COPY X-9219

May 21, 1935.

Honorable James Couzens
United States Senate
Washington, D. C.

Dear Senator Couzens:

You asked me the other day what procedure I would have followed in 1928 and 1929 had the Banking Bill of 1935 been in effect at that time and had I been Governor of the Federal Reserve Board. It is always difficult to state what one would have done in different circumstances, and I presume that what you meant was not what I myself would have done in the circumstances, but what powers this bill would confer on the Board that it did not have at that time that would have been helpful in preventing the excesses of 1928 and 1929.

As I stated in the hearing, the Banking Bill of 1935 is not primarily proposed for the purpose of meeting a situation such as existed in 1928 and 1929. Provisions that would have strengthened the Board's power to meet such a situation are contained in the Banking Act of 1933, which was the direct outcome of a Senate resolution and investigation occasioned by the stock market excesses during that period. The Securities Act and the establishment of the Securities and Exchange Commission were also the results of investigations by the Senate Committee into abuses in the capital market and on the Stock Exchange.

Conditions in 1928 and 1929 represented the culmination of developments during the entire post-war period. Interest rates were falling steadily from 1920 to the end of 1927, owing partly to the great inflow of gold from abroad; business was generally active; there were large profits earned by certain corporations, particularly by the larger corporations with monopolistic advantages. Opportunities for floating securities at profitable rates were exceptionally good, with the consequence that many corporations built up large cash reserves beyond their immediate needs, and this money was available for temporary employment in the stock market when the demand for brokers' loans increased.

Speculative activity on the stock market had become pronounced in 1924 and had continued to be large with fluctuations from that time to the autumn of 1929. In 1927 an easy money policy, adopted primarily for the purpose of helping England remain on the gold standard and helping France and other countries to return to the gold standard, was followed by an additional spurt in the stock market. During 1928 the Federal Reserve

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

System raised discount rates and sold Government securities, but this had relatively little effect on speculation.

In 1929 the Federal Reserve System had only a small volume of Government securities left and member bank indebtedness was large. The question that arose was whether the discount rates should be raised. Some of the Reserve banks recommended such advances, but the Federal Reserve Board felt that there was nothing in the business situation that required restraint; that, in fact, there was a recession in building activity and that advances in discount rates would be undesirable because they would probably not deter speculators, but would have a bad effect on business activity. The Board, therefore, adopted a policy of trying to reach member banks directly by curtailing Federal Reserve credit extended to banks that had a large volume of loans in the stock market. This policy was only partially successful in restraining speculation, partly because under the then existing law the Reserve banks could only deal with member banks who were actually in debt at the Federal Reserve banks. This enabled banks with large stock exchange accounts to buy Federal funds from other banks and thus to acquire reserve funds without borrowing directly from the Reserve banks. Control of speculative loans was difficult under these conditions. Furthermore, there was little or no growth in the volume of bank credit in 1928 and 1929. Loans by member banks to brokers and member bank deposits did not increase. The speculative demand for credit in the market was met largely by the loaning of surplus funds owned by corporations.

It is impossible at this time to say what could have been done to remedy the situation, certainly at so late a date as 1928 and 1929. It is to be hoped that with security issues and stock exchange practices under regulation by the Securities and Exchange Commission, with authority in the Federal Reserve Board to regulate margin requirements on collateral loans, both for brokers and for banks, with loans by corporations to brokers prohibited, and with the additional powers of control over speculative activity by member banks contained in the Banking Act of 1933, the Federal Reserve System will be in a much stronger position to prevent the development of an unsound situation such as the one that culminated in the stock market debacle of 1929.

The Banking Bill of 1935 is not directed towards preventing stock market abuses, which, as has just been said, have been dealt with by other legislation. This bill is concerned with improving the machinery of the Federal Reserve System and with centralizing in the Federal Reserve Board responsibility for all the instruments of monetary policy, namely, discount rates, open-market operations, and changes in reserve requirements. It was not in 1929 that the powers contained in this bill would have been valuable, but in 1931. At that time, when England went off the gold standard and there was a heavy drain on gold in this country and a drastic deflation in business and in bank credit, the System would have been in a

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

much stronger position to adopt a vigorous open market policy if this bill had been in effect. As things were at that time the System could not buy Government securities freely because they were not eligible as collateral for Federal Reserve notes and the Reserve banks had an inadequate supply of commercial paper eligible for that purpose. It was not until the passage of the Glass-Steagall Act at the end of February 1932 that the System was able to pursue a vigorous open market policy. This obstacle to an easing policy at a critical time will be removed by the proposed bill.

Moreover, if banks had been able to borrow on their sound assets from the Reserve banks during the depression, as they would have been had this bill been in effect, much liquidation would have been avoided.

The bill would also increase the ability of the Federal Reserve Board to cope with such a situation by placing on it the full responsibility for open market policy, so that it could adopt and carry out such a policy on the basis of its conception of the national interest without being delayed by negotiations with the individual Reserve banks, which under existing law not only have the sole power of initiating open market policy but also have the power of refusing to participate in such a policy when it is adopted.

The situation in 1931 and the early part of 1932 illustrates how the present bill would have helped at a time when deflation was in progress. Another purpose of the bill is to strengthen the Federal Reserve System's power to counteract inflation, if it should get under way in the future. With the large volume of excess reserves at member banks at the present time and the likelihood of further increases in these reserves through gold imports, silver purchases, the use of the stabilization fund, and through possible currency issues under the bonus bill or otherwise, there are possibilities of further increases of the reserves of member banks without corresponding growth in security holdings of the Federal Reserve banks that would be available to sell in the market for the purpose of absorbing member bank reserves. The proposed bill would improve the position of the Federal Reserve System in such a situation by concentrating the open market power in the hands of the Federal Reserve Board, which could act promptly and decisively without possibility of delay or inability to agree on a policy. It would also give the Board the power to increase member bank reserve requirements without the necessity of declaring an emergency or obtaining permission from the President, who ought not to have this responsibility.

The fact that the proposed bill prescribes as an objective of monetary policy the maintenance of business stability would also strengthen the Board's power to act because an inflationary boom is not consistent with business stability.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

It is for these reasons that I feel that the proposed bill would strengthen the power of the Board to act promptly both in a period of inflation and in a period of deflation. With the powers contained in this bill, together with the provisions of the Banking Act of 1933 and the Securities Exchange Act, I believe that the Federal Reserve System would be in a much stronger position to moderate booms and depressions and would be better able to contribute to business stability in so far as this can be done within the scope of monetary action.

I hope that this is a satisfactory answer to your question. I have not dwelt on other phases of the bill because these matters are not directly in line with your question and have been discussed in my testimony.

Very truly yours,

(Signed) M. S. Eccles

M. S. Eccles
Governor

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis