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STATEMENT ON TITLE II OF THE BANKING BILL OF 1935

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FEDERAL RESERVE BOARD

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In making a statement on the proposed Banking Bill of 1935, I wish first of all to make it clear that, although I am Director of the Division of Research and Statistics of the Federal Reserve Board, my statement represents my views alone and in no way reflects the opinions of the Federal Reserve Board.

What I propose to do is to discuss the provisions of each section of Title II of the bill and to analyze somewhat their technical significance and their relationship to the experience of the Federal Reserve System. The references in my statement will be to H. R. 7617, which is the bill as passed by the House of Representatives.

Section 201 provides for the combination of the position of governor and chairman of the Federal Reserve banks. It is provided that the

governor and chairman be a Class C director and that his appointment be approved by the Federal Reserve Board every three years when his term as Class C director expires.

Combining the two principal officers in each Federal Reserve bank is clearly in the interest of administrative efficiency. Experience has demonstrated that there are a number of occasions and circumstances where the present set-up results in delay and confusion and sometimes in even more serious difficulties. As is well known, the Federal Reserve Board now appoints the chairman and the deputy chairman of the board of directors of each Federal Reserve bank. The board of directors elects the governor and the Federal Reserve Board has no official relationship to his selection, and only has authority to pass upon his salary and the power of removal for cause. While in many cases the arrangement has worked reasonably well, there are many other cases and occasions where, either through a lack of cooperation between the two officers, or for some other reason, undesirable situations have developed. The governor is the chief executive of the bank and has direct contact with the operating staff. The chairman, on the other hand, is the representative of the Federal Reserve Board through whom the Board usually communicates with the bank. Occasions may arise and actually do arise where the Board's communications to the chairman do not reach the governor promptly enough to be a guide to him in his operating policies. On the other hand, there are occasions where the governor by communicating directly with the Board leaves the chairman uninformed of situations for which he has a certain amount of responsibility. Such occurrences are almost inevitable under the present system.

It may be said also that the chairman of the board, who is supposed to represent the Federal Reserve Board, is in reality closer to the local directors over whom he presides and with whom he has to work from day to day. It is probably impossible for the Federal Reserve Board to have a man of local standing represent it in effect on any issue where the local point of view may differ from the national point of view. In the light of this experience it seems better to recognize that the local management has to be primarily local in character; that the Board needs and can have no direct representative in the bank, and that one officer, elected by the local directors, should be at the head of the bank. That this officer should be subject to approval by the Board would seem to go without saying, for otherwise the Board would have little or no say in the management of the banks.

It is not true, as has been alleged by critics, that this would greatly increase the Board's authority over the individual Reserve banks. The Board under existing law could have just as much authority if it chose to make the chairman of the board the principal officer by paying him a higher salary and prescribing that he be the chief executive. This was probably intended by the original Federal Reserve Act. It is believed, however, that it is best, in view of the fact that the office of the governor has become established and has obtained a definite status in the public mind, that it be retained and combined with that of the chairman. It is true that under the proposed law the Federal Reserve Board theoretically could control the chief executive by holding out a threat that in case he did not comply with the Board's wishes his appointment at the expiration of his term would not be renewed. But this is a situation that has always prevailed, and has always remained theoretical. The Board under existing law could have made the chairman the chief executive and actually appointed him every year,

rather than merely passing on his appointment once in three years, and could have insisted that the chairman in all cases carry out the Board's wishes or be removed. The Board has not done so, however, and there is no reason to believe that it would act differently under the proposed arrangement. The point to be kept in mind is that any board that has sufficient powers to perform its functions and to be of service must necessarily also have powers that can be abused. Protection against this must be sought in selecting for the Board the caliber of men that would not abuse the powers entrusted to them, and also in the growth of a tradition of service. Ultimately the only safeguard is an enlightened public opinion.

It has been said that under this proposal the Board will be able to select every employee of the Reserve banks. This is entirely contrary to the change which the bill proposes in existing law. Under existing law the Board has the power to select directly about 600 employees who are now carried in the Federal Reserve agents' departments, and it also has the power of approval of the salaries of all of the other employees. Under the proposed bill the Board will not have the power of selecting anyone in the Federal Reserve banks. It will merely have the power of approving or disapproving every three years a governor who has been selected by the local directors. The Board, therefore, will not be in a position to force a governor on unwilling directors. It will merely be in a position not to approve a governor or vice-governor who has been selected and is unacceptable. Outside of these two offices, the Federal Reserve Board will have no powers over the personnel of the banks other than approval of their salaries, which is in existing law and is being retained.

It would appear that this is a retention by the Board of a minimum of power that is necessary in order to discharge its supervisory and coordi-

nating responsibilities. It will not diminish local autonomy, but on the contrary will increase it, because there will be no officer in any Federal Reserve bank who has not been selected by its own board of directors.

There has been some criticism of the sentence in the proposed bill that all officers and employees of a bank shall be responsible to the governor. This sentence is unimportant and merely represents the draftman's desire to make it clear that the governor shall be the sole executive head of the bank. It does not in any way conflict with the authority of the board of directors, which is provided for in other portions of the law, which it is not proposed to repeal or modify. (See section 4 on page 7 of the 1933 edition of the Federal Reserve Act.)

Section 202 is related to a section in the Banking Act of 1933, which provides that all insured nonmember banks shall become members of the Federal Reserve System by July 1937. This provision of the act of 1933 was repealed in the House bill, but ought to be restored because it is of great importance that all insured banks be subject to Federal supervision. It is a step in the direction of unification of bank supervision which is an essential to the discharge of their responsibilities by both the Federal Deposit Insurance Corporation and the Federal Reserve System.

It has been said that the proposal in section 202 for giving the Board authority to waive requirements for admission of insured banks prior to July 1, 1937, would lower the standards of the Federal Reserve System and that it might be better to retain those standards and have the Federal Deposit Insurance Corporation bring the banks up to the standard before they are admitted. This argument disregards the fact that Federal Reserve

banks and member banks are all affected by conditions that develop in nonmember banks. An unsound banking situation affects the entire community, and since the Federal Reserve System has to stand the consequences of unsoundness in nonmember banks, it should have authority to admit all existing insured banks and gradually to bring them up to standard.

The suggestion that only insured nonmember banks with deposits of $500,000 or more be required to join the System may be a reasonable compromise, because it would bring into the Federal Reserve System more than 95 percent of all deposits of the banking system and would leave outside only such small banks as may find it difficult to earn expenses without charging for exchange, which the Federal Reserve System does not permit. This compromise would also prevent banks with $500,000 or more of deposits that are members of the System from leaving it. It would be better to have all the banks come into the System, but the compromise would be an important step in that direction and would appear to be the minimum of what ought to be required at this time.

Section 203 of the proposed bill provides that members of the Federal Reserve Board shall be persons well qualified by education or experience, or both, to participate in the formulation of national economic, and monetary policies. This is a change from the existing requirement of law which reads: "In selecting the six appointive members of the Federal Reserve Board . . . the President shall have due regard to a fair representation of the financial, agricultural, industrial and commercial interests, and geographic divisions of the country." This enumeration of

interests to be represented does not give the President any definite directions and does not appear to be the proper principle on which Board members should be selected. It would seem that they should be selected on the basis of their qualifications to perform the functions given the Board rather than on the basis of representing specified interests. The worst way to constitute a Board would be to have it constitute a group of representatives of special interests which might be at odds with each other. It is vastly better to say that Board members shall be qualified to do their work. While this is not a guarantee of the appointment of efficient Board members, it may exert an influence in that direction and may make it more difficult for a President to appoint persons without appropriate training or experience.

It has been said that under the proposed bill the President would have the power to appoint all the members of the Board from one district, but there is nothing in the bill to justify this statement. The requirement that no more than one member be from the same district is retained, with the exception only that it need not apply to the Governor of the Board. The reason for this exception is that the President ought not to be prevented from appointing as Governor a man preeminently qualified for the position, merely because some other member of the Board may be from the same district.

While it would seem that the proposed qualifications of Board members are desirable, it might be wise in addition to provide that at least two of them shall have had experience as executive officers in a Federal Reserve bank or a commercial bank. There was a provision in the original act

requiring that there be two trained bankers on the Board, but it was repealed in 1923. In view of the necessity of deciding many technical banking problems, and particularly technical Federal Reserve banking problems, it might be a useful indication to the President to say that at least two members shall have had such a background. It may also be desirable to provide that the Board members shall be qualified by education or experience to participate in the formulation of national economic, monetary and banking policies. The addition of the words "and banking" would be a recognition of the numerous duties of the Federal Reserve Board that deal with technical banking problems and of the general responsibility of the Board for using its influence toward the maintenance of sound banking conditions.

The House of Representatives in passing the bill eliminated the provision for raising the salaries of future Board members from $12,000 to $15,000 and also the provision for pensions for Board members. Both of these provisions are extremely important in the interest of obtaining the services of the best possible men for the Board. It is not possible to offer Board members salaries that would complete with what private enterprise could pay for similar positions or for men of similar caliber, but the salaries offered ought at least to be sufficient to enable the members to live in Washington in an appropriate manner and to make provision for their old age. It has been said that the Board members ought not to be removed except by impeachment. Anything that is done

in the direction of strengthening the Board's independence from partisan political control would be in the public interest and, therefore, any provision that would be in that direction would be highly desirable.

There has been a good deal of criticism of the provisions relating to the position of the Governor of the Federal Reserve Board. This criticism has been directed at provisions that exist in the present law as much as at those in the proposed bill. The President always has had the power to designate a member of the Board as Governor and to terminate this designation. In drafting the bill this power of terminating the designation has been stated more clearly. In the bill as originally introduced the President was given the power to remove the Governor not only from the Governorship, but also from membership on the Board. This has been changed in the bill as it passed the House, a change that is desirable. In the form in which the bill passed the House there is no increase of the power of the President over the Governor of the Board, and the only change in the matter is that a Governor, who resigns, upon not being redesignated as Governor, would not be obliged to stay out of the banking business for two years, but would be permitted to resume it at once. This is desirable in the interest of obtaining successful men from the banking field as Governors of the Federal Reserve Board.

In view of the outcry against the proposed increase of political domination of the Federal Reserve System, it is worth repeating that the provision about the Governor in the bill as originally introduced was the only shadow of an excuse for this criticism, and that with the elimination of this provision, which was not intended to increase political power, but could be so interpreted, there is nothing in the bill that in any way increases

the power of the Administration over the Federal Reserve Board. There is, on the other hand, a great deal that increases the Board's independence; increased salaries, increased pensions, definition of qualifications all add to the possibilities of having an independent Board. The Board is also given a definite objective, which would increase the Board's power to resist political pressure, because this pressure is likely to be exercised in a direction not consistent with the objective to be prescribed by law as a guide to Federal Reserve policy.

Section 204a provides that the Federal Reserve Board may assign to its members or representatives the performance of such of its duties as do not involve the formulation of national policies. On the face of it this is a minor provision, but it has important consequences, because it will enable the Boafd to be relieved of a large number of routine duties which do not permit it to give its entire time to the study of economic conditions and the formulation of credit policies. It is expected that this provision would help to make the Board more of a policy-making body and less of an administrative organization. It will also enable the Board to delegate duties to the Reserve banks and thus to increase their responsibility and independence in local matters.

Section 204b provides the objective towards which the powers of the Federal Reserve Board shall be used. This objective reads as follows: "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 general level of production, trade, prices, and employment, so far as may be possible within the scope of monetary action and credit administration."

The wording of this objective is not necessarily the best that can be devised. The general purpose of it, however, is clearly in line with what every other central bank does, what the more recent ones are being required to do by their charters, and what the Federal Reserve System has tried to do without legislative direction. The criticism that has been made of this objective has been entirely unjustified. There is nothing in it that will give the Board any power to limit the amount of credit to be extended to any one industry or to expand it for another industry. The authority of the Board over the loaning activities of the member banks would not be in any way affected. The objective is merely a statement of a direction by Congress that the Federal Reserve Board must do what can be done through its powers towards bringing about a sounder and more stable condition of business. The objective might be modified to read: "It shall be the duty of the Federal Reserve Board to exercise such powers as it possesses to aid in the maintenance of sound banking conditions and business stability and to mitigate by its influence injurious fluctuations in the general level of production, trade, prices, and employment, so far as may be possible within the scope of monetary action and credit administration." The purpose of this change is to eliminate some unnecessary words and to introduce into the objective the requirement that the Federal Reserve System shall work towards sound banking conditions as well as towards business stability. This has always been one of the functions of the System, and while it would be understood to continue to be one without being included in the objective, it should be stated explicitly.

Section 205 provides for giving the Federal Reserve Board full authority over open-market operations after consultation with a committee of

five governors of the Federal Reserve banks, elected by the twelve governors. This provision has been subjected to severe criticism on the ground that it increases the powers of the Board as against the powers of the Reserve banks. It is true that this proposal adds open-market operations to the instruments of monetary policy, which are now possessed by the Federal Reserve Board. This is done on the theory that the three principal instruments of monetary policy, namely, raising or lowering of the discount rate, changes in reserve requirements, and open-market operations should all be in one body that is clearly defined and that has unescapable responsibility for the policies it adopts.

There has been criticism of this provision on the ground that the Federal Reserve Board, which has no financial interest in the Reserve banks, will by this provision acquire control over their funds. This would be a good argument for having the Government buy the stock in the Federal Reserve banks. For, if a small investment of $146,000,000 with an assured 6 percent return entitles the member banks to have a dominant say in the formulation of national monetary policies, then the only rational conclusion would be inevitable that they must not be permitted to hold the stock. The necessity of Government control of the public function of regulating the volume and cost of money should be beyond dispute. Another variant of this argument against the concentration of authority over open-market operations in the Federal Reserve Board is that the Federal Reserve banks obtain their available funds from member banks, and that, consequently, the boards of directors, which represent the member banks, should have the power to determine the manner in which these funds are to be employed. This contention would run counter to any attempt to entrust the determination of monetary policy to a public body; it would carry its proponents far beyond the proposals

in the new bill, into the heart of the present Federal Reserve Act itself, which, among other things, authorizes the Board to order one Reserve bank to rediscount the paper of another. The argument, furthermore, is based on a wrong assumption, since the Reserve banks do not obtain their funds from the member banks, except to the extent that these funds arise from the deposit of imported gold. The funds of the Reserve banks, or rather their ability to lend and invest, is not obtained from any source, but arises from the power given them by Congress to issue notes and create deposits. It is a power bestowed upon the Reserve banks by the Government, and it is fitting that its exercise be under control by a governmental body.

At the time the Federal Reserve Act was enacted, the conception of money was largely limited to currency, and over currency the Federal Reserve Board was given complete control. This conception has since had to be expanded to include bank deposits as money, and the Board's power to regulate the volume of deposits is in harmony with its power over currency issues. The fact is that it was intended in 1933 to give the Board this power, but in the course of legislation the section dealing with this matter was distorted and there was created what appears to be an impossible situation. Open-market policies can be initiated only by the governors on the Open Market Committee. The Federal Reserve Board has the power to approve or disapprove of policies adopted by the governors, but policies recommended by the governors and approved by the Board may still be nullified by refusal of the directors of the Reserve banks to participate in their execution. In a matter which is of vital national importance and in which timeliness and speed

may be decisive, it is obviously undesirable to have a complicated machinery calculated to bring about obstruction and delay, rather than to have a clear-cut fixation of responsibility on a national body appointed for that purpose.

There has been criticism on the ground that this bill would give the Board the right to authorize or even compel the Reserve banks to buy obligations directly from the United States Government. This is another line of criticism that is not in any way related to the bill. There is nothing in the bill that changes the situation in this respect. The power to buy directly from the Government now exists; it has been used regularly on quarter dates, but only for relatively short periods. There is nothing in the proposed bill that would change the legal situation in this respect. If the critics wish to prohibit direct borrowing by the Government, they should offer an amendment to the Federal Reserve Act to that effect.

Section 206 relates to eligibility of paper for discount at the Reserve banks. In place of elaborately defined and restrictive rules about the character and maturity of paper eligible for discount, the bill proposes to give full power to the Reserve Board to prescribe by regulation the kind of commercial, agricultural, and industrial paper that will be eligible for rediscount by a member bank with the Reserve banks and to authorize a Reserve bank, subject to the Board's regulations, to make advances to any member bank on a promissory note secured by any sound asset of such member bank.

It is not correct to say, as has been said, that the Board, under the Federal Reserve Act, has almost unlimited power to define eligible paper. The only kind of paper made eligible by the law is paper drawn for agricultural, industrial, or commercial purposes. When paper drawn for these purposes is limited in maturity to 90 days for commercial paper and to 9 months for agricultural paper, it is limited rigidly to loans for current productive operations. The law excludes, not only investment paper, but also all long-time consumer paper and all paper arising out of the purchase of capital equipment.

The proposed change in eligibility in some respects represents the greatest departure in the bill from the conceptions that prevailed at the time that the Federal Reserve Act was adopted. The theory of the Federal Reserve Act is that the Federal Reserve banks by concentrating the reserves of member banks will be in a position to lend to member banks for seasonal or emergency purposes and thereby prevent periodic stringencies at crop-moving seasons and at other times, which have been the cause of much trouble in our banking system. With this limited conception of the functions of the Federal Reserve System, it was natural that the kind of paper that the Federal Reserve banks should hold was hedged in by rigid regulations. It was felt that strict limitation of eligibility would (1) protect the assets of the Reserve banks; (2) limit the access to the Reserve banks; and (3) encourage the member banks to have a larger supply of strictly commercial assets, rather than to venture into longer-time enterprises, and particularly into speculation. One of the objects of the Federal Reserve System was to prevent the use of member bank reserves in the New York money market, which was one of the causes of difficulties in earlier days. Out of this conception came the requirement that assets should be self-liquidating, which means that they should arise out of commercial transactions, and the means of repayment

should be the outcome of the consummation of the transaction for which the loans were made.

In the light of experience, it is clear that the functions of the Federal Reserve banks must be much broader than merely helping out banks in emergencies. It has also become clear that access to the Reserve banks is not limited even by strict limitations, because there never has been a time when there has not been more eligible paper in the member banks in the aggregate than was needed to meet all the requirements for rediscount, to say nothing of the fact that the eligibility of paper secured by Government obligations has still further expanded the channels of entry into the Federal Reserve banks. Limitation of the access to the Reserve banks through eligibility requirements, furthermore, is a fallacious principle. At times when credit expansion is active and restriction may be desirable, limitation through eligibility is ineffective, because at such times there is ample eligible paper available practically to all banks. On the other hand, at a time of rapid credit contraction, like the one that took place between 1930 and 1932, the amount of eligible paper becomes more limited and many banks, after having been subject to drains, no longer hold eligible paper. This results in preventing the Reserve banks from coming to the aid of member banks which may have sound assets, but no assets eligible for discount. The situation in this respect became so acute, that in February 1932 it became necessary to pass the Glass-Steagall Act, which belatedly relaxed the limitations and made it possible for the Federal Reserve System to help out in many situations.

The other object of eligibility, namely, to protect the assets of the Reserve banks, is one that cannot be attained by strict technicalities. So-called eligible paper is frequently as bad as, or worse than, long-time

paper. It is much safer to leave this matter to the credit judgement of the Reserve banks and the regulations of the Board, so that adjustments may be made in response to changes in economic and business conditions. The assets of the Reserve banks will be safer if the simple injunction is placed upon them that they must acquire only sound assets, than if they are more or less relieved of that necessity in the eyes of the law if only they abide by the strict rules prescribed in the statute. For these reasons, there is not much in the argument that eligibility affords protection to the assets of the Reserve banks.

The argument for strict eligibility rules as an encouragement for banks to have commercial assets has more substance than the other reasons for eligibility, but it is impracticable. Since eligible paper constitutes only 8 or 10 percent of the banks' assets, it is clear that the strict definition of eligibility has not been effective in keeping the banks in the straight and narrow path of commercial activity. Our banking system represents a combination of commercial banking with savings banking. Whether or not these two functions ought to be separated, it is impossible to say, but many believe that they should. Certain it is that that cannot be done overnight. So long as the member banks hold $10,000,000,000 of time deposits, it is necessary in the interest of continued economic activity that they contribute to the capital formation of the nation by investing those funds in capital assets. Encouragement of banks to make commercial loans will make no practical difference in this respect. In the particular situation that now prevails, it is more important to encourage

the banks to serve their communities' needs, both for long and short-time credit. If the banks do not do that, then other agencies or the Government will, because the needs of the communities must be met. Many Government lending agencies have been performing services that the banks could have performed, and at this time a quixotic fight for a pure state of liquidity is not only futile but harmful.

It has been alleged that the availability of all kinds of assets for discount at the Reserve banks would encourage member banks to make unsound long-time investments, and that this is the disease which brought the banking system low in 1930-1932. Perhaps the most sincere and convinced criticism of the proposed bill has been on this general ground. Fundamentally, however, this is not a realistic approach. The judgement of those who maintain this position appears to be guided by the fact that in many cases banks that failed had been mismanaged and had indulged in unsound lending practices. It is beyond dispute that many such cases have occurred. It is also beyond question that better banking supervision through unification under Federal control of banks, of supervision, and of chartering should help to prevent the recurrence of bad practices at the banks. The power of the Board to remove officers and directors of member banks should work in the same direction and many other powers given to the Board in the Banking Act of 1933 and in the Securities Exchange Act of 1934 should contribute to the solution of this problem. It is through these channels that the influence of the Federal Reserve banks towards the maintenance of sound practices in the member banks should be exerted. Eligibility is neither an adequate nor an effective means of control.

It should be kept in mind that in an economic system like ours, where nine-tenths of the money is in the form of bank deposits, bank assets back of demand deposits are the counterpart of the nation's current funds. In such an economy a drop in the national income to less than one-half of its normal level inevitably must result in the destruction of a considerable part of the value of bank assets, and since the banks' liabilities to depositors remain intact, the total value of the assets will no longer equal the total of deposit liabilities. With full recognition of the fact that much of the banking trouble came through mismanagement and speculation, it is nevertheless certain that the major part of the catastrophe, particularly after 1929, was not due to mismanagement alone, and in many banks was not due to mismanagement at all, but represented the effect on the banks of a collapse of national income. Against mismanagement the fight should be along the line of more careful chartering, better supervision, and administrative correction of unsound situations. Against losses in value of bank assets arising from the collapse of national income, the fight should be for the maintenance of economic stability.

In theory neither the depositors nor the banks should suffer from losses caused by a national collapse, since it is brought about by forces beyond their control. Economic stability should be the objective. With this objective achieved, bank failures from that source should not recur. It is too much to hope, however, with any degree of certainty, that this can be achieved in the predictable future. Until such time as this is achieved, the banks should be protected from this cause of mortality, both by a guaranty of deposits and by the readiness of the central bank to liquefy sound assets

when there is no market for them in a period of deflation. Assurance to the bank depositors that they will suffer no losses so long as banks are soundly managed will prevent the recurrence of withdrawals of deposits such as swept over the country in the years 1931 and 1932. There might still be losses of deposits, owing to unfavorable balances of payment in individual localities, but mass withdrawals followed by mass bank failures should not be allowed to recur.

This is not a radical doctrine -- it is essentially what was done in countries that are often mentioned as protecting commercial banks against unliquid assets and as a consequence having stood the depression without bank failures. The countries particularly mentioned are England and Canada. It may be said with assurance that the banks of Canada and the banks of Great Britain at the low point of the depression were insolvent in the sense that if their assets had to be sold the proceeds would not have been sufficient to meet the liabilities. But the assets did not have to be sold, because depositors did not withdraw their deposits, and that in turn was because the depositors knew that the banks would not be permitted to fail. With all the banking concentrated in the hands of a small number of large branch banking institutions, it was general knowledge that the banks would be protected by the Government in case of an emergency. And so the deposits remained intact and as prosperity returns the solvency of the banks will be restored.

This is not a doctrine of encouraging banks to be conducted on an unsound basis. It is a plea for the recognition of the necessity that assets back of the nation's current funds be protected by the maintenance

of economic stability, and that to the extent that endeavors in that direction fail the banks must be carried over the abyss of economic depression by positive underwriting of their solvency by the central bank or the government.

Eligibility of paper for advances at the Federal Reserve banks determined by regulation of the Federal Reserve Board is a step in the direction of having our central banking institution do its share in carrying the consequencies of national economic mismanagement. A timely policy along this line, boldly pursued, should do much to prevent the extreme deflation which occurred in this country and in which the collapse of the banking system was an important contributory factor.

The question naturally arises why it is that, notwithstanding the depression, many banks have survived. Does that not mean that prudent management could put the banks in a position to weather the storm? The answer to this would seem to be that in part there enters into this situation an element of luck. There never has been a battle in which all of the participants were killed, and if some survived that does not necessarily mean that they were the bravest or the strongest. They might have been the ones whom the fire of the enemy happened to miss. It may not all be a matter of luck. As said before, management is a part of the picture, but it may also be that in many of the cases the banks that have survived are banks that happened to have had their funds in an industry that escaped the worst phases of the depression. In another group of cases the banks that have weathered the storm are banks that had failed to do their duty in serving their communities when the skies were clear. It is certain that a bank which conducts its business in good times on a basis that would enable

it to meet all its liabilities on demand at the depth of a depression is a bank that is not adequately serving the needs of its community. For in times of depression nothing is liquid, except open-market short-time paper, and a time comes when even that cannot be realized upon, except at a heavy loss. The survival of some banks, therefore, is not proof that all the banks that failed did so because of mismanagement.

Section 207 provides that obligations which are fully guaranteed by the United States as to principal and interest shall be eligible for purchase by the Federal Reserve banks on the same basis as direct obligations of the United States Government. This is a minor provision which eliminates the unnecessary distinction between direct and guaranteed obligations of the Government.

Section 208 deals with the question of collateral against Federal Reserve notes. It follows the example of practically all central banks, except the Bank of England, in providing that all the assets of the Federal Reserve banks shall be the collateral back of all its liabilities and that the privileged position of the note liability as against the deposit liability shall be eliminated. The segregation of collateral against notes has not served a useful purpose and so far as one can predict never will, because it becomes restrictive only at a time when restriction is harmful and does not restrict at a time when restriction may be desirable. It has, therefore, a perverse restrictive effect. The reason for that is that at a time when credit expansion is proceeding at a rapid rate there is plenty of commercial paper available as collateral, because the banks are borrowing heavily from the Reserve banks. Therefore, collateral requirements do not restrict. At a time, however, when the Reserve banks are pursuing a liberal policy of purchases in the open market, in order to prevent deflation, as was the case in 1931, a point is soon reached when there

is a shortage of collateral and gold has to be impounded back of Federal Reserve notes, and then the technical restrictions on the Reserve banks aggravate the deflationary process. This is exactly what had happened prior to February 1932, when the Congress had to adopt the Glass-Steagall Act which permitted temporarily the use of Government securities as collateral against Federal Reserve notes.

Collateral requirements against Federal Reserve notes should be abolished. It it is the wish of Congress to restrict the amount of Government securities that Federal Reserve banks may purchase, that should be done directly, as is done in some of the foreign central banks. To aim at it through indirection by requiring commercial collateral or gold against Federal Reserve notes works at the wrong time and in the wrong circumstances. It does not protect the Reserve bank against excessive holdings of Government securities, and does prevent them from doing their share in fighting a deflationary movement.

Section 209 clarifies the power of the Reserve Board to raise or lower reserve requirements of member banks. This power was granted to the Reserve banks under the Thomas amendment to the Agricultural Adjustment Act of 1933, but under the provisions of that act the Reserve banks can change reserve requirements only whem the President proclaims an emergency and gives his approval to the action. To proclaim an emergency in banking, as Mr. Owen D. Young said the other day, is to bring about an emergency. It should not be necessary to proclaim one. It also is undesirable to have the President have the responsibility for this matter. It is, therefore, best to give the Board the necessary authority and to make

it as elastic as possible by permitting changes in reserve requirements in financial centers alone when a speculative situation may develop there without having developed in the country districts.

Fantastic interpretations of the reserve requirement provision have been made by opponents. Some believe that this is a move to establish a 100 percent reserve plan without direct authorization by Congress. A 100 percent reserve plan is an absolute impossibility without a very large amount of readjustment in many lines of banking legislation and the danger of it being introduced surreptitiously by this provision is purely imaginary. Limitations on the extent to which the Reserve Board could raise or lower reserve requirements may be devised and have been proposed. It would be better to have no such limitations, however, because in the face of the enormous possibilities of expansion on the basis of existing excess reserves and potential additions to them, the amount by which reserve requirements may have to be raised to combat inflation is hard to predict. It is best to leave the matter flexible in the hands of the Federal Reserve Board.

There has also been the theory expressed that through this method of increasing reserves the Reserve Board may acquire the power to prescribe to member banks how to invest their deposits. This statement is based on a complete misunderstanding of our financial mechanism. Take, for example, the present situation. The member banks have about $2,400,000,000 of excess reserves. If the Federal Reserve Board should decide that reserve requirements be increased by that amount, then these reserves instead of being excess reserves would become required reserves. This would in no way change the Reserve banks' ability to discount paper or to purchase

Government securities. The thought that by increasing reserve requirements the Reserve banks could in some way get control of member bank funds and dictate the uses to which they could be put is not in accordance with the workings of our banking system.

The proposals in section 210 about real estate loans are in the nature not only of liberalization, but also of increased flexibility, by permitting the Federal Reserve Board to prescribe rules and regulations under which real estate loans may be made. This proposal is in line with the proper functioning of our banking system as discussed in some detail under section 206. The real estate provisions of this bill appear to be clearly in the right direction and would serve the public good. More specifically they might contribute to revival in the building industry, which at this time is a fundamental requisite of recovery.