power to set up an agency and to delegate to that agency the actual management of money. Obviously, Congress itself is not a suitable body to regulate directly the supply of money. Congress should declare the objective toward which policy should be directed but should not attempt either to regulate money itself or to appoint the personnel of the regulatory body. If the body is to be appointed by the Government, all appear agreed that it should be by the President with the advice and consent of the Senate.

The important and controversial question is the closeness of the relationship that should exist between the President and the board of the regulatory body,-in this case the Federal Reserve Board. On the one extreme are those who claim that there should be no connection, not even that of initial appointment. They argue that politicians are interested in reelection and to this end desire prosperity and rising prices regardless of the current injustices and the ultimate consequences of such a policy. Consequently, politicians as a class have a continuous bias on the side of an expansive or "inflationary" monetary policy. People with fixed incomes, who are neither as numerous nor as articulate as other classes, may find their real incomes steadily reduced.

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Moreover, people with variable incomes do not gain in the long run since periods of expansion and rising prices are inevitably followed by crashes and depressions. Just as an autonomous and thoroughly independent Supreme Court is necessary to protect the rights of minorities, so an autonomous and independent monetary authority is necessary to insure that monetary contracts have some meaning in terms of goods and services. The inflation episodes in Central Europe, in which the savings of the middle class were almost completely wiped out, are frequently cited as illustrations of the consequences that may follow when politicians control the monetary authority.

It is moreover claimed that a close relationship between the party in power and the Federal Reserve System exposes the latter to the danger of a spoils system. Appointments will be made not on the basis of merit and technical competence but as a reward for party services.

On the other side are those who would like to see the monetary authority directly responsible to the Administration, which means in effect the political party currently in power. They argue that increases or decreases in the supply of money affect directly or indirectly the economic well-being of every person in the community, and that therefore if we are to have a system which is not purely automatic but one in which discretion must play an important role, the people who exercise discretion in varying the money supply must be directly responsible to the representatives of the people. Most of the problems with which Congress grapples are economic problems and the efficacy or workability of many Acts of Congress are directly dependent upon a smoothly functioning banking system. At

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the present time there is no economic problem more important than achieving and maintaining prosperity, and since the actions of the monetary authority have a direct bearing upon the state of business activity they must be subject to the control of the Administration.

Regardless of the extent to which Congress may delegate the money controlling authority to an autonomous board, it is nevertheless held responsible for the policy of that authority. If the monetary authority has caused or has failed to prevent a depression, it is useless for a party coming up for reelection to explain that it had nothing to do with the monetary policy followed by an autonomous board. The majority of the people will express their dissatisfaction with their economic conditions by turning out the party in power and putting in another. It may be quite unjustifiable but it is nevertheless a fact that the voters are inclined to hold the party in power responsible for current business conditions. Since, threefore, the dominant party is held responsible for monetary policy, it might reasonably be held that it should appoint the monetary authority.

Proponents of a politically appointed monetary authority deny that policy would always be in the direction of rising prices. They point out that the cases of inflation constantly cited should not be attributed to governmental control of money but rather to extraordinary fiscal needs of governments in war or post-war periods. When the pressing emergency need was past, governments have frequently embarked upon a deflation policy. Surveying the monetary history of this

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country, it is possible to generalize that there has never been a numerically significant "cheap money" party except in periods of falling prices. When the secular trend of prices turned upward, "cheap money" movements quickly lost their popular appeal. In their place there arose widespread complaint against "the high cost of living." In other words, there appears to be little empirical basis for the frequent analogy of the effects of rising prices and drug taking. Instead of the appetite growing by what it feeds upon, resistances arise which grow in force as the price rise continues. It is significant in this connection that no numerically important "cheap money" party has advocated steadily rising prices. It is quite true that recently those who are popularly called "inflationists" have advocated a rise in prices. They have, however, very emphatically declared that this was a temporary measure. For a long run policy they have advocated stable prices.

The monetary policies in this country in 1919 and 1928-1929 are often cited as instances of the bad effects of governmental influence. In 1919 restrictive action was delayed out of deference, it is alleged, to the wishes of the Treasury. The only direct evidence we have of interference by the Treasury with Federal Reserve policy in 1919 was a letter by Mr. Leffenwell, Assistant Secretary of the Treasury, to Governor Harding, of November 29th, opposing a rise in discount rates because of the imminence of heavy government financing.

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On December 10th he wrote that the financing was being put through satisfactorily and that therefore the Treasury did not oppose any action taken by the Board. These letters are in the files of the Federal Reserve Board, but have never, so far as I know, been published. The Treasury did, of course, dominate Federal Reserve policy during and immediately after the war. I think, however, that it would be most unrealistic to maintain that this should not have been the case. Government policy may be by many considered unwise, but the will of the Government must prevail, particularly at a time when it is believed that important national interests are at stake. The policy followed in England at the same period was similar to ours, even though England possessed a privately owned and controlled bank. It is sometimes said that the Reserve Administration was hampered in its restrictive policy in 1928-29 by political pressure. There is not a single scrap of evidence on which to base this accusation. The Board was at all times given a free hand in the determination of its policies.

England is the only important country which possesses a central bank which is legally entirely independent of the Government, and this is the result of peculiar historical developments. Actually, the Bank of England has close relationships with the Chancellor of the Exchequer and its independence is nominal rather than real. Its charter can be revoked at any time by Parliament, if a serious difference of opinion as to desirable policies ever arose between the Government of the day and the Bank of England. Almost all other central

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banks provide for some degree of government control. The Governor and directors of the Swedish , Australian, New Zealand, and Finnish central banks, to cite only democracies, are all appointed by the Government. Even the new Bank of Canada, with whose establishment Englishmen had a lot to do, is under a considerable degree of government control since the Governor who has the veto power over all decisions of the directors, is appointed subject to the approval of the Finance Minister.

In order to make the issue clear cut, I have presented the two extremes. I now propose to present the type of relationship I should favor.

5. Method of appointment of the Federal Reserve Board.

In the first place, the argument for appointment of the controlling body by the President appears to be overwhelmingly strong. Variations in the money supply affect the economic wellbeing of everyone in the community. The control of money, therefore, is a public duty of the highest importance. If a hopelessly incompetent board pursues policies which adversely affect the wellbeing of the nation, it is desirable that the nation should be able to fix responsibility and express its dissatisfaction in an effective manner. Only through appointment by the President can responsibility be placed for the goodness or badness of policy. A corollary to this argument ment is that not only should the board be appointed by the President but that the board so appointed should have responsibility for all policies which are national in scope. Since open-market

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policies are preeminently national in scope, their formulation should be the responsibility of the Federal Reserve Board.

6. Terms of Office. Many people argue that the terms of appointments should be for life or until retirement at the age of seventy. This argument appears to rest on the belief that monetary management is an exact science rather than an art; that if objectives are stated in the law it is a comparatively simple matter to carry out these objectives. Nothing could be further from the truth. Let me cite an illustration. Suppose that the Federal Reserve Board were to be directed either to maintain stable prices or business stability, and a situation such as 1928-29 occurred. On the one hand a large group of experts declared that security speculation was potentially inflationary and that the reserve administration should adopt drastic restrictive measures, if a rise in prices and boom conditions were to be avoided. On the other hand, it was argued that security speculation, by forcing interest rates up, was potentially deflationary and that an easing policy on the part of the reserve administration was required if falling prices and depression were to be avoided. Obviously, the handling of such a situation requires judgment and knowledge of a high order. A Federal Reserve Board, even while acting on the very highest motives, might make mistake after mistake and, if appointed for life, nothing could be done about it. The Administration would have to take responsibility for such mistakes and yet would be able to do nothing to change the composition of the Board.

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The analogy to the Supreme Court does not hold. The Supreme Court is an essential part of a theory of checks and balances. Its duty is to apply the law as embodied in the Constitution to specific cases. When a Constitution is in the nature of a contract between States it is necessary to provide for its interpretation by some body which is independent of the parties to the contract. Obviously the function of the Supreme Court is quite different from that of the Federal Reserve Board. The latter body is a creation of Congress and not of the Constitution, and its duty is to carry out the will of Congress.

Since, therefore, the formulation of monetary policy must involve a large measure of discretionary judgment, and since there is so much disagreement even among professional monetary theorists as to the correct policy to adopt in any given situation, and since it is highly desirable that monetary policy be dovetailed in and operated in conjunction with other activities of the Government that affect business activity, it would appear unwise to establish a body with life terms. The people must have some way, even though it is remote, of expressing their satisfaction or dissatisfaction with the manner in which the delegated powers of monetary control are being exercised.

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The present term of appointed members is twelve years. This is as long as it should be. In fact it might be argued that it is too long. A new administration coming into office in January 1937 would have no opportunity to appoint a new member to the Board until August 1938. No other term would expire during the four-year period. The administration would have the Secretary of the Treasury and the Comptroller of the Currency on the Board, but they are not active members. An administration coming to office in January 1941 would have an opportunity to appoint one new member in April 1941 and two additional members in 1943. It will be seen, therefore, that leaving out of account retirements, deaths, and resignations, a new administration will be confronted with a Federal Reserve Board the majority of whose members has been appointed by the preceding administration. A liberal administration would have to deal with a conservative Board and a conservative administration with a liberal Board. This might be defended on the general theory of checks and balances, but this is one field where checks and balances are dangerous and where cooperation and coordination are necessary and desirable.

Most writers on this subject appear to believe that it will be the administration which will always be requesting the Federal Reserve Board to take certain actions. They appear to forget that it is very desirous from the point of view of the successful prosecution of monetary policy that other activities of the Government be in a direction conducive to business stability. The Federal Reserve Board

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should be the agency specifically charged with the duty of promoting stability and it is desirable that its influence be not restricted solely to the monetary sphere. The ideal situation would be for the President to be willing and anxious to avail himself of the advice and counsel of the Federal Reserve Board on all matters affecting business stability. There is grave danger that an incoming President who differed widely in his economic views from his predecessor would distrust the disinterestedness and technical competence of a board, all of whose members were appointed by former Presidents.

I am not here advocating that the terms of Board Members be shortened. What I am advocating, however, is that the Governor should cease to be a member of the Board when he is no longer designated as Governor. It is highly important from the viewpoint of monetary policy and banking administration that there should be a liason between the Administration and the Federal Reserve Board, and the Governor of the Board appears to be the proper person for this purpose. The Secretary of the Treasury is unsuitable as he is a greatly overburdened official, rarely attends board meetings, and does not regard himself primarily as a board member.

If a Governor's term as board member did not expire when he was no longer designated as Governor, and he chose to remain on the board, there would be no vacancy, and the President would have to appoint as Governor another member of the Board, who had been originally appointed by his predecessor. It may be said that as a practical matter any Governor would resign from the Board when he is

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no longer designated as Governor. This is broadly true, and if one could be absolutely sure that it would always be so there would be no need of a formal amendment to the law. The fact is, however, that we cannot be certain that a Governor would always resign and it would be in just such cases that it would be most important that the President be permitted to appoint a new member to the board to act as Governor, Any man who would remain would probably do so either to embarrass the President politically or because he bitterly opposed the President's views. In either case the likelihood of the Federal Reserve Board's being consulted by the President on matters pertaining to business stability and banking legislation would be diminished and to this extent the usefulness of the board would likewise be diminished.

There is nothing in this proposal to prevent a board member serving as Governor under different administrations. It is very much to be hoped that there will be Governors who will achieve such reputations for disinterested competence that they will possess the confidence of different Presidents and different parties. The present Governor of the governmentally-controlled Swedish Riksbank is a Conservative and yet he has served under a Labor government. There are other examples in our own country of technical officials securing such reputations and possessing the confidence of different parties.

7. The Secretary of the Treasury and the Comptroller of the Currency. At the present time the advantage of having these officers ex-officio members of the board outweigh the disadvantages. It is

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sometimes said that the one interest of the Secretary of the Treasury in monetary policy is in the manner in which it affected Government financing. Even if this were the only interest it is an important interest and should be adequately represented. At the present time, however, the Secretary of the Treasury is a monetary authority in his own right. He is charged with the duty of maintaining parity between the monies of the United States, and hence in maintaining the gold standard when we are on it; he is in charge of the exchange equalization fund the use of which affects member banks' reserves; he is in charge of the silver-buying program and plays a leading role in foreign exchange negotiations; he is in charge of large Government balances the disposition of which affect member bank reserves; his recommendations relating to taxes and expenditures vitally affect business activity. It is important, therefore, that not only he should be a member of the Federal Reserve Board but that he should as far as possible be an active member and consult with the board constantly on all matters affecting business stability. It is to be hoped that with added powers, responsibility and prestige, the board will be consulted more frequently in the future than it has in the past on all matters relating to business activity.

The Comptroller of the Currency contributes little to the board but, on the other hand, he detracts little from it. He attends only when matters affecting his jurisdiction arise and at such times it is very useful and desirable that he should attend.

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9. How the danger of undesirable political domination is lessened by the Banking Bill of 1935. It is very desirable to distinguish between cooperation with the Government for worthy purposes and domination by the Government for unworthy purposes. It is as important to secure the former as it is to avoid the latter. By giving the Federal Reserve Board authority and responsibility for national monetary policies and providing that its Governor will always be a person who possesses the confidence of the Administration we have sought to make possible the desirable form of cooperation. I shall now explain how we seek to avoid undesirable political domination which would take the form of adopting policies for the purpose of reelection of the Administration and of exposing the Reserve System to the dangers of the spoils system.

a. I have already pointed out that it is unlikely that the majority of the members of the Federal Reserve Board have been appointed by any President except in his second successive term of office. We propose to do nothing to alter this situation.

b. It will probably be generally agreed that few things can weaken the high-mindedness of a person's motives as much as financial dependence. With salaries that preclude adequate saving and with no provision for pensions, the desire for reappointment may well be very strong. We regard as one of the most important features of the bill that section which provides for more adequate salaries and, of even more importance, for adequate pensions. It should contribute to the feeling of independence of members of the Board.

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c. The new qualifications for members will, we hope, enhance the prestige and independence of the Board. They call attention to the character of the duties of the Federal Reserve Board, and offer a criterion by which Congress and the press may discuss and judge the goodness of the President's appointments.

d. The added compensation, authority and responsibility attached to membership on the Board should likewise add to the public esteem and prestige of the Federal Reserve Board. The more prestige and responsibility an office carries, the more likelihood that its occupants will be outstanding men. The more outstanding the men, the less likelihood that they will be activated by other than the most high-minded and public-spirited motives.

e. The present objective of monetary policy specified in the Federal Reserve Act is the accommodation of commerce and business. This is vague to the point of meaninglessness, and in fact permits and indeed forces the Board to determine its own objectives. This is an undesirable situation, as it constantly exposes the Board to suspicion as to the motives which activate its policies. We propose, therefore, that the following mandate be written into the law:

"It shall be the duty of the Federal Reserve Board to exercise such powers as it possesses in such manner as to promote conditions conducive to business stability and to mitigate by its influence unstabilizing fluctuations in the

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general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action and credit administration."

This is as specific and as definite a mandate as it is safe and desirable to make at the present time. If such an objective is incorporated in the law, it would appear extremely likely that every action of the board in the future will be extensively discussed and judged in the light of this objective. The danger that undesirable political pressure will be exercised is obviously greater when the objectives of monetary policy are not clearly defined as at present. If, after this objective is incorporated in the law, the Federal Reserve Board should deliberately try to manipulate monetary policies for partisan or other unworthy purposes, it would be specifically breaking the law and would be subject to impeachment.

The adoption of this objective would tend to make the Federal Reserve Board more of a technical board concerned with technical ways and means of achieving the objective and less of a board with legislative functions. It is true that the board would be subject to criticism if it failed to achieve the objectives, but I do not think that this would be serious if the board by full publicity would show that it had used every reasonable means in its power. There are, after all, very few people who believe that business stability can be obtained solely through monetary policy.

There are other considerations which will operate to lessen the danger of undesirable political pressure. In the first place,

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there is the considerable lag between the inauguration of a central banking policy and its discernible effect on business activity. For example, the sharp reversal in the trend of interest rates at the beginning of 1928 did not have any discernible restrictive effect on business activity until the autumn of 1929. It would thus be extraordinarily difficult to so time policy as to bring about a desired degree of business activity at some given time in the future.

It appears to me that one of the best safeguards against manipulation of monetary policy for partisan purposes would be full publicity and widespread awareness of the importance and significance of Federal Reserve policy. One of the few good effects of the depression has been the growth of such awareness. There has rarely been such widespread discussion and thinking about monetary matters as there has been in the past few years. With concentration of authority and responsibility in the Federal Reserve Board, with general recognition of the importance and significance of its policies, with a specific mandate by which its policies may be judged, and with the full light of publicity turned on its every action, I do not think that any Administration would dare to exert pressure on the board to pursue policies on political grounds. The real danger to my mind is that the board will lean over backward and refuse to pursue a policy desirable on monetary grounds solely because it may be interpreted to be on political grounds.

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Up to this point I have been concerned with showing the remoteness of the danger that policy will be dictated for political purposes. I now propose to discuss very briefly the danger that the personnel of the Federal Reserve System will be selected not on grounds of technical competence but on grounds of services to a political party. I have already pointed out that so far as the Board itself is concerned the added prestige and responsibility will militate against purely political appointments. As far as the Federal Reserve banks are concerned it should be emphasized that the Governors must not only be approved by the Federal Reserve Board but that they must be selected by the boards of directors of the Federal Reserve banks. All appointments of officers and employees of the Federal Reserve banks are the responsibility of their boards of directors. Thus the danger of the spoils system in the Federal Reserve banks is more remote than at present. At present the Federal Reserve Board can appoint not only the Chairman of a Federal Reserve bank but also every employee in the chairman's and reserve agent's department. This right is now being surrendered.

10. Political domination of the reserve banks. (I understand that Dr. Goldenweiser has written you a memorandum showing that under the Banking Bill of 1935 the reserve banks actually have more regional autonomy than they have at present, so I shall not go into that subject here.)

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