THE BANKING BILL OF 1935

by

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On May 9, the House of Representatives by a vote of 271 to 110 passed the Banking Bill of 1935. It is now under consideration by a subcommittee of the Senate Committee on Banking and Currency. The scope and purpose of the provisions of Title II which deal with the Federal Reserve System have been the subject of wide discussion in Congress and outside, much of which has done more to confuse than to clarify the nature of the proposals. In this article I shall analyze briefly the proposed changes in the Federal Reserve System, referring to the text of the bill as originally introduced with such modifications as I recommended during the course of my testimony before Congressional Committees.

Bill the outcome of experience

Changes in the Federal Reserve System which are proposed in Title II of the Banking Bill of 1935 arise out of the experience of the past twenty years, and particularly of the experience during the depression. Their general objective is to improve the administrative machinery of the Federal Reserve System, to determine more clearly the distribution of authority and responsibility between the Federal Reserve Board and the Reserve banks, and to eliminate unnecessary restrictions on the Reserve banks and the member banks that have proved to be ineffective in preventing disaster and are hampering economic recovery.

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These changes are important and urgent. They do not, however, alter the fundamental character of the System as established by the original Federal Reserve Act nor the principle underlying the distribution of responsibility between the Federal Reserve Board and the regional banks.

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Administrative changes

Several sections of the bill propose improvements in administrative organization. Section 201 would combine the offices of governor and chairman of the Federal Reserve banks; the appointment to the combined office would be approved by the Board and the governor and chairman would be a director of the bank. This change would carry out the intention of the original act that the Federal Reserve Board be a party to the selection of the active head of the Reserve banks. Combining the offices of governor and chairman would unify the administrative organization of the Federal Reserve banks and promote smoother cooperation between the Board and the banks. Section 204 would permit the Federal Reserve Board to assign duties to members of the Board or to its representatives. This would relieve the Board of administrative details and give it more time for the study of policy matters.

These organization changes would not diminish the authority of the Reserve banks but would rather clarify and increase their responsibility in matters of local concern. The regional character of the System as established in the 1913 act was based on the principle that responsibility for policies of national scope and purpose shall be lodged in the

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Federal Reserve Board and that actual banking operations and all activities or policies of local concern shall be entrusted to individual Reserve banks, subject to the necessary degree of coordination.

Increase of local autonomy

There are several ways in which the proposed bill would strengthen the regional autonomy of the Reserve banks. At present the Federal Reserve Board appoints three directors of each Federal Reserve bank, the so-called Class C directors, one of whom is designated by the Board as chairman. Under this bill the Board would appoint at the most two and possibly only one director. The governor, who would be a Class C director, and the vice-governor, who might also be a Class C director, would be appointed by the local directors, subject only to the Federal Reserve Board's approval. At the present time the Reserve agent, who is also chairman of the board of directors, is by law the Board's representative at the Reserve bank, and maintains an office of the Board on the premises of the Reserve bank. Not only is he himself directly appointed by the Board, but the appointment of his entire staff, including bank relations and economic services, is subject to approval by the Board. Under the proposed bill the agent's department would be abolished and its functions and personnel brought directly under the governors of the Reserve banks. The power of the Federal Reserve Board to assign duties to its representatives would also enable the Board to authorize Reserve banks to handle many administrative matters, which under present law must be passed upon by the Federal Reserve Board. The proposed change in eligibility requirements for discount and the proposed elimination of the collateral requirements for Federal Reserve notes would likewise increase local discretion and autonomy in dealing

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with member banks.

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National control of open-market operations

The proposed change in the control of open-market operations would clearly define and centralize responsibility for this function. This is one of the most important provisions of the bill.

Open-market operations as a means of credit control in this country are a post-war development. They were not regarded as a major instrument of policy when the original Federal Reserve Act was passed. From small informal beginnings, whose significance was not fully appreciated, open-market operations have gradually come to be recognized as the principal instrument of credit control. At first open-market operations of the individual Reserve banks were designed merely to supplement the earnings of these banks in periods when the volume of discounts was low; then, as their effect on bank reserves and on member bank operations was realized, they were conducted at first by a committee appointed by the Reserve bank governors, and later by the same committee after approval by the Federal Reserve Board.

Under a provision of the Banking Act of 1933, open-market policies at present are formulated by the Federal Open Market Committee, which consists of the governors of the twelve Federal Reserve banks. The recommendations of the committee are subject to approval by the Federal Reserve Board. The board of directors of each Federal Reserve bank retains the authority to refuse participation in the policies adopted. It would be difficult to conceive of an arrangement better calculated than this for diffusing responsibility.

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Local, or regional, control of open-market policies is, in fact, impossible because their effects are nation-wide. Consequently, it is necessary to place definite responsibility for this instrument of policy in a national body with a national viewpoint. The only question is where the national control shall be. I believe that it should be vested in the Federal Reserve Board, which has the responsibility for other instruments of monetary policy through determination of discount rates and changes in reserve requirements.

My recommendation, which has been adopted by the House, is to vest in the Federal Reserve Board full power and responsibility to initiate, adopt and enforce open-market policies for the Federal Reserve System, after consulting with an advisory committee consisting of five representatives of the Federal Reserve banks selected annually by the governors of the twelve Reserve banks. The Board should be required to consult this committee before adopting an open-market policy, a change in discount rates, or a change in member bank reserve requirements.

Such a provision would eliminate conflicts of jurisdiction and policy and at the same time would preserve the participation of Federal Reserve bank governors in the formulation of open-market policies. Open-market operations might be initiated by either the committee of the governors or by the Board, but the ultimate responsibility for making a final decision and the power to adopt and carry out national policies would be centralized in one body, as they should be.

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Soundness versus liquidity

Changes proposed in provisions for eligibility for discount and for collateral for note issues are the result primarily of our experience during the depression.

Section 206 would give the Federal Reserve banks authority under regulations by the Federal Reserve Board to make advances to member banks on any sound asset. The criterion for eligibility would be soundness rather than liquidity. The eligibility provisions of the original act were based on the theory that bank assets should be self-liquidating, in other words that member banks should be engaged primarily in commercial banking. It was hoped that through the operation of these provisions banking would develop along more purely commercial lines. These hopes have not been realized. The banking system today could not operate profitably on self-liquidating loans when only $2,000,000,000 of such paper is available. And yet banks may feel hesitant about making loans on sound but ineligible assets because under the present rigid requirements they would not be able in case of need to liquefy these assets at the Federal Reserve banks.

If the Reserve banks are to give genuine assistance to member banks, they must serve in an emergency as an agency for liquefying all sound assets. During the depression many banks were forced into bankruptcy not because their assets were bad but because they could not meet the narrow and essentially unrealistic eligibility requirements, and it became necessary, by the Glass-Steagall Act of February 1932, to pass emergency legislation permitting the member banks to

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It is not a new idea first proposed in this legislation or in the emergency legislation of 1932 to permit borrowing from Reserve banks on the basis of assets other than eligible paper. The earlier drafts of the original Federal Reserve Act and the bill as it was introduced in both the House and the Senate included a provision to permit Federal Reserve banks under certain conditions "to discount the direct obligations of member banks secured by the pledge and deposit of satisfactory securities."

No segregation of assets back of Federal Reserve notes

Section 208 would eliminate the collateral requirements for Federal Reserve notes and would thus do away with unnecessary, cumbersome, and expensive machinery, which has caused serious difficulties at critical times.

The requirement for segregation of collateral against Federal Reserve notes adds nothing to the quality of the notes, which are a prior lien on the assets of the issuing Reserve banks, and an obligation of the United States Government.

While these collateral requirements do not protect the Federal Reserve notes, they have interfered with the functioning of the Federal Reserve System by preventing the adoption of an easing policy during a period of deflation. Such a situation developed in the early months of 1932. The System was purchasing Government securities in order to help member banks reduce their indebtedness, and, as a consequence, the Reserve banks did not have an adequate amount of discounts, which ~~are~~ were

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the only paper available as collateral for Federal Reserve notes. As a consequence, it was necessary to impound a large amount of gold as collateral against the notes over and above the 40 percent reserve requirement. With gold reserves thus impounded, the Federal Reserve banks were unable to carry out the policy of open-market purchases which was necessary to arrest the process of deflation, and to meet the emergency, Congress passed the Glass-Steagall Act which authorized the use of Government securities as collateral for notes. The proposal in the bill would eliminate the possibility of a recurrence of such a situation.

More liberal real estate loans

The only provision of the bill directly affecting the lending activities of member banks is section 210, which liberalizes the provisions for real estate loans. This section in the bill as introduced would provide for an increase in the total volume of such loans that a bank may make, for amortized loans with longer maturity and for an increase in the proportion of the value of the real estate that banks may lend. In view of the fact that these fixed requirements do not take account of the widely different conditions affecting the soundness of real estate loans at different times and in different parts of the country, I have recommended that this provision be changed to give the Board power to regulate real estate loans, subject to the limitations that new loans shall not exceed 60 percent of the appraised value of the real estate.

Criticism of more liberal provisions for real estate loans has come largely from those who believe in the separation of savings banking from commercial banking and overlooks the fact that we have thousands of small banks that cannot operate profitably on the basis of their demand deposits alone. Member banks have 10 billion dollars of time deposits which represent the people's savings. So long as they have time deposits, they of necessity must participate in financing long-term undertakings that will yield enough to pay for doing the business. The law places no limits on what the banks may do in the purchase of bonds or of other long-time paper; there is no reason for singling out real estate loans for special restrictions.

It is hoped that liberalization of the real estate loan provisions, combined with the broadened eligibility requirements for borrowing at the Federal Reserve banks, will encourage activity in the construction industry, which is essential to recovery.

Public--not political control

The most widespread criticism of the banking bill has come from those who see in it an attempt to subordinate the Federal Reserve System and, through it, the country's banking system, to political control. On this subject there appears to be much misinterpretation of what the bill provides, coupled with a lack of clear understanding of existing law and of the proper relationship between the Federal Reserve System and the Government. There is nothing in this bill that would increase the powers of a political administration over the Federal Reserve Board.

That matters of national credit and monetary policy should be under public control--and this is the guiding principle of the proposed legislation--has been recognized since the System was first proposed. The statement by President Wilson before the Congress in joint session on June 23, 1913 is decisive on this point. On that occasion President Wilson said: "The control of the system of banking and of issue which our new laws are to set up must be public, not private; must be vested in the Government itself, so that the banks may be the instruments, not the masters, of business and of individual enterprise and initiative."

Apprehension can be expressed only against the dominance in the Federal Reserve System of political, and particularly of partisan, control as distinguished from public control. On this point I wish to emphasize that the bill, far from proposing an increase in the powers of a political administration over the Federal Reserve System, contains provisions intended to increase the dignity and independence of the Federal Reserve Board. The bill provides that members of the Board shall be well qualified by education or experience, or both, to participate in the formulation of national economic and monetary policies. Although the requirement of such qualifications cannot insure that only qualified men will be appointed to the Federal Reserve Board, it is a step in the direction of strengthening the tradition that members of the Federal Reserve Board must be qualified to carry the responsibilities which their duties entail. The bill as introduced also provides for more adequate compensation for Board members and for pensions when they retire. These provisions would further add to the independence of Board members.

There is in the bill a much misunderstood provision which was introduced for the purpose of making the position of Governor of the Federal

Reserve Board more attractive to competent men with banking experience. This provision states that when the Governor is no longer designated as Governor by the President, he shall no longer be a member of the Federal Reserve Board and shall be considered to have served out his term. This would make it possible for a Governor, if he be drawn from the banking field, to reenter the banking business without having to wait for two years when he is no longer designated as Governor.

There has been a great deal of discussion about the fact that this makes the Board a more political Board. In practice, however, no man would stay on the Board if the President of the United States wished to appoint someone else in his place. Under existing law the President designates one of the appointive members as Governor of the Board and this has been consistently interpreted to mean that the Governor serves as such at the pleasure of the President.

In the bill as passed by the House this provision has been modified so that the Governor could retain his position on the Board, if he were not redesignated, but if he resigned within ninety days, he would be permitted to resume his banking connection without a two years' delay.

In the final analysis freedom of the Reserve System from undesirable political influence must depend on the prestige of the Federal Reserve Board, on the proper appreciation by the public of the functions of the System, and on public opinion. I hope and believe that the adoption of the proposed bill will be a step in the direction of enhancing the Board's prestige and making clearer to the people of the country the importance of the Board's function.

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Objective of monetary policy

Recognition of the importance of monetary control is not based on the belief that all economic ills can be cured by monetary action alone. The volume and cost of money are important, however, and are the particular responsibility of the Federal Reserve System. That is the reason why our immediate concern in this legislation is to make the machinery of regulating the volume of money as efficient as possible.

That is also the reason why I have suggested a more clearly defined objective for Federal Reserve policy than the somewhat indefinite phrase in the Federal Reserve Act which provides that the Reserve banks shall conduct their operations with a view to accommodating commerce, industry, and agriculture. I have recommended the substitution of a definite mandate that the Federal Reserve System shall "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." I believe that a more definite indication by the Congress of the broad objectives of monetary policy would help the Federal Reserve Board to exercise its powers more effectively, and would also increase the Board's ability to resist political pressure for the adoption of policies inconsistent with the maintenance of business stability.

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