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Office Correspondence

FEDERAL RESERVE BOARD

Date May 6, 1935.

To Governor Eccles

From Mr. Wyatt

Subject: Development of the Federal Open Market Committee

GPO 16—852

I am handing you herewith for your information a short outline of the development of the Federal Open Market Committee which was prepared at my request by Mr. J. T. Owens, Assistant Counsel, and also an appendix showing the different forms in which the legislation on this subject appeared in different drafts of the Banking Act of 1933.

Respectfully,

Walter Wyatt

Walter Wyatt,
General Counsel

Papers attached

DEVELOPMENT OF THE FEDERAL OPEN MARKET COMMITTEE

In his testimony before the House Banking and Currency Committee on the proposed Banking Act of 1935, Governor Eccles of the Federal Reserve Board characterized open-market operations as the most important single instrument of control over the volume and cost of credit in this country. Accordingly, it seems worth while to examine briefly the history of this paramount instrument of Federal Reserve policy and the development of the Committee which is charged with the performance of this function.

Throughout the early years of the Federal Reserve System the holdings of United States Government securities by the Federal Reserve banks had gradually increased until in 1920 they held approximately $300,000,000 of such obligations, and somewhat less in 1921. However, the open-market operations of the Federal Reserve System, as they are known today, date from the year 1922. Prior to that time, practically all of the resources of the System had been utilized in supporting the Government's bond issues for the purpose of carrying on the war. This support was given by the Federal Reserve banks by discounting paper secured by Government obligations.

The liquidation of 1920 and 1921 caused a large scale repayment by member banks of their discounted paper and resulted in a sharp decline in the earning assets of the Federal Reserve banks. However, there was in the market a large amount of Government securities and in order to obtain enough earning assets to meet their expenses the

Federal Reserve banks began to purchase these securities. Before many weeks had elapsed it was discovered that the purchases of Government obligations by the Federal Reserve banks was having an unforeseen but none the less profound influence upon the volume and cost of credit.

Naturally, most of the purchases were made in New York City which was the principal market for Government securities. It was observed, however, that the sellers of the bonds would deposit the amount paid therefor in New York banks and the banks would put the money to their account at the New York Federal Reserve Bank and would use it to extinguish their indebtedness to such Reserve bank. The payment of the member bank's indebtedness to the Reserve bank naturally resulted in a decrease of the earning assets of such Reserve bank so that the purchase of Government securities by a Federal Reserve bank in the interior increased the earning assets of such Federal Reserve bank at the expense of the Federal Reserve Bank of New York. It was also observed that these uncoordinated purchases were upsetting the Government bond market and this was, of course, disturbing to the Treasury.

The Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities.

As a result of these observations it was decided that open-market operations of the Federal Reserve banks should be coordinated and, accordingly, a committee of five governors known as the "Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities" was appointed in May, 1922 to perform this function. The full implications of the open-market operations were not realized at this time and the purposes of this Committee were somewhat narrow and limited, one of the purposes being to see that purchases did not unduly upset the Government bond market. This Committee functioned for about a year and during that time it was clearly observed that purchases of Government securities resulted in decreased discounts and in no increase in the total earning assets of the Federal Reserve banks taken collectively. As a consequence, the Conference of Governors of the Federal Reserve banks decided that "investment policy should give minor consideration to the question of earnings and constant consideration to the effects which open-market operations have upon the condition and the course of the money market and the volume of credit".

The Open Market Investment Committee.

On April 7, 1923, the Federal Reserve Board advised the Governors of the Federal Reserve banks of a resolution adopted by the Board on March 22, 1923, with respect to open-market operations by Federal Reserve banks, pointing out the necessity of the coordination of such operations of the Federal Reserve banks with their discount operations and their general credit policy. It also announced the organization of the "Open Market Investment Committee" which superseded the former Committee. From this time on, open-market operations were not engaged in by the Federal Reserve banks except with the approval of the Federal Reserve Board. The Open Market Investment Committee functioned from 1923 to 1930 at which time it was decided that, since open-market operations were of great importance to all of the Federal Reserve banks and to the entire country, the Committee in charge of such operations should be composed of representatives of all of the Reserve banks instead of the Governors of only five of the banks.

The Open Market Policy Conference.

On March 31, 1930, the Federal Reserve Board announced that as a result of a meeting attended by representatives of the twelve Federal Reserve banks, the Open Market Investment Committee would be discontinued and a new Committee, voluntary in character, to be known as the "Open Market Policy Conference", would be set up in its place. The functions of the new Committee were to consider, develop and recommend policies and plans regarding open-market operations with the view of accommodating commerce and business and with regard to the bearing of such operations upon the credit situation.

The Federal Open Market Committee

The present "Federal Open Market Committee" was created on June 16, 1933 by the Banking Act of 1933 and consists of one representative from each Federal Reserve bank selected by the board of directors of the bank. Strange as it may seem, however, the section establishing the Committee does not provide for any function to be performed by it. In some respects, it appears that the Committee was modeled after the Open Market Policy Conference. For instance, paragraph (c) of section 12A of the Federal Reserve Act, which is the section establishing the Federal Open Market Committee, is almost identical with paragraph (5) of the Statement of Open Market Procedure dated March 25, 1930, which announced the establishment of the Open Market Policy Conference.

An examination of the earlier drafts of the Banking Act of 1933 discloses that paragraph (b) of section 12A of the Federal Reserve Act at one time contained a provision outlining the functions of the Federal Open Market Committee in language similar to that used in paragraph (4) of the Statement of March 25, 1930, outlining the functions of the Open Market Policy Conference. In certain early drafts of the Banking Act of 1933, paragraph (b) of section 12A read as follows:

> "(b) No Federal reserve bank shall engage in open market operations under section 14 of this Act except in accordance with resolutions adopted by the committee and approved by the Federal Reserve Board as hereinafter provided. The committee shall consider, adopt, and transmit to the several Federal reserve banks resolutions relating to the open market transactions of such banks and the relations of the Federal reserve system with foreign central or other foreign banks. Every such resolution shall be reported to the Federal Reserve Board and be subject to its approval."

Paragraph (d) of section 12A at that time read as follows:

> "(d) If any Federal reserve bank shall decide not to participate in open market operations recommended and approved as provided in paragraph (b) hereof, it shall file with the chairman of the committee within thirty days a notice of its decision, and transmit a copy thereof to the Federal Reserve Board."

Through some legislative slip-up, paragraph (b) was finally enacted in a form which omitted the statement of the functions of the Federal Open Market Committee and which provided merely that the Federal Reserve Board should adopt regulations relating to open-market transactions and that no Federal Reserve bank should engage in open-market operations except in accordance with such regulations. However, paragraph (d) was finally enacted in the same form in which it appeared in the earlier drafts and as a result it contains an incongruous reference to "open-market operations recommended and approved as provided in paragraph (b) hereof". As shown above, paragraph (b) in its final form, contains no provisions for recommendation and approval of open-market operations.

Despite the obvious confusion in section 12A of the Federal Reserve Act, the Federal Open Market Committee and the Federal Reserve Board have attempted to make the provision workable. In the Federal Reserve Board's Regulation M, the section has been interpreted as giving to the Federal Open Market Committee the authority to initiate open-market operations subject to the approval or disapproval of the Federal Reserve Board. When a particular open-market operation has been initiated by the Committee and approved by the Board, any Federal Reserve bank may then decide whether or not it wishes to participate in such operation. Thus the power to block any open-market operation rests in the Committee, the Board, or in the Federal Reserve banks.

Proposed Legislation.

In this situation, section 205 of H.R. 7617, the proposed Banking Act of 1935, provides that the open-market operations of the Federal Reserve System shall be under the control of the Federal Reserve Board. The proposed section also provides for an Open Market Advisory Committee to consist of five representatives of the Federal Reserve banks and requires the Federal Reserve Board to consult such Committee before making any changes in open-market policy.