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Form No. 131

Office Correspondence

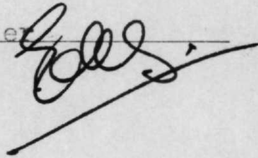
FEDERAL RESERVE BOARD

Date April 16, 1935

To Governor Eccles

Subject:

From Mr. Goldenweiser



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Attached is a memorandum on the nature of objection to the Banking Bill of 1935, which may serve the purpose of a statement to the President on the subject.

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April 16, 1935

NATURE OF OBJECTIONS TO BANKING BILL OF 1935

Now that the lines of attack by opponents of the Banking Bill have become clarified, it is possible to summarize the principal arguments advanced against it.

Political control

The chief objection raised against the bill is that it would put the Federal Reserve System under political domination. This line of argument centers upon the proposal that the Governor of the Federal Reserve Board cease to be a member of the Board when he is no longer redesignated as Governor by the President. This provision affords an important talking point, although there is little merit in it, because a governor in most conceivable circumstances would not insist on remaining on the Board if the President did not wish to redesignate him and desired him to resign.

Modification of this provision to meet the criticism would not satisfy the critics, however, because they use this provision only as a peg on which to hang their general distrust of the Administration's proposals. Nearly all of the arguments against the bill along the lines of political control are just as applicable to the existing law as to the proposed modifications; they are a channel through which those who believe in deflation and an immediately balanced budget and those who do not approve of the monetary and credit policies of this Administration express their discontent and their hostility.

The fact is that the proposed bill in no way increases political control over the Federal Reserve Board. On the contrary, it does a great deal to make the Board more independent: by requiring expert qualifications for Board members, by providing them with better salaries and with pensions, by prescribing

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a definite objective towards which the Board must use all its powers, and by eliminating the need of Presidential approval for changes in reserve requirements.

Public vs banker control

While the bill beyond doubt increases the independence of the Federal Reserve Board from purely political control, it unequivocally recognizes the need of public control over the country's monetary policy. It is this feature of the bill which underlies much of the resentment against the bill.

The bill in this respect is in line with the idea of Woodrow Wilson who said that the money system of the country must be controlled by the Government, and Carter Glass, who frequently made similar statements and drew a clear distinction between matters of national concern which should be in the hands of the Federal Reserve Board and local credits which should be in the hands of the individual Reserve banks.

The opposition to the bill on these scores is not based on the provisions of this bill, but represents a continuation of the fight of the money interests to have representation and, if possible, control of the Federal Reserve System. This fight was waged at the time that the Federal Reserve Act was under consideration and has been continued ever since. Some headway has been made by the bankers, both as a matter of procedure, through creating the office of governor and making him, rather than the Government-appointed chairman, the head of the bank; also by having the Banking Act of 1933 make it clear that the Federal Reserve Board has no power to initiate open-market operations, and give each individual Reserve bank the power not to participate in the carrying out of an open-market policy after it had been determined and approved.

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To yield to this pressure for banker representation and management of the Federal Reserve System would be to give away the main purpose of the legislation and would be entirely inconsistent with the trend of the times, both here and abroad, since the recognition of the necessity of public control of monetary policy has become general in the light of post-war experience. In the newer central banks established in recent years this is definitely recognized by giving the Government powers over the directors of central banks and in the old banks it has become more clearly recognized as a matter of practice and policy, even though the charters have not been changed. Witness, for example, the removal of Moret from the Bank of France.

Local autonomy in local matters

While the bill as modified by suggestions made to the House Committee places full power over open-market operations, discount rates and reserve requirements in the Federal Reserve Board, after consultation with a committee of governors, it increases rather than diminishes the autonomy of the Federal Reserve banks in matters of local concern, that is, in all the relations with the banks of the district, the determination of individual credits, etc. The bill does this by reducing the number of directors of the Reserve banks that are to be appointed by the Federal Reserve Board through providing that the Governor of the bank, who shall be one of the Class C directors and also be the Chairman, is to be appointed by the Directors of the Reserve banks subject only to approval by the Federal Reserve Board every three years.

Other provisions that would increase local autonomy are the elimination of the Federal Reserve agent, who was the Federal Reserve Board's local representative in each Federal Reserve bank, was supposed to maintain an office of the Reserve Board on the premises of the bank, and had a large staff which

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could be directly appointed by the Board and, in fact, was subject to the Board's approval. This included the entire staff of examiners, of the bank relations department, the statistical and economic services; it included the handling of voting permits to holding companies, recommendations as to admission of banks to the Federal Reserve System, approval of authority for directors to serve on more than one bank, and other matters. These staffs of the Federal Reserve agent will under the new bill all be consolidated with the other departments of the Federal Reserve banks and will be under complete control of the governor and board of directors subject only to approval of salaries by the Federal Reserve Board, which applies now, and will continue to apply to all officers and employees of Federal Reserve banks.

Soundness vs liquidity

The other main line of attack on the bill is that it represents an encouragement of unsound banking by member banks and involves the danger of loading up the Federal Reserve banks with frozen assets.

This line of attack is not indulged in to any extent by officials of the Federal Reserve System who are familiar with the operations of the system and know that the technical definitions of eligibility and the technical restrictions on the character of bank loans have not saved the banks from disaster and have had to be abandoned when put to the test of a depression. Criticisms along this line represent pious wishes that the member banks be purely commercial in character and that the Federal Reserve banks handle nothing but self-liquidating short-term commercial paper. The fact that there is not enough of that paper in existence, only about $2,000,000,000,

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and that it would not be feasible to support a banking system on this kind of paper is ignored by the opponents. They are thinking, theoretically, about the establishment of a banking system on paper, in which savings banking and deposit banking would be entirely separated.

The fact that with our multitude of banks it is impossible to do this without depriving a large number of banks of a chance to make a living is not taken into consideration. More than 60 per cent of the deposits of the banks outside of the financial centers is in the form of time deposits and the so-called commercial banking system has $10,000,000,000 of the people's savings. It is, therefore, necessary for these banks to use their long-time funds in long-time investments, which is the normal way of capital formation.

The fact is that all this is recognized in existing law and what is proposed in the Banking Bill is merely making the laws relating to real estate mortgages more flexible by giving the Federal Reserve Board power to determine by regulation the maximum ratio of loans to values, the maximum maturity, and other matters. This is particularly necessary because many banks now have real estate loans in excess of the amounts permitted by existing law and this results in heavy pressure for liquidation which exerts a serious deflationary influence.

The removal of technical limitations on eligibility of paper for borrowing at the Reserve banks is in line with the System's experience. During the depression it became necessary to have these restrictions removed, but only after a great deal of harm had been done, because the Federal Reserve banks were not able to assist member banks even though these banks had sound assets, when these assets were not technically eligible for discount.

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The bill does not propose to load the Reserve banks with unliquid assets. It merely proposes to make soundness rather than liquidity be the basis and leave it to the Federal Reserve Board by regulation to determine what the Reserve banks shall and shall not be permitted to discount. This provision, together with the real estate provision, is expected to be an important factor in recovery by encouraging the banks to make long-time commitments with the assurance that they would be able to liquefy them by borrowing from the Reserve banks in case of large-scale withdrawals of deposits.

Steps toward unification of banking

There is also an attempt to prevent the going into effect of a provision of the Banking Act of 1933 by which all banks that belong to the deposit insurance corporation must be members of the Federal Reserve System by July 1937. This is not a provision of the Banking Bill of 1935, but of previous legislation. The present bill only attempts to make it more feasible for the banks to comply with this previous legislation by permitting the Reserve Board to waive capital and other requirements for admission to the System, so that small banks that belong to the deposit insurance corporation will have an opportunity to become members of the System without having to raise additional capital, which it may not be possible for them to do, and which in many cases would not be justified by the volume of their business.

The opponents of unification, or protagonists of the State banking system, use this provision of the bill as an occasion for pressing an amendment that would repeal legislation enacted two years ago. They want the State non-member banks to have all the benefits arising from deposit insurance and from the functioning of the Federal Reserve System without contributing anything to the System and without being subject to supervision by the System.

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Monetary objectives

In the House Committee there was a good deal of discussion of the objective proposed by the bill for the Federal Reserve System. The objective proposed by the proponents of the bill was modeled after the objective of the Bank of Canada and required that the Federal Reserve Board use all its powers towards maintaining stability of production, prices, and employment, in so far as it is possible within the scope of monetary action. There are many in the House who believe that a better objective would be the 1926 price level. It is believed that an objective that points directly at what really ought to be accomplished, namely, improvement in business conditions and the maintenance of stable employment, is vastly superior as an objective to price stability, which is not an object in itself, and which in many cases may be directly opposed to the mainteance of satisfactory business conditions.

Attempts to delay action

As a means of combatting this legislation, its opponents are getting together on a proposal that it is necessary prior to the passage of banking legislation to create a commission of experts which would review the whole banking field and make a report. This, of course, is a time-worn device for delaying legislation and gaining time to organize opposition and possibly wait for a change in conditions that would make it more difficult to pass such legislation. It is the same procedure that was followed in 1908 after the panic of 1907 when banking reform was delayed by the creation of a Monetary Commission, which did not make its report until 1911, and which did not result in legislation until 1913. The legislation in the end was, furthermore, quite different from what the Monetary Commission recommended.

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The argument for the commission is based on the supposition that the Banking Bill was hastily drawn and does not represent the best expert opinion. The fact, of course, is that the bill was drawn carefully with the participation of persons having a great deal of experience and was also studied by the policy committee of the American Bankers Association. Most of its provisions are the direct outcome of experience under the existing system, they are few and simple, deal with matters on which there is complete information, and delay in the enactment of which would not only serve no useful service, but would retard recovery and be dangerous if inflation should develop.

As already stated, the battle against the bill is a continuation of a fight by bankers against Government control. They lost with Woodrow Wilson, they have regained some of the ground by various steps since that time, and now they want not only to hold what they have gained, but to increase their hold.

Commission not opposed

While the provisions of this bill do not require any further study by a commission, the creation of such a commission, nevertheless, might be desirable, after the enactment of this bill, for the purpose of considering at greater leisure those phases of our banking problem that are not touched upon in the Banking Bill of 1935, such as branch banking, unification of banking, the proper relationship between savings banking and deposit banking, and other matters.

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The passage of the present bill would in no way interfere with the labors of such a commission. Enactment of the bill, furthermore, is urgent for two purposes: first, to encourage recovery and particularly activity in construction, through the liberalization of lending provisions and elimination of red tape; and, secondly, to improve the machinery of monetary control with a view to being prepared to meet conditions that may arise if, on the basis of existing reserves, an inflationary boom should develop that would require prompt and efficient action.

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