February 23, 1935.

COMMENTS ON TITLE II OF THE BANKING ACT OF 1935

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Some observations on the theory behind the proposals that (a) the appointment of Governors of reserve banks be subject to approval of the Federal Reserve Board; (b) the Federal Reserve Board be given greater powers over open market operations; (c) the term of membership of the Governor on the Federal Reserve Board shall correspond with the time he is Governor.

1. Control vs. laissez faire.

There can be, I think, little room for argument on this point. There are no longer any automatic rules on which we can rely. The automatic gold standard had ceased to exist in this country even before 1929, and with the events that have occurred since that date it is highly improbable that any central bank will adopt as its criterion of policy the maintenance of a constant reserve ratio. There is no automatic guide to policy which will work satisfactorily, for the reason that we are never confronted with the same business situation twice. Booms and depressions, once started, tend to be self-generating for a considerable period rather than self-corrective. The action of the banking system left to itself tends to intensify upswings and downswings, rather than to modify them. I think the incompatability of laissez faire in banking and business stability was sufficiently stressed in the Governor's Columbus speech. If, therefore, we are agreed on the necessity of control, the next issue becomes:

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2. Centralized vs. decentralized control.

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Decentralized control is almost a contradiction in terms. The more decentralzation 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 administrative 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.

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One of the most unfortunate consequences of the diffusion of authority has been that it has detracted from the prestige of the Federal Reserve Board, and the attractiveness of a position on that Board.

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

3. Government vs. private control.

A. Arguments for an autonomous monetary authority.

On the one side there are those who would like to see the monetary authority absolutely autonomous, and completely divorced from "politics". 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. 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

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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.

B. Arguments for a monetary authority responsible to the Administration.

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 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 control of Congress.

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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, therefore, 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 country, it is possible to generalize that there has never been a numerically significant "cheap money" party except in periods of falling prices. This is brought out in the accompanying chart which shows the correlation between falling prices and cheap money movements. When

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the secular trend of prices turned upward, "cheap money" movements quickly lost their popular appeal. In their place there arose wide-spread 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. 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

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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.

4. How the dangers of a governmentally-appointed board may be avoided or lessened.

There is a possibility that with the growing awareness of the economic power of the Federal Reserve Board the Board may at sometime in the future be subject to pressure to pursue an expansionist policy prior to a national election, not because such a policy appears to be called for on general grounds, but because it is expected to aid in the re-election of the Administration. There are various factors and considerations which will lessen the possibility that this undesirable type of political pressure will actually occur:

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1. In the first place it is interesting to observe that the people who advance this argument are the very ones who ordinarily deny that monetary policy can influence business conditions significantly. Even those who believe that the monetary system can be operated so as to promote business stability rarely maintain that the degree of control is so precise that business conditions respond immediately to banking policy. It is very doubtful if normal banking policy has any perceptible effect on business in a period of less than a year. The lack of precision of control would render it difficult to manipulate policy for political purposes.

2. Personally, I think that the best safeguard against determination of policy on political grounds is 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 on the Federal Reserve Board, with general recognition of the importance and significance of its policies, 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

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pursue policies on political grounds. In fact, the danger may very well be 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. The recent action of the Board in postponing the order lowering interest rates on time deposits until after the December financing was out of the way was significant in this regard.

3. The new qualifications for members will, I think, 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.

4. The new salary and pension provisions will likewise contribute to the independence of the Board, since they will remove in large part the financial dependence of members by eliminating the pressing need for reappointment.

5. I think the independence of the Board from undesirable political pressure would be greatly increased if Congress laid down more specific objectives of monetary policy. The objectives in the present Act are vague to the point of meaninglessness. The consequence of this lack of specific objectives is that the Board not only formulates policies but it also in effect <u>determines objectives.</u> Since the determination of objectives is really a governmental or political function,

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the Board's action will be the object of controversy and political discussion so long as it exercises these functions. If the objectives were laid down by Congress, the Federal Reserve Board could become a technical board concerned with the technical ways and means of achieving those objectives. 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 or stable prices can be obtained solely through monetary policy.

The great advantage of having objectives determined by Congress is that Board members could thus be judged by their technical competence, their party affiliation would no longer be important from the point of view of monetary policy. The President of the Swedish Riksbank, Mr. Rooth, is a Conservative, and yet he is serving at the pleasure of thedominant political party, which is Labor. This can be attributed in part to the fact that Mr. Rooth is careful not to assume legislative functions. When Sweden went off gold he immediately asked Parliament for instructions. He makes recommendations but does not presume to determine objectives.

Similarly, the fairly specific objectives laid down in the new Canada Bank Act should do much to safeguard the Board from undesirable political pressure.

I realize, of course, that our bill does not mention objectives but I am certain that they will be proposed in Congress. I feel strongly that Board Members should accept and welcome the objective of business stability. I suggest meeting the demand for price stability with something similar to the objectives in the Bank of Canada Act, which follow:

"Whereas it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion:"

I am devoting considerable space to the political question as I think this will be the main line of attack. So far I have been defending a governmentally-appointed controlling board. I think we could also strengthen our position by taking the offensive and considering the alternatives.

Most of the alternative proposals involve in some degree banker representation and banker control. The theory back of such proposals is that the duties and operations of Federal Reserve banks are similar to those of commercial banks. Nothing could be further from the truth. The major task of a commercial banker is to make safe,liquid and profitable loans. This plays almost no role in the central banker's duties. A central banker <u>must</u> be a theorist

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whether he likes the term or not. When he is formulating national monetary policies most of his thinking, if it is any good, must be highly abstract. He is dealing with the interrelationships of many economic variables, and there is almost nothing in his own practical experience which will aid him in solving the problem of business stability. From the point of view of formulating desirable national policies previous experience as a banker is a handicap rather than a help. Bankers as a class have a bias on the side of restriction and high interest rates. A banker who lasts very long in his profession must be by nature and training conservative. He operates on a thin margin and a few bad losses may wipe out his capital. Moreover, by the very nature of his business it is difficult for him to look with favor on a policy which makes for lower interest rates. Those bankers who have made reputations as central or reserve bankers, such as Governor Strong, have done so because they acquired a new viewpoint and learned to speak and think in a different language.

A point worth making is that in many countries bankers are prohibited from serving on central banks. One might also make the analogy, though it cannot be pushed very far, of putting private utility operators upon utility regulatory bodies.

A good case can be made for the division of labor and functions under the proposed Federal Reserve administrative set-up. There are some duties with which the Reserve administration is charged which require some knowledge of banking practice and do not directly

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concern monetary policy. Such duties, such as examinations, can be handled more efficiently locally by persons who have had prior banking experience. If these duties are handled by the reserve banks, and the reserve banks do not participate in national policies, there is real point in having banker representation on their boards. Although the Federal Reserve Board is surrendering the power of appointing Chairmen, and merely reserves the veto power over the appointment of Governor, I do not think the Board is giving up any real power. The Governor has been the really influential official in most banks so that the power of appointing chairmen has not meant much in substance. If full power over national policies is given to the Board, there is no objection to leaving a considerable amount of local autonomy over local matters with the reserve banks. The veto power over appointments of Governors will obviate the danger that the execution of national policies by individual reserve bank Governors will be counter to the wishes of the Federal Reserve Board.

5. <u>Open market provisions of the Bill.</u>

I do not care particularly for the new open market provisions. I think an effort should be made to give the Board full control. It is illogical to increase the salaries and prestige of Board members and to make their qualifications ability to formulate national and economic monetary policies,

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and then deny some members of the Board an opportunity to formulate such policies. It also provides in some degree for a continuation of the diffusion of authority which is one of our big objections to the present setup. An argument that can be made for the proposed change is that it is very difficult and inadvisable to attempt to separate the functions of formulating and executing policy. It is said that in many cases the effectiveness of policy will depend upon technical factors which are known to the persons who execute policy but are less likely to be known to persons who have no direct contact with the banking system. Any policy-formulating board that is set up will gradually come to rely more and more upon the persons who actually execute policy which means in practice the executive officers of the Federal Reserve Board of New York. This, it is said, has been the history of the relationship between the Federal Reserve Board and the Federal Reserve Bank of New York. Since this situation has developed in the past and is likely to develop in the future it is argued that instead of attempting a further separation of the duties of formulating and executing policy, it would be better to seek to tie them closer together in one body. This, in effect, would require the Governor and possibly the Deputy Governor of the Federal Reserve Bank of New York to be members of the policy-formulating body.

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This line of argument merits careful consideration. There are, however, various objections that may be urged against it. In the first place it is by no means certain that the technical problems involved in the execution of policy are of such a nature as to require important modifications of the policy. It is to be expected that the Federal Reserve Board would concern itself mainly with open market operations in governments and acceptances. Having decided to buy, say, $500 million securities, the problem of execution arises. What issues should be bought, long or short? Should governments be bought or acceptances? How many should be bought per week? For the solution of such problems the officers of the Federal Reserve Bank of New York should certainly be consulted and their advice generally followed. The line between formulation and execution, however, remains clear. The board, we shall say, is interested in increasing member bank reserves or reducing member bank indebtedness by $500 million. The reserve bank should see to it that the operation is carried out with as little friction and disturbance as possible.

One of the cases sometimes cited as evidence of dependence of Washington on New York has to do with the determination of the rate and type of government security issues. But here again the line between formulation and execution is clear. The important decision is whether the Government shall finance expenditures

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by taxation or bonds. Having decided on bonds, the question of ways and means becomes more largely an executive problem on which it is quite proper that technical authorities be consulted. There is no reason why this type of cooperation should not continue in the future.

The problem of the relationship between formulation and execution of policy cannot be settled on broad grounds of theory since the closeness of the dependence of one on the other varies. Thus in government the dependence is greater than in law. In monetary policy I feel that the line between these two functions can be fairly clearly drawn. If, of course, a hopelessly incompetent board is appointed which neither knows anything about the theory of money nor about the mechanics of monetary control, it will naturally rely upon people who at least know the latter. A knowledge of the mechanics of monetary control, however, is by itself not sufficient. It is difficult for men engaged in administrative and executive duties to avoid exaggerating the importance of such duties and to get away from their work sufficiently to be able to take a broad view of the economic process. If the board is of high caliber it can make full use of the technical knowledge of the reserve bank officers without sacrificing in the slightest its own supreme policy-making functions. If the board is of mediocre caliber, of course, prospects of good monetary control are dubious. It may or it may not rely heavily in its formulation

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of policy on the executive officers. If it does, policy is likely to be influenced too largely by the financial and banking point of view. If it does not the policy is likely to be even worse. We come back again to the sine qua non of good monetary administration, - a strong and expert policy-making board in which authority and responsibility are centered.

6. Real estate provision.

There is nothing I can add here to the detailed arguments assembled by our division. I would suggest, however, that it be emphasized that this is not something new. We propose merely to extend the maturity, the amount that can be loaned on a given piece of property, and the amount of total bank funds that can be so loaned. I should stress the point that a twenty-year amortized mortgage is a sounder loan than a five-year unamortized mortgage. There is nothing in the Bill to encourage unsound loans. In fact, there is increased emphasis on soundness. There is nothing in the Bill that would permit bankers "to dump their mortgages on the Federal Reserve banks". They can use them as collateral only on which to borrow provided they are sound. There is nothing in the Bill that relieves the banker from the compulsion of making safe loans. All that eligibility requirements do is to assure bankers that if they make good loans they need not worry about liquidity.

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