Form No. 131

Office Correspondence

FEDERAL RESERVE BOARD

Date March 16, 1935.

To Governor Eccles

Subject:

From Mr. Currie

L.C.

GPO 16—852

Attached is a draft of a letter to the President of the Young Men's Board of Trade of New York. I have had so much work on hand of a more important nature that I had my assistant prepare some comments on their report. I think they are all right. The report, by the way, is so atrociously bad that it is difficult to treat it reasonably and rationally.

LC.em

March 16, 1935.

Mr. Harrison D. Blair,
President, Young Men's Board of Trade,
41 Park Row,
New York, New York.

My dear Mr. Blair:

I have read the report of your Banking and Investment Committee on the Banking Bill of 1935 with interest and care. I regret that the pressure of many duties does not allow me time to make a detailed comment on the many fundamental issues raised by the report. I am, however, enclosing some comments prepared by a member of the Research Division, which I have read and in which I concur.

I am also enclosing a copy of my address on the bill before the Ohio State Bankers' Association, wherein I think I have answered some of the objections to the bill raised by your committee.

In my testimony before the House Banking and Currency Committee I suggested certain changes in the bill. I am enclosing a summary list of such changes.

Yours very sincerely,

Marriner S. Eccles
Governor

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R-C

LBG

March 14, 1935.

COMMENTS ON A REPORT ON THE FEDERAL RESERVE SYSTEM
MADE BY THE YOUNG MEN'S BOARD OF TRADE OF NEW YORK

The report begins with the results of a survey of foreign central banks. On the relations between Governments and Central Banks, the study has apparently been confined to statutory provisions, no account being taken of the informal relations which are sometimes so important and of the actual behavior of Central Banks in periods of crisis in national finance. The provision of the Bank of Canada Act that the Bank's holdings of government securities not maturing within two years should not exceed three times the amount of the Bank's paid-up capital is recommended for introduction into the Federal Reserve Act "to set at rest fears of currency or credit inflation." Such a provision would effectively hamper the carrying on of open-market operations. If it is considered desirable to substitute rigid and automatic rules-of-thumb for conscious control in the operation of the monetary system, such limitations should relate directly to the volume of currency and to member bank reserves rather than to the volume of any particular type of central bank asset.

The conclusions drawn from the study are that there should be only one agency authorized to issue currency, that this agency should be as free from political interference as possible, and that central bank credit should reflect the volume of business activity and be composed of short-term items. These conclusions ignore, as does the rest of the report, the central banking function of holding and influencing the volume of member bank reserves. The objection to political interference is accompanied by no discussion of what the functions of Central Banks are or should be, what the objectives of monetary policy should be and who should determine them, and why the democratic method of making decisions on important public issues is inappropriate here. The report states that central bank credit should reflect the volume of business prevailing in the country but the volume of central bank credit is necessarily affected by inflows or outflows of gold and cash which may be in a direction counter to that of business. Assuming, therefore, that they mean not central bank credit but central bank liabilities in the form of member bank reserve balances, the question becomes, "Should the volume of such balances reflect the volume of business prevailing in the country?"

Such a policy would mean additional stimulation to business in times of increasing activity and restrictive measures in times of depression, thus intensifying the violence of cyclical movements, rather than moderating their force. It may be that intensifying the severity of the business cycle is considered desirable by this group on general economic grounds, but in the absence of an explicit statement to that effect it is assumed that they share in the general consensus that the primary aim of monetary policy should be the stabilization of business activity. If central banks wish to pursue this objective they must try to increase the volume of spending in periods of declining business activity. Their only means of accomplishing this is thru increasing the volume of money and lowering interest rates and their only means of doing this, directly or indirectly, is by acquiring assets of some sort. In periods of declining business activity, the kinds of short-term assets usually held by central banks are likely to be scarce. Moreover, for reasons peculiar to the American money market, an increase in the Reserve banks' holdings of bills discounted is an indication of tighter, rather than easier, money. In these circumstances, if a central bank wishes to do anything at all to stop the progress of deflation, it must increase its holdings of Government securities and the supply of such short-dated securities may be too small to enable it to accomplish its purposes without acquiring a considerable volume of longer-term obligations.

Moreover, the holding of such obligations, as this group believe, does not "prevent the contraction of central bank credit when desired" and does not "add to the inflexibility of the currency". Such securities may be sold on the open market whenever the central bank administration considers it advisable to do so. It might even be said that such securities are more easily disposed of than bills discounted, since the latter must mature before they can leave the portfolio of the central bank, while a Government security can be marketed at any time. The writers of the report seem to believe that a central bank, whether by choice or necessity, keeps outstanding a volume of currency equal to its earning assets and that the currency does not or cannot contract until the earning assets contract. Under modern conditions, nothing could be further from the truth. Money in circulation declines whenever the public prefers to hold bank deposits rather than the cash it has in its pockets or tills and never for any other reason.

A review of recent developments follows. This contains numerous errors of interpretation. Most of these are brought out in the following summary and comments on the report's conclusions:

1. Federal Reserve bank credit should gradually come to reflect the requirements of business instead of representing Government securities. The major part of Government obligations held should mature within 90 days. Government securities of longer maturities should not exceed a definite ratio to Reserve bank capital and/or Federal revenue. This proposal would probably prevent any effective use of open market operations. It is commented on in detail above.

2. The decline in holdings of Bills Bought and Bills Discounted by the Federal Reserve banks has far exceeded the decline in the country's business. The comment may be made that the only way the Reserve System could have maintained or increased its holdings of bills discounted would have been to maintain a constant deflationary pressure on the money market. The supply of acceptances is now

and has been for a long period so small relatively to the demand for them that yields approach the vanishing point. Extensive investment by the Reserve Banks in this type of asset would probably have seriously disturbed customary relationships and threatened the future existence of the acceptance market, which the Reserve System has been largely responsible for creating in the United States.

3. The Reserve System should become the exclusive agency of issue in the United States.

4. The desirability of selling to the public the capital stock of the Reserve banks should be investigated. The comment may be made that there is an extensive network of relationships between member banks and reserve banks quite unlike the relationships between central banks and commercial banks in other countries. These relationships center around and facilitate the performance of certain technical functions such as the clearance of checks, the provision of coin and currency, examination and supervision, the collection and provision of business information, and so on. It would probably be difficult to conduct these operations as efficiently through institutions in the management of which member banks had no direct voice or interest. If the changes proposed in the Banking Act of 1935 were made, the question of stock ownership would not be of primary importance in the selection of the

higher executires of the system, or in decisions on matters of policy.

5. The Banking Act of 1935 is in every respect an undesirable measure. It would completely deprive the System of independence and further endanger the liquidity of the people's money.

The one proposed change in the law that could be used to support the political domination argument was the provision that when a Governor is no longer designated as such his term of office as a member of the Board should be assumed to have ended. This merely recognized the actual realities of the situation. However, since Governor Eccles has indicated that he is prepared to modify this proposal we need not argue its merits. It is now merely sufficient to point out that the Banking Bill of 1935 proposes to change in no respect the present relations between the Administration of the day and the Federal Reserve Board. It is true that the Federal Reserve Board is asking for the power of approval of the appointment of Federal Reserve Governors but in exchange for this it is proposed to surrender the power of appointment of Federal Reserve Chairmen.

It is hard to guess just what is meant by "liquidity of the people's money." The commonest meaning of liquidity is convertibility into cash. In this sense "liquidity of money" means nothing. Or perhaps liquidity is used here to mean convertibility into gold. But the Banking Act leaves the present situation unchanged in that respect.

On the assumption that the phrase was intended to convey some significant meaning, it is most probable that it was intended to stand for "value of money in terms of goods and services". It is not necessary to discuss the general question of whether the Banking Act of 1935 increases the danger of an inflationary rise in prices, since there is every indication that the writers of this report share the ancient fallacy that the value of money (the general price level) is determined by the nature and quantity of the reserves and collateral behind it. The value of money is determined by its quantity and the use made of it in relation to the volume and nature of the transactions in which money is used. The collateral and reserves behind money influence its value by determining the maximum amount of money which can be outstanding and in no other way. This is true whether the collateral and reserves consist of gold, commercial paper, Government bonds, real estate, or pebbles.

6. A study should be made of the advisability of creating a system of mortgage banks.

7. The program proposed would not be inconsistent with the provision of unemployment relief, which should be continued under all circumstances. However, the liquidity of the currency should be

preserved at all cost. It may be commented that men generous enough to see the necessity for maintaining the unemployed at subsistence levels should not find it too difficult to proceed a little further to consideration of the question whether the government should not take action to restore these unfortunate people to permanent jobs, and to prevent a return of the conditions which threw them out of work. They might then consider whether monetary policy would not constitute an important and necessary part of such a program. When they have reached this point in their thinking, doubts may occur to them as to the relative importance of maintaining a normal level of employment and preserving the currency against potential damage to its liquidity, whatever that may mean.