Comments on Title II of the Banking Bill of 1935

(H. R. 5357 and S. 1715)

Walter E. Spahr

1. There are no circumstances calling for legislation dealing with the fundamentals of the Federal Reserve System at this time. Legislation of this type should not be undertaken until after a commission of competent experts has made a thorough study of the money and banking problems of this country and, on the basis of adequate evidence and after careful deliberations, has drafted a plan which offers real promise of providing this country with appropriate and workable money and banking systems. Both systems have suffered sad mutilation in recent years; and what is needed now is careful and deliberate overhauling and reconstruction, rather than further mutilation and distortion such as will result if Title II of this bill is passed under the administrative whip and in the atmosphere of tense emotionalism now prevailing with respect to our money and banking problems.

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It is very important that there be no legislation at this time beyond that necessary to correct technical difficulties, or to remove crude inconsistencies, in existing laws. And even this type of legislation should be undertaken only upon the recommendation of the Federal Reserve Board and in strict accord with specific proposals drafted by the Board.

Evidently implies "Board" has not really recommended anything.

2. The Senate and House Committees on Banking and Currency could perform no better service at this time, with respect to the proposed legislation, as embodied in this bill--S.1715-H.R.5357--than to refuse to vote it out of committee and to substitute in its stead a bill of technical corrections embodying the recommendations of the Federal Reserve Board on specific difficulties. At the same time a joint resolution should be prepared providing for the creation of a National Commission on Money and Banking to gather evidence on our money and banking problems and to draft bills to provide this country with the proper type of money and bank-

ing systems. This Commission I believe, should be composed of the leading money and banking authorities of this country. Its membership might well be composed of (1) those members of the Senate and House Committees on Banking and Currency who have devoted years to the study of problems of money and banking; (2) the most outstanding and experienced professors of money and banking in our leading universities--men whose reputation, intellectual integrity, and capacity are beyond question; (3) outstanding bankers who are men of experience, maturity, and social vision; and (4) other students of money and banking, drawn from other fields of activity, if they are recognized as thorough students of money and banking problems.

The delay in legislation which would result from the adoption of such a program is eminently desirable. Money and banking mechanisms are probably the most delicate and, at the same time, most vital of all instrumentalities in our economic system; and it is for this reason that hasty and ill-conceived legislation in such a field is very unwise and is to be deplored. In its stead there should be substituted legislation growing out of careful deliberation by our most competent experts.

3. Title II of the Banking Bill of 1935 is particularly dangerous, when viewed in its entirety, because it is a manifestation of the unsound philosophy held by some officials in this Administration regarding the causal relationships existing between the supply of currency, on the one hand, and prices, recovery, and prosperity on the other. Involved in this false philosophy are also misconceptions as to (a) the proper functions of central banking systems, especially with respect to the appropriate relation between a nation's central banking system and government financing; (b) the appropriate functions and powers of the central banks with respect to the control of the money and credit supply; and, above all, (c) the appropriate relationship between the government, acting in its supervisory capacity, and a properly-constituted central banking system.

These false notions and misconceptions shows themselves clearly in those sections of Title II which will enable the party in power to control completely the personnel of the Federal Reserve Board. They are revealed in those sections which

will enable this politically-controlled Board to attempt to put into effect the theories of money and credit control held by many of those in power. They are seen in those sections of the bill which will enable the government to force the central and commercial banking structure to aid the government in carrying out its fiscal policies regardless of their wisdom, to give government credit on artificially high rating, and to use the banking system and people's savings without their approval and regardless of the effect upon commerce, agriculture, and industry. In short, nearly all the fundamental conceptions regarding the appropriate functions, the methods of operation of a well-conceived central banking system, and the proper relation of the government to such a banking system, are false, are contrary to the most outstanding lessons learned from central banking experiences, are dangerous, and are almost certain to lead to great trouble in the future.

4. The following analysis of the various sections of Title II of the Banking Bill of 1935 support the accuracy of the preceding general observations:

Section 201 (a) provides the means by which the Board of Directors of each Federal reserve bank will be brought under the control of the Federal Reserve Board, which, in turn, will be politically controlled. This means of control is found in the fact that the Governor and Vice Governor of each Federal reserve bank can be appointed only with the approval of the Federal Reserve Board.

The Governor and Vice Governor can come from any district. In this manner the Federal Reserve Board can inflict any outsider on a Federal reserve bank as Governor or Vice Governor.

Since the Governor and Vice Governor are approved by the Federal Reserve Board, and since two other class C directors, other than the Governor, are representatives of the Federal Reserve Board, the government can have four representatives as against the present three, since the Vice Governor need not be appointed a class C director. Why the office of deputy chairman is not combined with that of the Vice Governor is not clear unless the purpose be to enlarge the number of government representatives on the Board of Directors of each Federal reserve bank.

It is to be noticed also that "all other officers and employees of the bank shall be directly responsible" to the Governor of the Board of Directors. This gives him the powers of a Czar; and through him the politically-controlled Federal Reserve Board can reach directly and arbitrarily down to every employee in every Federal reserve bank. This means, of course, that the political authorities can reach any employee they please. In this manner every employee of every Federal reserve bank will lose his independence and become, like the Federal Reserve Board, an unwilling vassal of the political party in power. Classes A and B directors will carry no weight under such a system, since the Governor of each Federal reserve bank is given this authority and is a government agent.

Today the elected Governors of the Federal reserve banks are Chairmen of the Executive Committees and, in this manner, they have increased their powers as against the Chairman-Federal Reserve Agent. This bill makes a government agent Chairman of the Executive Committee and thus the government worms its way into the direct operation of each Federal reserve bank.

The slightest reflection upon such a proposed arrangement should convince one that all activities of each Federal reserve bank can be brought under the absolute control and domination of the political party in power. These Governors and Vice Governors may be as arbitrary as they please, so long as they satisfy the politically-controlled Federal Reserve Board. In this manner the political party in power can lay its rough hands on the Federal reserve banks, which the government does not own, but which are owned by the member banks that, in turn, are owned largely by private individuals.

Such an arrangement provides conclusive evidence of the intent of the present party in power to extend its political tentacles over the banking system. In this case, it is attempting to lay hold of one of the most delicate and most vital agencies of our economic system--an agency that must be free from such domination if our economic system and our people in it are to maintain any appreciable amount of their traditional freedom. When a nation's banking system passes into control of the political party in power the freedom of a people can speedily disappear. And

certainly there is no reason to expect that better banking can or will result from any such proposal as this one in Section 201 (a) of this bill.

It is to be observed that one of the class C directors shall be appointed Deputy Chairman of the Board of Directors, and that the Vice Governor may be appointed a class C director. It is because of this word "may" that the Federal Reserve Board may have four representatives on the Board of Directors of each Federal reserve bank.

The duties now performed by the Federal Reserve Agent "shall be performed by such person as the Federal Reserve Board shall designate." This provides the Reserve Board with another representative at each Federal reserve bank. In this manner it can have five agents there.

The last paragraph of Section 201 (a), p. 40, lines 17-22, permitting present incumbents of the Boards of Directors to serve out their terms would seem to require a modification of these parts of the bill which provide that this section shall be effective ninety days after enactment.

Section 202 is one of those coaxing, half-hearted measures by which attempts are made to persuade non-member banks to become members of the Federal Reserve System. Our statute books are cluttered up with these conciliatory provisions in law. This particular provision merely lowers still further the capital requirements of banks which may enter the System. At present the capital requirements are too low. And, if it is believed that non-member banks should be members of the System, then the Federal Reserve Act should be amended so as to provide that all banks should, after a certain date, be members of the System. If the capital requirements of some of the banks are too small, such banks should be made branches of larger member banks. But all legislation of this type probably should be left until a competent money and banking commission makes its report.

Section 203 provides the means by which the Federal Reserve Board is to be made into a politically-controlled and dominated agent of the President. Lines 1-3, p. 42, of Section 203 (1), are probably the worst, if not the most subtle, in

the bill. They provide that the President "shall choose persons well qualified by education or experience or both to participate in the formulation of national economic and monetary policies." It will be noticed that these members of the Board are to be qualified to participate in the formulation of national economic policies as well as monetary policies. Does this mean that they are to participate in the formulation of national economic policies? If this sentence means what it appears to mean, then this Board will become a part of the planning bureaucracy of the government, and the Federal Reserve System can become, and can be made to become, the financial agent of the government in carrying out its planning policies. It can be made an engine of oppression, rather than a neutral agent to finance commerce, agriculture, and industry.

This section of the bill is either subtle or stupid. In any case, it is dangerous. It reveals how far removed its drafters are, in their notions of how to constitute a central bank board from those who would profit from experience.

Section 203 (2) provides a means by which Mr. Hamlin may retire at once and Messrs. Miller and James in 1936, thus removing from the Board in a very short time, even if more arbitrary methods are not used, its three most experienced members. If this provision is to be enacted into law it would seem that it should be so amended that all ex-members of the Board would become ex-officio members of some advisory body, such as the Federal Advisory Council, in order that the benefits of the knowledge and experience of such men are not lost to the younger members of the Board. Such an arrangement could be an effective factor in developing fine traditions in central banking.

Lines 17-25, p.42, are awkard and confusing. Lines 17-22 say literally that "each member of the Board so retired from active service who shall have served for at least five years shall receive, during the remainder of his life, retirement pay in an amount equal to the annual salary paid" now. Thus he would receive a total pension of $12,000 for the rest of his life. How much will he be paid the first year of retirement? Or is he to be paid $12,000 in a lump sum? This sentence

probably was intended to give the retired members, who have reached 70 years of age and who have served five or more years, an annual pension based upon the years served, the yearly amount to be determined by the number of years served multiplied by $1,000, but the bill certainly does not make this point clear. According to the first proviso, a person who has served, say, eight years will receive $8,000 per year, and if he lives three years thereafter he will receive $24,000 in a pension, whereas lines 17-22 preceding the proviso would give him only $12,000 regardless of how long he lived. This proviso also omits the five-year minimum, and, in line 25, the word "served" apparently should be inserted after the third word, "year." The entire section is badly muddled, and it should be rewritten and made to say what the authors intended that it should say.

Nor is the second proviso, p. 43, clear or sufficiently specific in its meaning.

Furthermore, it is to be noted that, according to Section 203 (3) every Governor appointed and removed will come in for this pension if he is 65 years of age, since he shall be deemed to have served the full term for which he was appointed even though he may have served only one month or even one day. What a great opportunity this provides a President to place his friends on a fine pension for life! In thirty days he could give thirty of his friends who had reached 65 years of age a $12,000 pension for life. In four years he could develop a large pension list, all to be paid by the Federal reserve banks. The Vice Governor apparently can have his term of service terminated by the President without the benefit of it being deemed that he had served his full term. It would appear that no member of the Board could afford to accept the office of Vice Governor.

This Section 203 (3) reveals clearly the method by which a President can change the Board's personnel within the space of a week to suit his particular wishes. It would be difficult to conceive of a more dangerous provision written into any central banking law. It reveals beyond the shadow of a doubt the purposes of the authors of this measure. They propose to convert the Federal Reserve System into a political instrumentality of the party in power. This section of the bill reflects clearly the authors' motives and concepts regarding central banking. It

shows that they stand ready to destroy our Federal Reserve System which we have tried to evolve into a useful system over a period of twenty years. If every other section of the bill and of the Federal Reserve Act, as amended by this bill, were perfect, the System still could be destroyed and the bill still would be dangerous. Considering the dangers in Sections 201 and 203 of this bill, the possibilities of dangers in the other sections of Title II are accentuated. For this reason there are many today who oppose other sections of Title II principally because they would be administered by a politically-controlled Federal Reserve Board.

The answer to this proposed amendment to the Federal Reserve Act is that it must not be permitted to pass. The lessons of central banking teach that the farther the central banking administrative authorities are removed from political domination the better for the country concerned. The independence of the Federal Reserve Board should be strengthened, not weakened, and our Federal Reserve System will not be what it should be until this is accomplished. There are various ways in which this can be done. Indeed, there are so many devices available that it would be absurd for anyone to insist that he can suggest the best one. My contention is that our lessons have taught us that our Federal Reserve Board has not been sufficiently independent of the government and that the method of nomination and final selection should be so changed as to remove the Board as far from political control as is the United States Supreme Court.

Of course every central banking system must come under the control of the government in some degree; but this control should be exercised through the passage of the proper organic act providing for the proper type of banking system and administrative boards, after which the government should leave the system to operate, free from partisan politics, within the limits of the organic act. As the Board is reconstituted and strengthened after a careful study of the problem by our best experts, I should like to see the Secretary of the Treasury removed from the Board, though I think he should be a non-voting

auditor or participant in the Board's discussions; and I should like to see the Office and functions of the Comptroller of the Currency absorbed by the Board.

Everything that any central banking system can be expected to accomplish can be written into the organic banking act, and thereafter the administration of the system should be left to independent non-political administrative bodies.

Section 204 appears to be free from criticism.

Section 205 creating a new type of Federal Open Market Committee might have many virtues if the Federal Reserve Board were a properly-constituted independent Board. But considering how the Board is to be politically-controlled, this section of the bill merely provides additional means by which the government can extend its powers over the activities of the Federal reserve banks.

Government financing, in the final analysis, should be looked upon as an intrusion into, and a disturbing factor in, the fields of private finance. And if a well-ordered central banking system performs its functions properly, there will be many times in which it must and should go into the open money markets to combat the effects of government financing. It is not the function of a central banking system to give government credit a higher rating than it would otherwise have in the open money markets to which non-government borrowers and lenders must go. It is the function of all commercial banks to give borrowers the exact credit rating to which they are entitled; and it is the function of these banks and the central banking authorities to give government borrowers exactly the same type of credit rating. To assume that government credit should be given an artificially high value by a central banking system is to assume that it is the function of a central banking system to inflate the currency.

This Section 205 recognizes no such principle of central banking and opens the way by which the banking system can be made to absorb government securities on terms satisfactory to the government and is, for this reason, unsound in

principle. The section provides the means by which the government can compel open market operations to suit its particular notions and purposes regardless of the needs of commerce, agriculture, and industry, and regardless of any principles of sound central banking.

All five members of the Federal Open Market Committee are to be government agents. The fact that two of the members are to be selected from the Governors of the reserve banks by the Governors does not change this fact since all these Governors will be government agents.

The Committee is also given the power to make recommendations to the Federal Reserve Board from time to time regarding the discount rates of the Federal reserve banks. It may be presumed that giving this Committee this power has no particular significance unless it be assumed that the Reserve Board exercises the power of prescribing discount rates for the reserve banks. It would seem preferable that the present method of having rates initiated by the respective reserve banks subject to approval of the Board, is preferable. But if the Reserve Board were properly constituted and independent of political influences I should advocate that the Board be given the power not only to review discount rates but to institute the rates when a Federal reserve bank is clearly running counter to sound national banking policies.

Section 206, which opens the way for discounting any commercial, agricultural or industrial paper and for advances secured by any "sound assets" of such member bank, seems to be tacked on to the preceding parts of Section 13 of the Federal Reserve Act without any regard to how it affects the preceding paragraphs of that section. It would appear that most of the preceding paragraphs are nullified. Just what the law is would be difficult to determine. It reveals a hasty and careless type of bill drafting.

It is doubtful whether, under the best type of central banking system, such a provision can be defended. It would seem that, under such a system,

this wide-open provision should be reserved for emergencies.

Under a politically-dominated system of central banking, as provided by this bill, Section 206 provides the means by which the Reserve Board can admit to the portfolios of the Federal reserve banks any kind of paper, regardless of its illiquidity, and fix the maturity of the paper at any distant date it chooses to adopt.

Since it is not the function of a central banking system to accept illiquid paper, the proper restrictions against such acceptance should be set up. Wise exceptions to meet emergencies can be provided, and the proper penalties and handicaps attached, so that emergency transactions will not become the normal ones. This section, as it stands, it unsound and unwise.

Section 207, provides the means by which the Federal reserve banks can be compelled to absorb government securities regardless of maturities. In this manner the reserve banks can become gorged with government securities with long maturities and consequently can become very illiquid. Under a properly organized Federal Reserve Board, and with other appropriate administrative machinery, such a provision might be safe enough, but under the system provided in this bill, this section adds another dangerous provision to the Federal Reserve Act.

Section 208(1) provides the means by which Federal reserve notes are to be issued against the general assets of the reserve banks in addition to requiring the 40 per cent reserve of gold certificates. If these assets were liquid, this provision would not be objectionable, but since the way is opened by this bill for admitting all kinds of illiquid paper to the portfolios of the reserve banks, this section provides the way for converting illiquid assets into legal tender paper money. This of course means inflation and is unsound in principle.

Then the question may be raised as to why the Federal reserve notes are

made legal tender for all purposes? When a money is legal tender for all purposes, it can be used to pay all debts, public and private. This means, literally, that these notes could be used for lawful reserves and could be used to redeem any other currency. Is it intended that these notes shall be "lawful money" for reserve purposes, thus converting a liability into an asset? This, of course, is not a rational procedure, and yet this is what lines 22-23, p. 46, really provide.

In contradiction to this, lines 24-25 exclude these notes from the lawful money for reserve purposes in the Federal reserve banks. This means that the Federal reserve notes are not permitted to fulfill their functions as full legal tender money. The two provisions are in direct conflict and should make clear the fact that it is irrational to attempt to make Federal reserve notes full legal tender.

This section provides, in lines 8-10, p. 47, that the Treasurer of the United States shall cancel and retire unfit Federal reserve notes coming from a source other than a Federal reserve bank, but it does not specify or provide any fund for such retirement. The last sentence of this section, lines 10-12, p. 48, provides that notes unfit for circulation shall be returned by the reserve banks to the Comptroller of the Currency for cancellation and destruction. Just why both the Comptroller of the Currency and the Treasurer of the United States should be involved in cancelling unfit notes is not clear.

This bill abolishes the 5 per cent redemption fund with the Treasurer of the United States. It also permits one reserve bank to pay out the reserve notes of other reserve banks without any penalties, and in this manner one of the factors forcing a retirement of these notes is removed. There appears to be no good reason for repealing either of these prevailing requirements. The

omission of the latter requirement merely serves as another means of inviting a looser type of banking. The omission of the redemption fund may be due to careless bill-drafting.

Section 208(2) reveals careless bill-drafting in the fact that care was not taken to strike out all words which should be deleted. For example, in the second line following the last deletion the words "or subtreasuries" appear again and are permitted to stand by this repealing section.

Section 209, which permits the Federal Reserve Board to change the reserve requirements of the reserve banks as they see fit, is a dangerous weapon to put into the hands of a politically-dominated Board. The preceding sections of Title II of this bill, combined with this section, make it possible for the Board to pack government securities and other illiquid paper into the portfolios of the Federal reserve banks until the surplus reserves are exhausted, and then the reserve requirements of member banks can be reduced thus permitting the Board and banks to proceed with their inflation without let or hindrance. The provision that the reserve requirements of these banks may be changed "in order to prevent injurious credit expansion or contraction" is merely the statement of a pious hope. It would mean nothing in the hands of a politically-controlled Reserve Board.

Section 210, stipulating the conditions under which member banks may lend on real estate, flies in the face of all practical experience with such loans by commercial banks. Provisions for such loans should be restricted, not enlarged. To raise the percentage of the value of the property for lending purposes from 50 to 60 per cent is unwise, as is the 75 per cent provision for loans amortized within twenty years. To raise the limits of such investments from 50 to 60 per cent of time and savings deposits and from 25 to 100 per cent

of the bank's capital and surplus is a brazen denial of the value of our past experiences with such loans.

In lines 13-18, p. 50, in which real estate loans are insured by the provisions of Title II of the National Housing Act, all restrictions appear to be removed. The answer to this is that in sound commercial banking the question of the proper type of loans is not one of insurance and ultimate liquidation but one of maturity and immediate liquidity.

5. Thus we see in Title II of this bill a multitude of illustrations of the dangerous banking philosophy held by the advocates and authors of the bill. It must not be passed. It is extremely dangerous. The conceptions underlying it run counter to the best opinion on central banking. The bill is another--and probably the most brazen, daring, and dangerous--attempt of politically-minded planners to increase their destructive and devastating hold on business enterprise in this country. There are no sound defenses that can be offered for the bill. If its advocates insist that they have the welfare of this nation at heart, let them prove it by submitting the bill to a National Commission of experts for analysis. The authors of this bill would not risk such an analysis. What they want is not better central banking, but more political banking by political planners; they want to build a bigger and better political machine. Professions to the contrary are annihilated by the sections of this bill which provide the means desired by the political planners, and which are in harmony with the immature and muddled notions regarding principles of money and banking expressed from time to time by the chief backers of the type of proposals incorporated in this bill.

No person well trained in the principles of money and banking could examine the theories set forth by the present acting Governor of the Federal Reserve Board in his testimony before the Senate Committee on Finance in its

Investigation of Economic Problems in February, 1933, without perceiving the dangers in this bill and the dangers in having our Federal Reserve System, as amended by this bill, administered by an official holding such views. In that testimony is revealed a confusion of understanding as to the causal relationship between the currency supply and a sound business recovery; in that testimony the currency is held responsible for conditions which can only be traced properly to the maladjustments created by the World War; there is advocacy of the issue of fiat money, of currency manipulation to raise the price level artificially, and it is even proposed that money be given away; there is revealed an appalling lack of understanding of the nature and consequences of inflation; more inflation is recommended to correct difficulties caused by inflation; economic planning is an obsession, and it is proposed to use the Federal Reserve System to make such planning effective.

These disconcerting facts are pointed out because this bill apparently has been drafted for the purpose of providing the means by which these unsound and dangerous theories of money and banking and of currency control can be thrust upon the people of this nation.

If this bill becomes law only the most providential good luck will prevent this country from suffering severely as a consequence.

I firmly believe the best interests of the people of this nation are served by registering as vigorously as one can his protests and objections to this bill. It was born in secrecy. No known or trusted experts attended its birth. Its parentage is hidden largely in obscurity and anonymity, although the acting Governor of the Reserve Board, in his Columbus, Ohio, address of February 12, 1935, speaks of what "we propose" in referring to the changes provided by the bill. It reveals traits found in political and economic concepts alien to the best

principles of central banking and the best traditions of the people of this nation. It is an un-American, unsound creation that must never be permitted to find its way into our statute books.