SUMMARY OF STATEMENTS

BY

MARRINER S. ECCLES

Governor of the Federal Reserve Board

ON

THE BANKING BILL OF 1935

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GOVERNOR OF THE FEDERAL RESERVE BOARD

IN REPLY TO QUESTIONS BY

MEMBERS OF THE

COMMITTEE ON BANKING AND CURRENCY

OF THE

HOUSE OF REPRESENTATIVES

AT HEARINGS ON

THE BANKING BILL OF 1935

MARCH 4-20, 1935

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General Objectives and Other Background of Legislation

General objectives of legislation.—In recommending banking legislation at this time, it is recognized that the Congress has before it an unusual number of urgent matters that are engaging its attention, and that legislation in order to deserve consideration at this session must not only be important in general but must also be urgent at this particular time.

We are not unmindful of the fact that within the past two years you have passed the Emergency Banking Act, the Banking Act of 1933, the Securities Exchange Act, and other important pieces of legislation dealing with banks. One purpose of this legislation has been to meet emergency conditions, and it is now proposed to incorporate into permanent legislation the features of the emergency laws that have proved to be valuable.

Another purpose of recent banking legislation, and particularly of the Banking Bill of 1933 and of the portions of the Securities Exchange Act that deal with powers of the Federal Reserve Board, has been to prevent the recurrence of speculative excesses which preceded the recent breakdown of our banking machinery and were partly responsible for this collapse. These bills were largely inspired by the difficulties that came to a head in 1928 and 1929, and it is gratifying to know that we now have on our statute books measures that will go far toward preventing the recurrence of conditions such as prevailed during the speculative orgy of these years.

The present need is to so modify our banking law as to encourage the banking system to give a full measure of cooperation to efforts at economic recovery. It is even more important from the longer time point of view to so modify our banking structure and administration as to have it become an influence toward the moderation of fluctuations in employment, trade and business. This would tend not only to prevent the particular evils that came to a head in 1928 and 1929, but also to diminish the possibility of a speculative boom getting under way. For when speculation is once under way it is extremely difficult to control, and the only means of preventing excesses is to combat conditions that are favorable to their inception and early development.

In order to accomplish this it is necessary to improve our machinery of monetary control, which is the principal objective of Title II of the proposed bill.

More specifically these objectives are to increase the ability of the banking system to promote stability of employment and business in so far as this is possible within the scope of monetary action; as a necessary step in that direction, to concentrate the authority and responsibility for the formulation of national monetary policies in a body representing the nation; to modify the structure of the Federal Reserve System to the extent necessary for the accomplishment of these purposes, but without interfering with regional autonomy in matters of local concern; and finally to relieve the banks of the country of unnecessary restrictions that handicap them in the proper performance of their functions and thus to enable them to contribute more effectively to the acceleration of recovery.

Urgency of legislation at the present time.—I think it is very desirable and necessary that this legislation be passed at the present time. It is several years late. I think that if legislation of this sort had been passed four, five, or six years ago we might have avoided most of the banking difficulties that the country went through.

I do not believe that we will ever reach a point in this country where our banking legislation will be perfect. We are, of course, in a changing economy and, looking over the past hundred years, no one has been able to develop a perfect system of money and banking; and I do not believe that the proposed legislation means that we have reached the millenium in dealing with our banking and monetary problems.

Preparation of legislation.—At my request the Federal Reserve Board appointed a committee of members of the legal, economic and operating staff of the Federal Board, together with myself, to prepare Federal Reserve legislation to be considered by what is known as the Interdepartmental Loan Committee. This is a committee appointed by the President, with the Secretary of the Treasury as chairman, to consider all legislation dealing with financial matters, which might originate with any one of nine Government organizations, including the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Reconstruction Finance Corporation, the Home Owners' Loan Corporation and the Farm Credit Administration.

I was the Chairman of the Federal Reserve committee on banking legislation. The other members were Dr. Goldenweiser, who has been with the Federal Reserve Board for about 15 years, Mr. Wyatt, General Counsel, who has been with the Board for nearly 18 years, Mr. Morrill, the Secretary, who has been with the Federal Reserve Board for four or five years and prior to that was with the Federal Farm Loan Board, and Dr. Currie, who is Dr. Goldenweiser's assistant. They were assisted, of course, by other members of the staff, such as Mr. Smead, Chief of the Division of Bank Operations, and Mr. Paulger, Chief of the Division of Examinations, both of whom have been with the Federal Reserve Board for a good many years. This committee worked with me in the development of legislation which was considered necessary and advisable.

The proposed legislation was then cleared with a subcommittee of the Interdepartmental Loan Committee, which reviewed it and suggested modifications and changes. The subcommittee included Mr. Coolidge, the Undersecretary of the Treasury, Mr. Oliphant, General Counsel of the Treasury, Mr. Jesse H. Jones, Mr. Lynn P. Talley, who was formerly Governor of the Federal Reserve Bank of Dallas and is now Assistant to the Directors of the Reconstruction Finance Corporation, and Mr. Leo T. Crowley. I think Mr. J. F. T. O'Connor, Comptroller of the Currency, was in at one or two meetings, at the last. Most of the work on Title II was reviewed and discussed by Mr. Coolidge, Mr. Oliphant, and myself.

The Federal Reserve Board was not asked to approve the proposals, but it was kept advised of the development of the legislation. The Board felt that it would be better for it to take no official action in the matter. The members were invited to express their individual opinions, which they did.

The legislation was discussed with officials of the American Bankers' Association, including Mr. Rudolf S. Hecht, President, Mr. Robert V. Fleming, First Vice President, and Mr. Tom K. Smith, Second Vice President, and in particular, with Mr. Smith. A special committee of the Association has endorsed the proposed legislation as modified by the amendments, which I have suggested, with the exception of the proposal on open-market operations.

There was no consultation on this particular bill with the governors of the Federal Reserve banks, although I discussed banking legislation in a general way with Governor Harrison.

Section 201 (1) Combination of Offices of Chairman of the Board of Directors and Governor of the Federal Reserve Banks

It is proposed to combine the offices of the chairman of the board of directors and the governor of the Federal Reserve banks.

Each of the twelve Reserve banks has nine directors; six are elected by the stockholders of the member banks, and three are appointed by the Federal Reserve Board. These directors are appointed for three-year terms. Of the six directors elected by the member banks, three are bankers, known as "Class A" directors; three are selected from commerce, agriculture or industry, and are known as "Class B" directors. Of the three directors appointed by the Federal Reserve Board, known as Class C directors, one is appointed by the Federal Reserve Board as chairman of the board of directors of the Federal Reserve bank. He is also the Federal Reserve agent and is a full-time, highly paid official. It appears to have been the intention of the framers of the Federal Reserve Act that the chairman of the board of directors should be the principal executive officer of each bank and the law makes him also the official representative of the Federal Reserve Board at the bank.

In practice, however, it has developed that the directors appoint an executive officer for whom they have adopted the title of governor of the Federal Reserve bank, a title that is not mentioned in the law, and that these governors have become the active heads of the Federal Reserve banks.

The act provides that the directors of the bank shall select such officers and employees as are necessary to conduct the affairs of the bank. The title of governor was given to the person selected by the board of directors as the operating head of the bank. He is not a director of the bank. In practice, the position of the governor has become an outstanding and important position, and in nearly every instance he has become the head of the bank.

The Federal Reserve Board has no legal relationship with the governor of the bank and has no responsibility in his selection except that it passes on his salary. Its official relationship with the bank is through the chairman and Federal Reserve agent, whom the law designates as the Board's official representative at the Federal Reserve bank.

It is proposed, as a matter of efficiency of administration, of better coordination between the Board and the banks, and of economy, to do away with this dual organization and to combine the office of governor with that of chairman, making the governor and chairman a Class C director. This change will work towards smoother cooperation between the Board and the banks and will establish within the banks a greater unity of administrative control than now exists. It will also result in a saving of about $400,000 a year through the elimination of one of the two highest paid officers in each Federal Reserve bank.

The proposal is to recognize the existing situation by giving the governor of a Reserve bank a status in the law and to combine his office with that of the chairman of the board of directors. It is, of course, essential that the holders of these combined offices be approved by the Federal Reserve Board. The Board, you will note, will no longer appoint chairmen of the boards, but will merely have the power to approve or disapprove the appointment of the governors, who will also be chairmen of the boards. The Board will give up its right to appoint one of the Class C directors. In this proposal there is no encroachment on the autonomy of the individual Federal Reserve banks. It merely reestablishes the original principle of the Federal Reserve Act that the Federal Reserve Board, which has responsibility for national policies and for general supervision over the Reserve banks, shall be a party to the selection of the active heads of the twelve Reserve banks.

Under the present law the Federal Reserve agent is the person at the bank through whom the Federal Reserve Board deals. Under the proposed legislation these functions will be performed through the governor and the chairman, who will be one and the same; the governors will be the liaison officers between the twelve Federal Reserve banks and the Federal Reserve Board. One of the principal functions of the agent under the present law is to hold the collateral against the notes issued. He is responsible for seeing to it that gold certificates and commercial paper or Government bonds are deposited with him at all times in sufficient amount to meet the legal requirements for the issue of notes.

The right of the Board to approve the governors of the Reserve banks would make it necessary that the governors be satisfactory to the Federal Reserve Board. There should be cooperation throughout the entire System, if the functions of the System are to be carried out successfully. If the Reserve banks were to name their own chief executive officers without approval by the Reserve Board, you might as well do away with the Board. I do not know what the desire of Congress may be in this matter, but, certainly, if you want to have twelve independent banks, then there is no purpose in having a Federal Reserve Board. But, if you are going to have a Federal Reserve Board, then it must be charged with responsibility and it must be given authority.

I do not believe that the bill will take away the independence of the Reserve banks, because they will have the right to select a chairman and Class C director, which they do not now have, and, as a consideration for that, the Federal Reserve Board would be given the right to approve the appointment every three years. You would have anything but a satisfactory situation if the executive head of each of these twelve banks were entirely unsatisfactory to and uncooperative with the Federal Reserve Board.

Control of the Reserve banks would not be vested in the Federal Reserve Board because the Federal Reserve Board would not designate the governor. The Board could only approve or disapprove the person selected by the board of directors of the bank. The proposal is that the chief executive officer of the bank be acceptable to both the Federal Reserve Board and the board of directors of the bank.

Are there not enough good men so that it is possible to find a man who would be agreeable both to the Federal Reserve Board and to the regional bank board? Is it necessary to have as the head of one of the Reserve banks a man who is unacceptable to the Board, because of inefficiency or inability, and who may be retained in office because of the personal relationship between him and the local board? There is a sentimental relationship that is built up by close contacts; and directors of a bank, who are not stockholders of the bank, and who merely go to a meeting once every week or month, are not likely to oppose the reappointment of a governor, even though they may feel that he is not entirely desirable.

The fact that the Board can remove a governor of a Federal Reserve bank for cause does not remove the necessity for this legislation. The Board already has this power. It is very difficult to remove a man for cause. The matter of inefficiency or inability is very difficult to prove, unless there is some glaring lack of ability or some personal act that would justify the removal.

There is no thought or expectation that the governor of the Reserve bank will have less independent judgment because his appointment is approved by the Board. I am certain that under this bill the banks will be run very largely by the local boards of directors and by the governors of the banks, except so far as monetary policy is concerned. There is nothing in this bill that gives the Federal Reserve Board the power to force on a Reserve bank a governor who is unacceptable to the board of directors. The Farm Credit Administration has a similar power to approve the appointment of Federal land bank officers. They are appointed by the local boards, subject to the approval of the Farm Credit Administration; and the banks are owned by the local farm associations, which is private ownership. This arrangement has worked out very well.

Under the proposed legislation the chairman and governor will not be required to be a resident of the Federal Reserve district in which he serves. It will be possible to transfer a man from one Federal Reserve district and make him governor, chairman and Class C director of a Federal Reserve bank in another district. The governor may now be chosen from other Reserve districts; and the proposal simply applies the same principle to the chairman and Class C director, which is necessary in combining the offices of governor, chairman and Class C director. Such a provision would encourage a career system by permitting the promotion of able men in the Reserve System by moving them from one Reserve bank to another.

I am recommending that the governors and chairmen of the Federal Reserve banks be approved by the Federal Reserve Board every three years, rather than annually, so that their terms as governors and chairmen would coincide with their terms as Class C directors.

I find that the proposed combination of the offices of governor and chairman is universally looked upon as desirable. The American Bankers' Association is favorable to this section of the bill, as modified so that the governor is approved by the Board every three years.

Section 201 (2) Term of Office of Federal Reserve Bank Directors

It is proposed that directors of the Federal Reserve banks shall not be permitted to serve for more than six consecutive years.

Although the directors of the Federal Reserve banks are appointed for a period of three years only, in practice many of the directors have served since the beginning of the Federal Reserve System. It is thought advisable to limit the term of office of all of the directors to two consecutive terms, totalling a period of six years. This is proposed to avoid the crystallization of control or authority in any one group or combination.

It is felt that, in each Federal Reserve district, there are many able men to represent the member banks and also commerce, agriculture and industry, as well as the Board at Washington, which appoints the three Class C directors; and that the public nature of the Reserve System is such that it would be to the interest of the System to have a limit upon the terms of the directors.

It is recognized that some very able men would leave the System as the result of this restriction, but it is believed that on the whole there is more to be gained as a result of this policy than will be lost. As a matter of fact, the New York Bank and the Dallas Bank already have in operation the policy of limiting the terms of their directors elected by the member banks to three years. They adopted this policy in the interest of harmony among their member banks. If it has been found to operate in the public interest in the case of these banks, it would be well to apply it to all banks and to place the limitation at six years in the law.

There has been considerable discussion of this proposal, and I find that, almost universally, it is looked upon with favor by the banks throughout the country and that there is considerable feeling among banks that there has been a certain amount of crystallization of control in small groups.

Section 202 Admission of Insured Nonmember Banks

It is recognized that many of the insured nonmember banks could not readily qualify as members of the Federal Reserve System, and that a great hardship and injustice would be imposed upon them, if they were required to become members of the System under the existing law and under the existing rules and regulations for membership. It is, therefore, proposed that the Federal Reserve Board should have authority to waive the capital requirements for nonmember insured banks joining the System prior to July 1, 1937, when all insured banks are required by law to become members of the System.

In many instances, the capital of nonmember banks is less than the minimum amount required—$50,000, and their volume of business is such that they do not require and cannot support a capital of $50,000 plus an adequate surplus.

In connection with this proposal, I recommend that the authority for the Federal Reserve Board to waive the capital requirements for admission of insured banks prior to July 1, 1937, be broadened, so as to authorize the Board to waive not only the capital requirements, but all requirements, and to permit existing banks to continue permanently with their present capital, provided it is adequate, or is built up within a reasonable time to be adequate, in relation to their liabilities to depositors and other creditors. It is recognized that certain of the rules and regulations for membership would make it very difficult for many banks to qualify; and the Federal Reserve Board wishes, therefore, to modify the law and its rules and regulations so as to make it possible, under reasonable conditions, for nonmember banks to get the benefits of membership.

We want the language of the bill broad enough to give the Reserve Board the power to get nonmember banks into the System. The Federal Reserve Board has rather rigid regulations for admission to membership. For instance, banks are required to charge off all paper that is classified as a loss by the Reserve examiners, and all depreciation on bonds except those in the four highest classifications. Unless the proposal is modified, as suggested, the Federal Reserve Board would be expected to give the same consideration to the bond accounts of these banks that is now given to the bond accounts of existing member banks, both by the Reserve Board and by the Comptroller's office.

I have in mind another particular situation. A number of banks, in order to reopen after the banking crisis, found it necessary to get waivers of a certain percentage of their deposits. Certificates of claims were issued for the deposits which were waived. These claims are, of course, secondary to the deposits of the reopened banks, but senior to the stockholders' interest in the banks. It has been construed by the counsel of the Federal Reserve Board that, under our present Federal Reserve Act, these claims are a liability of the bank, and therefore that the banks cannot be considered to have unimpaired capital and cannot qualify for membership so long as the claims exist. For all practical purposes, the depositors are as fully protected as if the claim had not be issued.

It is also proposed that the existing capital requirements should be waived permanently, if the capital and surplus of the bank are adequate in relation to the bank's liabilities to depositors and other creditors. For instance, a bank with $40,000 of capital and surplus combined, and with a deposit liability of $250,000, has adequate protection for its deposit liability. That is as much protection, on the average, as the deposits have throughout the banking system, as a whole.

There would be no point in making requirements for these banks which would exclude them from the Federal Reserve System, and would thus exclude them from the benefits of the Deposit Insurance Corporation and possibly close them. That would be a foolhardy thing to do. With the guaranteeing of bank deposits by the Federal Deposit Insurance Corporation and with the purchases of preferred stock by the Reconstruction Finance Corporation, the banking problem is very different than it was. I am sure, so far as the present Federal Reserve Board is concerned, that they realize fully the situation with regard to individual banks and that it would be their expectation under the proposed amendment, to take into the System all, or practically all, banks which are insured.

I think it is desirable to encourage unification of the banking system, and I believe the most likely way is through all banks becoming members of the Federal Reserve System.

The Banking Act of 1933 provided that all insured nonmember banks must become members of the System by July 1, 1937. I think that it is helpful to provide the period until July 1, 1937, for the banks to adjust their affairs before applying for membership; and I see no reason for an extension of time in view of the proposed legislation.

After a reasonable time—and the period until 1937 is a reasonable time—and after the requirements for membership are liberalized, any bank which is insured by the Federal Deposit Insurance Corporation should be required to be a member of the Federal Reserve System for better protection of the Federal Deposit Insurance Corporation. The Federal Government has a moral obligation in connection with deposit insurance because the public looks to the United States Government to make that insurance corporation solvent if the banks cannot or do not.

In 1933 it was found that the Federal Reserve System was the only agency that could provide liquidity to the banking system and thus could enable the banks of the country, both member and nonmember banks, to reopen and to make available the depositors' money. This had to be done at that time, even though the Federal Government had nothing whatever to do with the chartering or the supervision of nonmember State banks. The Government had the responsibility through the Reserve System of giving these banks the benefits and protection of that System.

So long as the depositor is protected by the Federal Deposit Insurance, there should be an effort made to get all of the banks into the System, so as to unify the banking system and thus more effectively to carry out a monetary policy and by that means, also, greatly to assist in dealing with deflation as well as inflation. I believe we will never have in this country a banking system that can withstand the pressure of periods of financial distress until we get a unified banking system.

During the depression the greatest decline in deposits, both the percentage and the amount of decrease, was in nonmember State banks. Bank failures were also far more numerous in the case of nonmember State banks than in the case of member banks, both State and national. Of course there were exceptions in individual areas; but I am speaking of the United States as a whole. I am not attempting to make any odious comparisons between member and nonmember banks, for the purpose of putting the nonmember banks to any disadvantage. I am only trying to argue that all banks should be members of the Reserve System; that the borrowing and rediscount facilities of the System should be available to them, in addition to deposit insurance, so that we may avoid fires starting in the back alleys. After all, the net result of a conflagration of the bank failures is finally to burn down the System, if it is not stopped. We are interested in this problem, not only on account of the bankers and stockholders of the banks; but also because of the duty of Congress and of officials who are responsible for our money situation.

I feel that banking policy cannot be successfully carried out so long as a substantial part of the banking system is not under the Federal Reserve System. The control over reserves and the control over money is limited to the extent that a substantial part of the banking system is entirely outside the Reserve System. And, since the nonmember State banks came to the Federal Government in an emergency and requested the benefits of the Reserve System and since the Reserve System was required to give aid to nonmember State banks, I believe that the legislation passed last year and the amendment proposed are necessary and constructive.

I believe the benefits of membership for small nonmember banks are very real, particularly if the present law is amended as provided for in the proposed bill. I refer to the proposed change in eligibility requirements for discount; also to the recognition of the desirability of using funds representing time deposits for longer term lending, particularly for real estate loans. The opportunity of rediscounting or borrowing from the Reserve bank for seasonal or emergency requirements would be a great help to the local community and would tend to prevent bank failures which might otherwise develop. Furthermore, the banks would get 6 per cent on their investment in capital stock of the Reserve bank and at the present time this represents a very profitable investment.

I have met many nonmember State bankers, and I know that they feel that it is against their best interests to become members of the Federal Reserve System. That may have been true in the past to the extent that they could carry their reserve balances in the city banks and get 2 per cent or 1½ per cent interest. Today they get no interest on their reserve balances in the city banks, and they would be just as well off to have these balances in the Reserve banks. There are other advantages which I have already mentioned.

I have been in the banking business for 22 years, from 1913 up to the time I came to Washington, a little more than a year ago. My first banking connection was with about a million dollar bank which joined the Federal Reserve System shortly after the Federal Reserve System was organized. It is a State bank. During that period a banking organization of over $55,000,000 was built up, including over 25 banks, national, State member and State nonmember. I found that it is in the interest of a bank to be a member of the Federal Reserve System, whether it is a small country bank, or a city bank of substantial size; and I am stating here my honest conviction of what, as a result of experience and study for a period of years, I feel is in the public interest and in the bankers' interest.

And I believe that the great majority of the nonmember State banks, if they understood this problem, could be persuaded that it is in their own interest to become members. I have found in my contacts with nonmember State bankers that they can be sold the idea, and that the difficulty with a great many of them is a lack of understanding and information with reference to the problem.

This bill does not deal directly with the problem of unifying the banking system. That matter was covered by the legislation which was passed in 1933, which set the date when the insured nonmember banks will be required to become members of the Federal Reserve System.

The State banking departments are not to be eliminated and State banks are not to be brought under central control, so far as the examination of banks and the chartering of banks are concerned; but the legislation would unify the System by placing State banks under the influence of open-market operations and of changes in reserve requirements and in discount rates. The legislation now proposed merely facilitates the carrying out of the legislation which has already been passed.

It is my personal belief that it is impracticable to do more at the present time. Practically every other country in the world has one banking system; and, as the result of that, other countries have, I believe, avoided many of the banking troubles which we have had. But this country is young, and I do not believe that we can make changes in our methods and habits too rapidly. We cannot go faster than the people of the country are willing to have us go.

There is no question but what there are many improvements that can be made in the banking system which are not included in the proposed legislation. I believe, however, that banking legislation must be evolutionary and not revolutionary. We cannot expect in one session of Congress to get all the banking legislation we want, when we take into account the size and habits of the country and the diverse opinions. Other problems of banking which have been discussed from time to time, such as the matter of complete unification, of bank examinations, and of branch banking will come up from time to time for consideration. There is no question about that.

I think the experience of the past has been a very salutary one, and that, if this legislation is passed and is administered with understanding and in the spirit that has motivated it, a repetition of the banking catastrophes of the past will be impossible.

I do not believe that the other members of the Reserve System would be unfavorably affected by this legislation. It is in the interest of all member banks to have all nonmember banks admitted to membership in the System, for the purpose of uniformity in banking practices and procedure, and for other reasons. Admitting the insured nonmember banks into the System would place no liability upon the present member banks. Furthermore, it is in the interest of the banking system as a whole, nonmember banks as well as member banks, to have all banking institutions, which have the power to create money, members of the Federal Reserve System.

Section 203 (1) Qualifications for Membership on the Board

A change is proposed in the qualifications for membership on the Federal Reserve Board to make these qualifications more descriptive of the principal function of the Board, which is the formulation of national economic and monetary policy.

The proposed qualifications would recognize the fact that the functions and duties of the Federal Reserve Board require that it be a body representing the nation, rather than any group or combination of groups. It is proposed that future appointive members of the Board shall be men who are qualified by education or experience or both to participate in the formulation of economic and monetary policies.

Section 203 (2) Compensation and Retirement Provisions for Board Members

It is recognized that membership on the Federal Reserve Board is one of the most important, responsible and powerful positions of the nation, which should attract the men in the country best qualified to deal with monetary and economic problems. It is therefore believed that the compensation of Board members should be such as to enable them, without independent, private incomes, to live in Washington in the manner that their position requires. It is proposed that the compensation for future appointive members be increased to $15,000 per year, the salary now received by members of the Cabinet. Their salaries were originally fixed on this basis but those of Cabinet officers were subsequently increased. Pension or retirement provisions are also proposed, so that members of the Board can serve without financial worry.

I believe, however, that the pension provisions in the bill as introduced do not meet the situation adequately. It is provided that the present members may retire at the age of 70, and that future appointive members must retire at the age of 70. It also provides that, upon retirement, the member will receive a pension of $12,000 per year, when they have served the full period of twelve years or more, and a proportionate amount when they have served more than five but less than twelve years.

It does not seem fair to ask a person to accept the position and to serve for a twelve-year term, we will say from the age of 48 to 60, if at the end of that time he would be obliged to attempt to reestablish his former business connections. It would be in the public interest to provide that, if the term of a member expires and he is not reappointed, he would receive a pension on the same basis as though he retired at 70.

I believe that the proposed legislation would increase the independence of the members of the Board and would also make it possible to attract the ablest men to these positions, to make them willing to sever all other connections and to accept positions on this Board as careers. It would also have the effect of inducing men to accept membership on the Board during the most active and remunerative period of their lives.

It has been suggested that a President might control the Board through his power over the appointment of its members. This would be possible only to the extent that the terms of members expired. A member is appointed for a twelve-year term. There is no other way of getting rid of Board members except by the power of removal for cause which has always been in the law. There is no proposal to put in the bill any change in the method of appointing members of the Board, or in their terms.

During the period of twenty years that the Federal Reserve Board has been in existence no member of the Board has ever been removed for cause. Their terms have expired or they have resigned voluntarily.

Section 203 (3) Term of Office of Governor of the Board

There has been considerable discussion of the provision in the proposed legislation that the term of the Governor as a member of the Board shall expire when he is no longer designated as Governor by the President. The present law provides that the Governor shall be designated by the President, the designation being from among the Federal Reserve Board members. As a practical matter, this has been consistently interpreted that the Governor serves as Governor at the pleasure of the President.

I think, as a practical matter, that it is reasonable to allow the President to remove the Governor, whenever he sees fit. An Administration is charged with the economic and social problems of the nation. It seems to me that it would be extremely difficult for any Administration to deal intelligently with the economic and social problems of the country entirely apart from the money system. There must be a liaison, a responsive relationship, between the Administration and the money system; that does not mean political control in the undesirable sense which is so often implied. I think that the Governor of the Federal Reserve Board is the channel through which that relationship should develop.

It is said that there may be situations in which the political exigencies might be in direct conflict with wise banking and credit policy. All I can say is that, if there are such exigencies—war is a case in point and depression is a case in point—then I think it would be very unfortunate if the Administration were unable to carry out its program. Practically all political questions relate to social and economic problems. When an Administration comes into power, it cannot be charged with dealing with those problems separately, free and divorced from the money system.

There is an important disadvantage in the existing law which would be removed by the proposed legislation. When a Governor is no longer designated as Governor and resigns from membership on the Board without serving his full term—which is the only thing a Governor could or would do—he is precluded for a period of two years from accepting a position in a member bank. That is a serious deterrent in the present law to a man in the banking field in considering the position of Governor of the Board. He is required to sever all connections with the banking business for a long time, that is, for as long as he is designated as Governor, and for an additional two years, if he resigns from his membership before he has served his full term. If he has served his term as member, he may immediately enter the private field. With this drawback of the office removed by the proposed legislation, it seems to me that the position will be more attractive in the future than it has been in the past.

I can see no reason to expect the Federal Reserve System, under this bill, to be any more subject to political control than has been the case in the past. There is nothing in this bill that proposes that. The bill would give the Federal Reserve Board increased power, but the President has no different power over the Board, unless you construe the proposal to mean that it gives the President greater power over the Governor than he now has.

There has never been a legal test as to the power of the President to remove the Governor; but, in practice, the existing law has always been accepted as giving him that power. The present Federal Reserve Act requires that the President designate a member of the Board to serve as Governor. The provisions of the law read as follows: "Of the six persons thus appointed, one shall be designated by the President as Governor and one as Vice Governor of the Federal Reserve Board. The Governor of the Federal Reserve Board, subject to its supervision, shall be its active executive officer." This has been consistently interpreted that the Governor serves as Governor at the pleasure of the President. His term of office as a member of the Board is provided by law but not his term of office as Governor of the Board. When a member of the Board is no longer designated as Governor, he is still a member of the Board, unless he resigns, which he usually does when he is no longer designated as Governor. The bill clarifies this matter without changing it by including the additional provision "to serve as such until the further order of the President." The bill further provides that the Governor shall be deemed to have served his full term of membership on the Board when he is no longer designated as Governor.

Up until the time Governor Meyer was appointed, the President designated the Governor each year. It had been the custom from the beginning of the Federal Reserve System for the President to designate the Governor from year to year.

It seems to me that the present statute should be clarified and that, if it is the wish of Congress that the Executive shall have the right to appoint a Governor and remove him, the term of office as Governor should be made specific and the interpretation that has always been placed upon it should be clarified.

The present provision means that, if the Governor were no longer designated as Governor and did not resign as a member, there might be no vacancy on the Board to which the President could appoint a person not a Board member whom he desired to designate as Governor.

It is said that the proposed legislation would give the President the opportunity, if he cared to do so, to change the entire Federal Reserve Board in a few days. I do not believe that would be possible. If a member of the Reserve Board desired to retain his position on the Board, he would refuse to accept the position of Governor, knowing that he would go out the next day or the next week. If, on the other hand, he did not choose to stay on the Board if the President desired to remove him, he very likely would resign without going through the formality of being appointed as Governor. If we are going to conceive of a President who would resort to what would be considered sharp practice, we should realize that he would have more direct ways of changing the personnel of the Federal Reserve Board.

The possibility of a President resorting to sharp practice of that sort in order to change the Board did not occur to me nor, I think, to anybody else who had anything to do with this legislation. The reason for providing that a Governor's term as a member shall expire when he is no longer designated as Governor was not to give to the President additional power, but to make it possible for a Governor who was no longer designated as Governor to resume business without waiting for a period of two years.

I think that in most other countries the government in power designates the Governor and that the Governor serves during the pleasure of that administration. England is about the only exception. It has been recognized, in the establishment of all the central banks within recent years, that it is necessary and desirable that the administration in power have that responsibility and that authority.

There are, of course, differences in the organization of the various foreign central banks. The Bank of Canada is the most recent; and in Canada the board is really an advisory board and the governor can veto an action of the board. He is not required to follow their recommendations or their authorizations, as I understand it, so that the control of the bank is practically in the hands of the governor.

Section 204 Assignment of Duties

There is no controversy over the grant of power to the Board to assign specific duties to designated members of the Board or its representatives. It is a practical way of enabling the Board to meet the problems involved in its increased responsibilities by delegating to others many of the routine duties which do not involve questions of policy.

Section 205 Open-Market Operations

From the long time point of view the recommendations dealing with changes in the machinery for determining and carrying out the open-market policies of the Federal Reserve System are essential. Open-market operations are the most important single instrument of control over the volume and the cost of credit in this country. When I say credit in this connection I mean money, because by far the largest part of money in use by the people of this country is in the form of bank credit, or bank deposits. When the Federal Reserve banks buy bills or securities in the open market, they increase the volume of the people's money and lower its cost; and when they sell in the open market, they decrease the volume of money and increase its cost. Authority over these operations, which affect the welfare of the people as a whole, must be vested in a body representing the national interest.

Under existing law open-market operations must be initiated by a committee consisting of representatives of the twelve Federal Reserve banks, that is, by persons representing primarily local interests. They must be submitted for approval or disapproval to the Federal Reserve Board, and after they have been approved by the Federal Reserve

Board, the boards of directors of the Federal Reserve banks have the power to decide whether or not they wish to participate in the operations. We have, therefore, on this vital matter a set-up by which the body which initiates the policies is not in a position to ratify them; and the body which ratifies them is not in a position to initiate them or to insist on their being carried out after they are ratified; and still a third group has the power to nullify policies that have been initiated and ratified by the other two bodies. In this matter, therefore, which requires prompt and immediate action and the responsibility for which should be centralized so as to be inescapable, the existing law requires the participation of the twelve governors of the Federal Reserve banks, eight members of the Federal Reserve Board and 108 directors of the Federal Reserve banks scattered all over the country, before a policy can be put into operation.

It requires no further explanation to show that the existing machinery is better adapted to permit delay and obstruction than it is to promote effective operation, and that it results in a diffusion of responsibility which prevents the necessary feeling of complete authority and responsibility by a small group of men who can be held accountable by the Congress and the nation for the conduct of this matter of national importance.

The proposal in the bill is to set up a committee of five, three of whom shall be members of the Federal Reserve Board and two governors of Federal Reserve banks. This proposal would have the advantage of creating a small committee with undivided responsibility. It is not clear, however, that this arrangement is the best that can be devised for the desired purpose. Under this proposal, the Federal Reserve Board, which is appointed by the President and approved by the Senate for the purpose of having general responsibility for the formulation of monetary policies, would have to delegate its principal function to a committee, on which members of the Board would have a bare majority, while governors of the banks would have two out of five members.

From the point of view of the Board the disadvantages of this arrangement are that a minority of the Board could adopt a policy contrary to that favored by the majority. It would even be possible for one member of the Board by joining with the two governors to adopt a policy that would be objectionable to the seven other members of the Board.

The placing of this authority in such a committee would also have the disadvantage of giving one important power, the power of open-market operations, to the Open Market Committee, while other fundamental powers are vested in the Board. These powers could be utilized to nullify the actions of the Open Market Committee. For example, the committee might adopt a policy of easing credit, while the Federal Reserve Board would be in a position to tighten credit, either by raising discount and bill rates or by increasing member bank reserve requirements. Also the Board, through its power of prescribing regulations for open-market operations, could conceivably interfere with the carrying out of the policies of the committee. While it is not contemplated that such extreme situations would occur, it does not seem desirable to amend the law in a manner that might result in such unreasonable developments.

Upon further study it would appear that the best way to handle this proposal would be to place the responsibility for open-market operations in the Federal Reserve Board as a whole and to provide for a committee of five representatives of Federal Reserve banks selected by the governors of the twelve Federal Reserve banks to advise with the Board on this matter. The Board should be required to obtain the views of this committee before adopting a policy for open-market operations, discount rates, or changes in reserve requirements.

Such an arrangement would result in the power to initiate open-market operations either by a committee of the governors or by the Board, but would place the ultimate responsibility upon the Federal Reserve Board, which is created for that purpose. In this connection I should like to quote President Woodrow Wilson, who in his address to the joint session of Congress on June 23, 1913, said: "The control of the system of banking and of issue . . . 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."

The Board would not be required to accept the suggestions of the advisory committee. It is a question of giving the governors a hearing and of making a record before the Board can act; but the Board would have the final responsibility for the action taken. The Board would be charged with the responsibility for open-market policies and would have the power to initiate policies, but before taking action it would be required to advise with and get the views of the committee of the governors; also the governors could initiate policies and make recommendations for the consideration of the Board.

It has been suggested that it may be undesirable to eliminate the checks and balances that exist between the Open Market Committee, the Federal Reserve Board and the directors of the respective Federal Reserve banks. It seems to me that if each of the twelve Reserve banks be permitted to operate independently of the interests of the country as a whole, with reference to their monetary policies, great confusion would be inevitable. It would be impossible to have an effective monetary policy. So far as I know, no other country has a divided responsibility with reference to monetary policy that would be comparable to a policy made by the twelve different Federal Reserve banks.

I believe that monetary policies must be dealt with on a national basis. Money, like water, seeks a level; and to raise rates in one section would cause the funds to flow to that section from the section where the rates were lower and the excess reserves in the first area would increase substantially, making for expansion of credit and cheap money; in the area from which funds flow the effects would be the opposite.

On the other hand, I do not believe it is necessary to have a uniform discount rate at all the Reserve banks; and, as a matter of fact, there has rarely been uniformity in the discount rates. The discount rate is proposed by the Reserve banks and approved by the Federal Reserve Board, as a general rule.

If the Open Market Committee felt that it was in the national interest to raise rates in order to prevent undue expansion and speculation, they would do so; and, if they felt on the other hand that there was an unnecessary contraction of credit, they would reduce rates and reserve requirements in an effort to stop the deflationary process, so far as they could. These decisions must be made in the interests of the nation, because the various parts of the country are interdependent and money is transferable almost instantaneously.

It seems to me that when we speak of centralizing control outside of the banks we fail to recognize the peculiar structure of our Federal Reserve Banking System as contrasted with central banks elsewhere in the world. If we had one bank with twelve branches or as many branches as might be necessary to serve the country, then the board of directors would be charged with the responsibility for monetary policy as well as the responsibility of providing credit for business, agriculture and industry. The law as now constituted does not require the Federal Reserve Board as such to adopt an open-market policy; except, as I understand it, in giving their approval or disapproval to the policy initiated by the governors' committee. The Board cannot initiate open-market operations.

At the present time we are still in the depths of a depression and, beyond creating an easy money situation, there is very little, if anything, that the Reserve organization can do toward bringing about recovery. One cannot push a string. I believe, however, that if a condition of great business activity were developing to a point of credit inflation, monetary action could be very effective in curbing undue expansion. That would be pulling a string.

It has been asked whether the language of the proposed bill is adequate to make it obligatory for the Federal Reserve banks to engage in open-market operations if they do not want to do so. I believe that, under the proposal, the Reserve banks would be required to participate in the purchase of securities or bills as determined by the Open Market Committee. The bill as introduced contains this language, on page 45, lines 3 to 9: "The Committee from time to time shall consider, adopt, and transmit to the Federal Reserve banks resolutions setting forth policies which in the judgment of the Committee should be followed with respect to open-market operations of the Federal Reserve banks, and the Federal Reserve banks shall conform their open-market operations to the provisions thereof." That means that the Federal Reserve banks must conform their open-market operations to the provisions of the resolutions adopted by the Committee. If there is any doubt as to the adequacy of the language of the proposal in this respect, it should be clarified.

The proposed amendment in no way gives the Board power to compel the Reserve banks to make loans. It is expected that the Reserve banks will be just as independent as they have been with reference to their autonomy in matters of regional interest, including not only discounting, but all relations with member banks. In this bill we are only providing that the responsibility for monetary policy be located in a comparatively small body that can be charged with the public interest. That seems to me to be absolutely essential, if we expect to avoid in this country the dangers inherent in a purely banker control over the creation and the extinguishing of credit.

Section 206 Eligibility for Discount

It is proposed to give the Federal Reserve Board authority by regulation to determine the character of paper that may be eligible as a basis for borrowing at the Federal Reserve banks. This is particularly important at this time because it would encourage member banks to pay less attention to the form and maturity of paper that is offered by would-be borrowers and to concentrate their attention on the soundness of such paper. At present many banks are unwilling to extend loans to borrowers who have assets that are unquestionably sound because they lack assurance that in case of a withdrawal of deposits they would be able to liquefy these assets at the Federal Reserve banks.

In times of emergency it has been necessary to remove existing legal restrictions and to give discretion in the matter to the Federal Reserve authorities, as was done under the Glass-Steagall Act of 1932. This act, however, was passed after a great many banks had gone to the wall at least partly because of lack of eligible paper and its provisions, in so far as they relate to borrowing from the Reserve banks, expired on March 3, 1935.

What is proposed is not, as has been sometimes alleged, a policy of opening the doors of the Federal Reserve banks to all kinds of paper, regardless of its soundness. On the contrary, it is proposed to place emphasis on soundness rather than on the technical form of the paper that is presented.

Experience under emergency laws shows that the Federal Reserve banks and the Federal Reserve Board have exercised caution and, though they have extended credit on ineligible assets to the extent of $300,000,000, all but $1,500,000 of this has been paid back and the banks have suffered no considerable losses. It would appear safe, therefore, to intrust discretion in the matter to the Federal Reserve Board, which is always in session and, therefore, is in a position to consider emergencies promptly without being under the necessity of proclaiming them by an appeal to Congress and thereby aggravating the situation, and without being obliged to wait for Congress to be in session and to act on the matter.

The eligibility requirements of the existing law do not meet present-day banking conditions which differ from conditions at the time the Federal Reserve System was established. The amount of eligible paper now held by banks is a small part of the total resources of the banks. Even in 1929, it was only slightly over 12 per cent of their loans and investments, and today it is less than 8 per cent. The total amount of the paper which would be considered eligible by the banks themselves is only about $2,000,000,000 at the present time and was only about $4,000,000,000 in 1929. While this amount is sufficient in the aggregate to provide access to the Federal Reserve banks, there are many individual banks that do not posses sufficient eligible paper.

During the depression, the banks did not have eligible paper to meet the withdrawal of their deposits, which was brought about by the general liquidation of bank loans and by hoarding; in order to avoid closing, they were forced to liquidate in the market such bonds as they had and could sell without too large a loss; they were also forced to bring pressure for payment of all loans which came due and to refuse new credit, so that they might have as large cash reserve as possible and be as liquid as possible. The attitude of the banks throughout the nation was largely due to the fact that they lacked eligible paper in sufficient quantities for their required accommodation at the Federal Reserve banks.

As a consequence, in an effort to remain liquid, they froze themselves so completely that they finally closed the entire banking structure. In the final analysis, there can be no liquidity during a depression, except liquidity created by the Federal Reserve banks through their power of issue. It was finally recognized that it is not necessary to have rigidly defined eligibility for paper for discount.

This rigid eligibility was finally changed, but only after a great deal of damage had been done, after thousands of banks had been closed unnecessarily, after millions of individuals and institutions had been forced to the wall through the lack of available credit or through pressure to pay existing debts, and after millions of depositors had lost hundreds of millions of dollars through the closing of banks.

It seems to me only realistic to recognize that the Reserve banks, subject to rules and regulations made by the Reserve Board, should have the power to meet emergencies by loaning to member banks upon sound assets, rather than to see unnecessarily drastic liquidation forced upon the community.

This provision does not mean inflation. Before the banks today, as a whole, would have occasion to borrow from the Reserve banks, they would have to extend billions and billions of dollars of credit, because of the excess reserves they now possess. But, if the provision exists, it may make the banks feel altogether differently about extending credit today. It will make them realize that, in order to have access to Reserve bank credit, they do not have to have specified types of ninety-day or six-month paper, the supply of which is limited.

In a period of timidity like the present, the banks tend to refrain from making loans, except on paper eligible for discount at Federal Reserve banks. This is even now a factor causing liquidation in many communities and preventing adequate expansion of credit in others. There is ample credit today, but, without a change in the eligibility features, there will be great hesitancy on the part of the banks to loan on other than short-term commercial paper or Government bonds. If the bill is adopted, banks will be willing to loan existing funds on longer terms than they otherwise would.

A bank that conducts its business on the theory of having only such assets as can be disposed of at will in times of crisis, when the national income has been cut in two, cannot serve its community adequately. Such a bank would confine its operations to the purchase of the most liquid open-market paper, with the consequence that it would neglect its local responsibilities and would find it difficult to earn enough from the low returns on such paper to cover expenses. The banks should be in a position to meet the needs of their communities for all kinds of accommodation, both short- and long-term, so long as the credits are sound, and they ought to have the assurance that all sound assets can be liquified at the Federal Reserve bank in case of an emergency.

The proposed revision of eligibility requirements is one of the most important features of legislation at the present time. It will tend to do more towards inducing recovery through credit expansion than any other feature of the bill. The banking System must be made to provide the money and credit required, if it is going to justify its existence. At the present time, credit is provided largely by the Government.

The Government is lending to individuals and corporations through the various Government lending agencies, of which the three most important are the Home Owners' Loan Corporation, the Farm Credit Administration and the Reconstruction Finance Corporation. The banks have been liquidating their private loans, and the Government has been taking them over, and the banks have been providing funds through the purchase of Government bonds or of bonds guaranteed by the Government. If this is continued, it seems to me that the banks will have great difficulty in justifying their existence.

If the banks do not utilize their funds in the direct field of lending in place of the Government, they will find that the Government will have taken over the banking business, not because the Government wanted to, but because the banks forced it.

I think the emergency measures were very effective, because they stopped banks from closing. When people can get their mony, they do not want it. Instead of the Reserve banks being required to make loans to member banks, money which had gone into hoarding tended to come back into the banks. That enabled the banks to repay their borrowings to the Federal Reserve banks, so that the amount of member bank borrowings from the Reserve banks today, is negligible; whereas, in 1933, it was very large.

It was section 10 (b) of the Federal Reserve Act, as amended by the emergency banking act, which provided that, under exigent circumstances, member banks may borrow from Reserve banks on their time or demand notes secured to the satisfaction of the boards of directors of the Reserve banks. There was some use made of that provision, but not very much, because it was necessary for a bank when it applied for credit under the terms of the provision, to admit that it was in great distress and in exigent circumstances and that it required special treatment by the board of the Federal Reserve bank; this meant that a bank would use the borrowing privilege only as a last resort. Furthermore, this law came too late, after numerous banks had been obliged to close.

It is not proposed in the bill to make real estate loans eligible for discount. The bill would authorize Federal Reserve banks, subject to the regulations of the Board, to discount for a member bank all commercial, industrial or agricultural paper, and to make advances to a member bank on its promissory notes secured by any sound assets, which would include real estate loans, collateral loans, bonds, or any other sound assets. Real estate loans have not been eligible as collateral for advances from the Federal Reserve bank except during an emergency and then could be used as collateral for an advance only as an emergency matter. In a depression, only the Federal Reserve banks can liquify assets, and real estate loans do not differ from other types of assets. In a great depression, there is no other place for a bank to go for advances on such assets as real estate loans, loans on collateral, or investments in bonds. When the market is severely depressed, as it was for a period of several years, it means bankruptcy for any bank to liquidate its assets on the existing market.

It has been asked whether the difficulties of banks in meeting their demand obligations were the result of a scant supply of actual currency. The answer is no. The banks found that they were unable to meet their deposit liabilities in currency because of the lack of assets which the Reserve banks would accept. That reduced the amount of currency that they were able to pay out, and the very fact that many of them were unable to meet that demand created a general demand to convert deposits into currency. As soon as the Emergency Banking Act of 1933 permitted the banks, both member and nonmember, to get credit in the form of currency from the Reserve banks upon all of their sound assets, the people of the country no longer wanted their deposits in currency. The currency began to come back into the banks and deposits in banks increased.

Many of the assets considered eligible and held to be liquid were less sound than other assets held by banks which could not qualify for rediscount or as security for borrowing from the Reserve banks.

An asset that may be considered sound and liquid when business is active and there is a high rate of employment and national income is large, may become frozen and unsound if the national income diminishes. Liquidity and soundness are not determined merely by the substance of a loan or asset at the time the asset is purchased or the loan is made; they depend upon the state of trade and business which follows.

By way of illustration, when German bonds were purchased prior to the war, they were considered the best in the world, and they were sound assets. When wheat was selling at $2 a bushel, it would have been proper to have loaned upon that wheat with a 25 per cent margin, on the basis of a warehouse receipt; the loan would have been considered perfectly sound, and the paper would have been eligible for discount. The same thing is true for any other commodity. I remember when sheep were selling at $16 a head, and when within a six months period you could not sell them at $4 a head; yet a loan for nine months made on sheep at $16, say $8 a head for six months, was eligible for discount; but, before that loan came due, that security was selling for about one-half of the amount of the loan.

Even Government bonds would cease to be liquid at the price at which corporations could not sell them without going bankrupt. The price of Government bonds in 1932 was down, the 3's, I think, to $83. If any substantial amount of those bonds had been sold in that market, the market might have gone to $50 and any bank holding a substantial amount of the bonds would have been ruined. The banks, however, could go to the Federal Reserve banks and borrow on those Government bonds; that was a protection to the market and to the banks, which would not have existed had the banks been obliged to sell those bonds instead of using them as a basis for borrowing at the Reserve bank.

It is up to the banking system in so far as it is possible, to maintain a state of trade and business that will preserve soundness.

To the extent that forced deflation through forced credit contraction is obviated through making available the discount facilities of the Reserve banks—to that extent liquidity is provided. The only liquidity that really exists in a serious depression is the liquidity that is provided through the money-issuing agency, the Federal Reserve banks.

The banking system has excess funds seeking investment of over $2,000,000,000. The excess reserves of the banks are sufficient in amount to enable the banking system as a whole to extend new loans or to purchase additional bonds to the extent of about $20,000,000,000, without borrowing from the Federal Reserve System.

The banking system creates money through its loans and investments. A bank making a loan of a thousand dollars to a customer creates a thousand dollars of deposits. This increase in deposits increases reserve requirements by 10 per cent of that amount. For every thousand dollar increase in deposits the excess reserve decreases by 10 per cent of the increase, so that a loan of a thousand dollars increases the assets of the bank by a thousand dollars and the liabilities, in the form of deposits, by a thousand, and the reserve requirement by one hundred dollars, approximately. Therefore, $2,000,000,000 of reserves in the System as a whole are sufficient to enable the banks, on the basis of ten for one, to extend credit to the extent of $20,000,000,000 without having to go to the Reserve banks and discount or borrow money.

Under the present law, the Reserve banks determine the acceptability of assets or the type of paper which they will take from member banks, subject to the eligibility requirements of the Federal Reserve Act. In the future, if the law is amended to give discretion to the Federal Reserve Board in determining the eligibility requirements, the Reserve banks will have power to loan to member banks, according to rules and regulations laid down by the Federal Reserve Board. However, it would not be mandatory, and it is not mandatory in the present law, that the Federal Reserve banks loan to member banks; they simply have authority to loan to member banks upon what is considered eligible paper.

The policy of the Board in making regulations defining eligible paper under the proposed legislation would depend a great deal upon the conditions that confronted the country. In 1930 and 1931 it would have been in the interest of the banking system and in the interest of the entire country if, in the case of those member banks which had very little or no commercial paper, the Federal Reserve banks had been permitted to loan on any sound assets. The inability of the member banks to borrow from the Federal Reserve banks forced great deflation.

As to the additional specific types of paper which the Federal Reserve Board should class as eligible paper, for rediscount by member banks, I can merely give my personal opinion; I cannot speak for the Board. I believe that very broad rules and regulations should be made with reference to this subject and that broad discretion should be left to the Federal Reserve banks. I think that, in matters of local credit concerning each Federal Reserve district, the Reserve banks should be given discretionary power and that they can be relied upon to make only sound loans.

I would not like to say that, under normal conditions, paper on a bills-payable basis should be taken for longer than a six-months period, because it is always an easy matter to renew the paper. The question of renewal would be up to the Reserve banks.

It would be bad for the banking system as a whole to permit continuous borrowing from the Reserve banks by the member banks. Continuous borrowing from the Reserve banks by the member banks could only mean that the member banks were rediscounting or borrowing and then lending the money because of the difference between the rate that they paid the Reserve banks and the rate at which they loaned.

However, I can well imagine a situation in which there would be a crop failure, drought, or similar catastrophe, when it would be very desirable for the Reserve banks in the affected areas to carry loans for an additional period in order not to force liquidation. Past experience and the attitude of member banks towards borrowing indicate that we can be assured that in ordinary times member banks are not going to borrow from the Reserve banks except for short, seasonal requirements; when an emergency develops, it may be necessary for them to borrow for longer periods of time; and it is such borrowing for which this legislation is proposed.

In case of a rediscount, maturity should be based upon what would be considered the period of natural liquidation. For instance, for agricultural and live stock loans the period is nine months, since it is considered that the underlying transactions take that length of time. These loans are rediscountable now. Collateral loans, loans which are not considered rediscountable and are not self-liquidating through the completion of business transactions, such as real estate or collateral loans, would probably be made eligible only in cases of emergency, rather than in the natural course of business. Certainly the Reserve bank should be given the power to enable a bank that has an unusual shrinkage of its deposits and yet has sound assets, to get credit on them so that it can carry out a normal process of liquidation, without closing and without bringing about an undue deflation. That is the purpose of this legislation.

As a general rule, when manufacturing companies, such as sugar companies and other companies, borrow from the banks, they do not want to borrow for a period longer than six months, or even ninety days, because they are constantly reducing the outstanding loans. They do not know exactly by what amount they may be able to reduce loans; and, hence, they do not want to rediscount up to the maximum amount of their financial requirements for a period of nine months. It may be that they can pay a substantial amount in three months and renew the balance. I believe that, even if a nine-months rediscount were permitted in that type of transaction, there would be very few that would use it. If the condition of the company were such that an open line of credit were desirable, if the company were willing to borrow for nine months, and the bank should take its nine-months paper, there would be no reason for preventing the Reserve bank from taking such paper just as they would take live-stock paper.

I think that it has been the member banks rather than the Reserve banks which have held borrowers to a three-months period for borrowing. The member banks prefer ninety-day paper, because in the past they have seen very wide fluctuations in the prices of commodities against which they loan. In loaning for a period of nine months on any commodity, there is more risk from wide fluctuations in prices; and it is my belief that, for its own protection, the member bank passing on the credit will adhere to ninety-day paper and then will renew the loan. After all, even if the member bank borrows from the Reserve bank, it is responsible for the obligation.

It has been suggested that the reason for the gradual decrease in the amount of commercial paper is that many corporations, both large and small, have found that they can get funds through the investment bankers, through the issue of securities.

It seems to me that during the life of the Federal Reserve System our business system has become more concentrated, through consolidation and mergers, into larger and larger units; and that there is today a greater concentration of corporate operations in fewer companies than we have ever had before. The trend in that direction is evidenced by the chain store development and by developments in almost every field of manufacturing activity.

As a result, commercial deposits have tended to be concentrated to a greater extent than formerly in the centers where the headquarters of the various companies are located; and all borrowing on the commercial paper basis, has tended toward concentration in the money market at very low rates; so that the average small bank in the towns with a population of not more than 10,000 or even 25,000, even during the post-war period of great activity, did not have the demand for commercial loans from their local business concerns that they had had previously.

It is true that many of the consolidations and mergers were brought about through the flotation of securities, bonds and stocks, and that, as a result of those flotations, the banks that formerly made commercial loans and short-term loans for the carrying on of business transactions furnished funds through the purchase of bonds or through loans to customers, who purchased bonds or stock. As compared with pre-war days, there was a substitution to quite an extent, no doubt, of bonds and collateral loans for commercial paper in the loans and investments of banks.

And recently, of course, the short-term financing of agriculture has been taken away from the local banks to quite an extent through the Production Credit Corporations, which are a part of the Farm Credit Administration and which get most of their funds, other than their capital which has been furnished by the Government, through the Federal Intermediate Credit Banks by the sale of six-month and nine-month debentures. These debentures are sold in the market; the present rate is about 1½ per cent per annum. The big banks with surplus funds purchase these debentures, thus providing funds through the Federal Intermediate Credit banks to the Production Credit Corporations and the Production Credit Corporations supply the funds to the farmers. This means that the big banks in the financial centers, through Federal credit agencies, are financing agricultural production; and that the eligible agricultural paper is taken away from the banks in agricultural areas.

If you will examine the statements of most of our business concerns, you will find that they have an excess of working capital. One of the difficulties today is that these concerns have large deposits in the banks, which they are not using and are not able to utilize. Even with an improvement in business, the most that could be expected from many of our business concerns would be that they would use the funds that they now have on deposit; and under no circumstances would they be required to borrow. Of course, I am speaking of our business concerns in very general terms. In number there no doubt are a great many business concerns that would be required to borrow; but, measured by the volume of the business which they do, they would represent a small percentage of total business.

Section 207 Purchase of United States Guaranteed Obligations

It is proposed that obligations fully guaranteed by the United States Government should be put on the same basis as direct obligations of the Government, in respect to eligibility for purchase by Federal Reserve banks. There is no logical justification for discrimination; the guaranteed obligations should be eligible for purchase, without regard to their maturity, in the same manner as the direct obligations of the Government.

This proposal has no relation to the proposed elimination of the collateral requirements against the Federal Reserve notes. The reason for the provision in section 207 is that it is felt that there should be no discrimination between Government bonds and bonds fully guaranteed by the Government. At the time the law providing for the purchase of direct obligations was originally passed, there were no guaranteed obligations; had there been guaranteed obligations at that time, the law would very likely have included both direct and guaranteed obligations.

Section 208 Collateral for Federal Reserve Notes

It is proposed to repeal the collateral requirements for Federal Reserve notes which serve no useful purpose and which in critical times have been a source of serious trouble.

It is also proposed that the position of Federal Reserve agent as such be eliminated. The Federal Reserve agent now acts as a trustee holding the collateral against which Federal Reserve notes are issued, gold certificates and eligible paper or Government bonds, or both.

It was thought, originally, that the amount of currency outstanding at any time was influenced or regulated by the amount of commercial paper, which reflects the volume of trade or business. It has been found that there is little relationship between the volume of Federal Reserve notes and the volume of commercial borrowing, owing to the fact that currency, as such, plays so small a part in our money system and that bank credit or deposit currency plays a major role. The member banks discount or borrow from the Reserve banks in order to maintain their required reserve balances with the Reserve banks. The amount of currency or Federal Reserve notes outstanding depends upon the demand for currency, for day-to-day pocket money, by the customers of member banks.

The greatest demand for notes in any year in this country occurred when the business volume was at its lowest. Although fluctuations in the demand for currency usually reflect to some extent the activity of business, a call for notes in time of depression may be caused by a desire of the public to hoard currency and may occur at a time when business activity is low.

The collateral back of the Reserve notes in no way affects the use of currency; nor does it add to their security. They are a first lien on all the assets of the Reserve banks and are guaranteed by the United States Government.

It has been asked if Federal Reserve notes under the proposed legislation would be considered "asset currency." It seems to me that the notes would not be asset currency, in that they would not be backed specifically by this or that particular asset or assets, except to the extent that gold certificates would be held equal to not less than 40 per cent of the notes.

In order to understand what is back of the Federal Reserve notes, we must consider the balance sheet of the Federal Reserve bank. The liabilities of the Federal Reserve bank to the public consist chiefly of Federal Reserve notes and of deposits of member banks. Against these liabilities the Reserve banks hold assets, consisting of gold certificates and lawful money, and investments in bills, Government securities, and discounts to its member banks. It is impossible to issue Federal Reserve notes as liabilities without either an offsetting decrease in deposits or an offsetting increase in assets, in the form of gold certificates, Government bonds, eligible bills, or loans to member banks; and in the final analysis, the only question that could arise regarding the security back of Federal Reserve notes would be in connection with loans which the Federal Reserve banks make to the member banks. If they made loans which were bad, whether on eligible paper or loans secured by what would be considered as sound assets, and the losses on those loans were in excess of the capital and surplus of the Reserve bank, then in theory the United States Government would have to be called upon to make good the guarantee of the outstanding Federal Reserve notes. But that is the only way in which there could be any question as to the backing of the Federal Reserve notes.

There is no more justification for requiring specific collateral back of Federal Reserve notes, which are liabilities of the Reserve banks, than there is for requiring specific security to be pledged against the deposits of the Federal Reserve bank. There is no reason for giving Federal Reserve notes a preferred status over the deposit liability of the Reserve banks. In 1932 when gold was leaving the country very rapidly and when the banks held very limited amounts of commercial paper, it was found impractical to operate with the collateral for notes as then provided by law; in order to release the excess amount of gold then held as collateral for notes in lieu of commercial paper, it was necessary, in February, 1932, to suspend the requirements of the law and to provide that Government bonds might be accepted as a substitute for commercial paper. So the only time the provisions of the law were really tested, the restrictions on collateral had to be suspended.

The handling of the application for notes is a formal matter; it is almost an automatic operation. The amount of notes that any Reserve bank requires to meet the demands of its member banks is turned over to it by the Federal Reserve agent in exchange for the necessary collateral deposited with the Federal Reserve agent.

Under the present law, the Federal Reserve Board has technical control over the amount of issue, but it has found that it is useless to control note issue after the member banks have acquired deposits; when member banks wish to withdraw their deposits in cash, no Reserve bank can refuse to pay out the cash, and the Federal Reserve Board cannot take the responsibility for preventing it. The Federal Reserve bank would have to close if the member banks asked for currency in lieu of their accounts and were refused. Under the proposed law the Federal Reserve Board would not have even the purely technical or theoretical control it now has.

The question has been raised as to whether it is a sound policy for the Government to guarantee these notes and yet to have no control over their issue. I think that a controlled issue would not differ from an issue that is not controlled, because the Reserve banks are required to issue currency whenever member banks have deposits and desire to draw them down in currency. The real control over note issue is in the determination of the volume of credit extended to member banks for the purpose of creating deposits. Member banks cannot withdraw currency unless they have established balances with the Reserve bank by putting up acceptable assets, in which case they can draw down their deposits in currency in the same manner that any individual depositor of a commercial bank is able to draw out his deposit in currency. Whenever a bank is unable to pay out the deposits in currency, that bank must close.

This is the only country where there is a central banking system, other than Great Britain, which requires specific collateral to be held back of the note issue of the central bank. All of the new central banks which have been established in recent years recognize that in a check-using country there is no necessary relationship between the use of currency and the volume of available commercial paper.

Member banks, which carry their reserves with the Reserve banks, can withdraw currency from the Reserve banks only to the extent of their balances and such additional borrowings as they may require. They must maintain a minimum reserve balance with the Federal Reserve banks; and, when they want currency, they must acquire balances in excess of the minimum reserve balance against which they can charge the currency withdrawn. In order to acquire these additional balances, they may send paper to be discounted with the Reserve banks.

The member banks supply currency to their customers, to their depositors, when they want to draw out their deposits, or a portion of them, in currency; and, if a bank reaches a position where its customers have called for currency and it is unable to meet that call, that bank closes. During the period preceding the banking crisis in this country many of the banks were unable to meet that call, not because they were unsound, but because they did not have the eligible paper which they could take to the Reserve bank to acquire additional balances; and, therefore, because those banks were unable to borrow, they were compelled to close.

We hear a great deal of talk about issuing currency to improve business. The direct spending of currency by the Government would have no different effect on the actual money in circulation and on business activity, from that of the same amount of money spent by the Government by its present method of financing; you cannot keep in circulation more currency than is required by the country to meet its convenience in doing business. The currency comes right back to the banks and goes from the banks to the Federal Reserve banks. From the time of the bank holiday up until the present time, the amount of currency in circulation has declined by about $2,000,000,000.

It has been suggested that the gold reserve for note issue might also be eliminated. The law requires a 40 per cent reserve against Federal Reserve notes in circulation. Those gold certificates, plus Government bonds or commercial paper, or both, are held by the Federal Reserve agent as collateral for the issue of notes. Under this bill the 40 per cent gold reserve would be the only limitation on note issue.

The amount of gold now held, without regard to the gold held by the Treasury, is considerably more than 100 per cent of the amount of notes outstanding. The amount of notes outstanding is as large as we have ever used in our normal business operations.

The provision for gold reserve certainly does not add anything to the value of the notes under present circumstances. And in the past, when there was insufficient gold, or we felt there was, the requirement was suspended, as an emergency matter. If there is a bank run and banks are closing, as there was in this country, and gold is paid out and free exportation of gold is permitted, then further financial troubles develop which bring about a suspension of the gold requirements. In other words, when we get into an emergency these rigid requirements are suspended.

Personally, I think it is desirable to keep the gold reserve requirement for Federal Reserve notes, and also the reserve requirement for deposits. It may represent a limit beyond which Federal Reserve notes could not be issued, although excessive inflation would occur long before the limit was reached. I think the elimination of gold reserve requirements would have a very bad psychological effect upon the country and that it is unnecessary.

There is a difference between gold reserves and collateral requirements. Gold is held as a reserve against both deposits and notes. Other countries have gold requirements back of their notes but most have no collateral requirements back of them.

Section 209 Reserve Requirements

The Federal Reserve Act, as amended by the act of May 12, 1933, provides that the Federal Reserve Board may, with the approval of the President, declare that an emergency exists by reason of credit expansion and may change the reserve requirements of member banks against either demand or time deposits. It is proposed to clarify and modify this power, and to give to the Board, without declaring the existence of an emergency and without the approval of the President, the power to change reserve requirements for demand or time deposits, to be different in different Federal Reserve districts and in different classes of cities. This is a function of monetary control almost equal in importance to open-market operations, and it is believed necessary to give the Board this power, particularly in order to control inflation, should it develop.

It is conceivable that in a critical situation the reserves of member banks would be greatly in excess of the amount of Government bonds and paper held by the Reserve banks; the sale of these securities in the market would not be sufficient to absorb the excess reserves; and, therefore, the power to change reserve requirements would come into use as a means of controlling an inflation of credit. It is expected that the proposed powers would be used only as a method secondary to open-market operations, at a time when open-market operations failed to meet the situation.

It is recommended that the power to change reserve requirements be limited to two groups of cities: (1) reserve and central reserve cities, and (2) other cities. It is conceivable that different reserve requirements could be applied to the central reserve and reserve cities, if that is where speculation were going on and where excess reserves were located, which is usually the case. There is an element of time during which money seeks its level. Increases in reserves might be applied first to the reserve and central reserve cities, and then later to the other areas, if it seemed necessary, rather than to all areas at the same time.

I believe it would not be practicable to apply changes in reserve requirements to individual banks. The Federal Reserve Board has the power to regulate margin requirements on collateral and brokers' loans, which is one of the most effective instruments of speculation control now available. I believe that, had this power existed in 1928 and 1929, it would have been helpful in controlling or restricting the speculative orgy that we went through.

It has been asked whether the purpose of the proposed section is to provide greater flexibility in regulating the monetary system. The power to raise or lower reserve requirements is already in the law; the Thomas amendment to the act of May 12, 1933, gives the Federal Reserve Board the power, with the consent of the President, to declare an emergency and to increase or decrease reserve requirements. That amendment was passed to provide a monetary control supplemental to open-market operations as a control against inflation.

If the authority now granted to issue $3,000,000,000 of greenback currency were exercised and if the $2,000,000,000 of gold profit now in the stabilization fund were used, $5,000,000,000 of additional reserves would be created. If additional gold should continue to come into the country, it would also tend to increase reserves. So the banking system could build up excess reserves from the present amount of approximately $2,300,000,000 to $7,300,000,000, plus any additions to our monetary gold. That is a potential basis for bank credit inflation that would be simply terrific; no open-market operations could control it. An increase of reserve requirements of member banks would have the same effect in extinguishing the excess reserves as a sale of securities, and that is why this legislation is proposed.

Section 210 Real Estate Loans

It is proposed that the limitations on real estate loans be modified so as to permit member banks more adequately to supply the needs of their communities for mortgage loans. This proposal does not introduce a new character of loan, it merely relaxes existing limitations on real estate loans, which national banks have made for more than twenty years. What the bill proposes is to modify the requirements so as to make them more realistic and to enable the member banks better to serve their communities. Coupled with the provisions in regard to eligibility, these proposals ought to result in greater willingness of member banks to lend on real estate and, therefore, in an improvement in the mortgage market and a stimulation of construction which is essential to business recovery.

The bill as introduced proposes to amend the Federal Reserve Act to permit the national banks, as well as other member banks, to make first mortgage loans on improved real estate for a period up to twenty years, and up to 75 per cent of the value of the real estate in the case of amortized loans; and in the case of unamortized loans to reduce the period from five years to three years and to increase the amount that can be loaned from 50 to 60 per cent of the value of the real estate.

It is also proposed to increase the total amount of bank funds which may be invested in real estate loans from 50 per cent of time funds or 25 per cent of the paid-in and unimpaired capital and surplus, whichever is greater, to 60 per cent of the time funds or 100 per cent of the paid-in and unimpaired capital and surplus, whichever is greater. The amount loaned, however, would include real estate owned other than banking premises.

It is also proposed to remove the limitation that a bank must loan on real estate within its Federal Reserve district or within 100 miles of its city. It has been believed that the bank should loan funds in the area with which it is acquainted, where the officers can personally be informed concerning the property securing the loan. The advantage of removing the limitation is that funds in any one area that are in excess of the demand for real estate loans could be invested through some correspondent institution in an area in which there was a shortage of real estate money, just as our insurance companies in New York and other localities loan money throughout the United States, and building and loan companies loan in a more or less wide area, and mutual savings banks loan in areas far removed from their location.

Member banks hold about $10,000,000,000 of the people's savings, and it is therefore proper and necessary that they invest a part of their funds in long-time undertakings. The New England and the New York areas are served largely by mutual savings banks. More than 50 per cent of the deposits of the banks, outside of that area, consist of savings deposits. These funds are equivalent to the funds that the mutual savings banks are receiving from the people in the areas that they serve. The banks are required to pay interest on those time funds. The maximum rate of interest at the present time is fixed at 2½ per cent. It is impossible for these banks to pay that interest and to loan these funds on short-time paper. The amount of short-time commercial loans available is insufficient to utilize more than a fraction of the demand deposits, much less the savings deposits; and as a result, the banks hold a large volume of idle funds.

The separation of commercial banking from savings banking may be theoretically desirable, but it cannot be accomplished in this country without disrupting existing machinery. Member banks are suffering from the competition of Government and other agencies that are entering the field of real estate loans, and it is a matter of self-preservation for the banks to be able to hold and expand their activities in this field.

There has been no restriction imposed on banks with reference to their investments in long-term bonds. They have been permitted not only to invest their savings funds but as much of their commercial funds as they desire, in long-term bonds, railroad bonds, utility bonds, foreign bonds and industrial bonds. I cannot see that it is more desirable to permit banks to invest in long-term listed bonds than it is to loan their funds on improved real estate on an amortized basis in their local communities.

The fact that bonds are listed and, therefore, are supposed to be marketable, is considered a justification for the investment of funds in bonds in preference to real estate loans. The depression proved that during a period of deflation a ready market for bonds existed only at prices that bankrupted the banks, if they were forced to sell. More banks became insolvent as a result of the depreciation of their bond accounts than as the result of their real estate loans. The fact that bonds were listed and were greatly depreciated put the banks into a condition of insolvency when they were examined, because of the difference between the quoted market price and the cost; whereas in the case of real estate loans it was not expected that there should be a ready market for them, and so long as they were not in default, they were valued according to the amount loaned.

If we want to be so restrictive in the matter of real estate loans, because they represent long term investments of funds which may be withdrawn on demand, we should also be restrictive with reference to other long-term investments. Either the banks holding $10,000,000,000 of time funds must lose those funds to the savings and loan associations, to mutual savings banks, or to similar agencies, or they must be permitted to use the time funds in the long-term investment field.

I am convinced that it is not possible for the majority of banks in this country to operate with demand deposits alone. The volume of these funds is not adequate for profitable operation, except in the case of the larger institutions; and to take time deposits away from the banking system would reduce the size of many banks to the point where they would be unable to operate.

If a bank confined its loans to eligible paper, in order to be liquid, then the only avenues for investment of its funds would be short-term loans and Government bonds; this would mean at the present time that about 8 per cent of the total loans and investments of the banks would be in commercial paper, and about 92 per cent in Government securities. The Government, through its credit agencies, would be furnishing long-term credit, as it is largely doing today, and the banks which hold the savings of the people would be furnishing the Government funds by purchasing Government bonds or bonds guaranteed by the Government. That is the trend today. As a matter of fact, 39 per cent of the loans and investments of the member banks are now Government securities or bonds guaranteed by the Government.

The mutual banks are lending money on mortgages in certain sections and the insurance companies are also lending on mortgages. In the case of many mortgages that the banks now hold they are not in a position to continue holding them because, at present values, the loans are in excess of 50 per cent of the value of the property. The banks are forced to collect on the mortgages, and Congress is appropriating money for the Home Owners' Loan Corporation, the Federal Farm Mortgage Corporation, and the Reconstruction Finance Corporation, to take them up. The banks substitute for their own real estate loans obligations guaranteed by the Government. I would like to see the banks permitted to hold the mortgages they now have and to refund to them on a long-term basis, requiring amortized payments with reduced interest, instead of changing the form of the obligations they hold.

Another advantage of the proposal is that the banks could make loans which the Reconstruction Finance Corporation and other Government agencies are now making. There apparently is no demand for short-term commercial credit, but there does seem to be some demand for longer term credit. There is no prospect of stimulating building activity without providing long-term credit at low interest.

The English have provided thirty-year credit for home construction, on 80 per cent of the value of the property at 4½ per cent interest, and that is being done by the private savings institutions.

The most unsound type of mortgage credit is the straight 5-year loan that we have in this country. It is unsatisfactory for both the borrower and the lender. The borrower or the builder gets a straight 50 per cent loan from the banks and insurance companies and a second mortgage loan elsewhere at ruinous rates, until the cost of the mortgage money, considering the first and second mortgages, makes the financing cost of the property ruinous to the home builder and the home owner. It is the general practice to permit renewals of most loans on real estate or other security. The borrower usually pays a commission, however, each time the loan is renewed, and he never knows when payment of the loan may be demanded.

There should be no more objection to the twenty-year, amortized, 75 per cent real estate loan proposed in the bill than to the five-year straight 50 per cent mortgage, which has been permitted, by renewals, to run for a period of twenty years, or to investment in securities of all kinds without regard to maturity.

It has been suggested that we should keep the banks on a commercial basis and let them make loans to the existing mortgage agencies, such as the building and loan associations who would handle the long-time amortized real estate mortgages.

Many building and loan associations are members of the Home Loan Bank System and can borrow money from the Home Loan banks at 3 per cent. I do not know how commercial banks holding substantial savings funds upon which they pay 2½ per cent, could compete with the Home Loan banks in providing funds to these institutions. In order to pay 2½ per cent interest on time funds, the bank must loan these funds on a basis to yield them not less than 5 per cent. A building and loan association, as a member of the Home Loan Bank System, could not afford to pay the banks 5 per cent for funds, which they, in turn, would then have to loan at 8 per cent. Furthermore, in borrowing from the banks, they would borrow on a short-term basis, and would be loaning on homes, on a long-term basis. Therefore, I do not think it is practicable to expect the building and loan companies to borrow from the commercial banks.

I think there is a field for all the lending agencies, the commercial banks, the building and loan associations, the insurance companies, the savings banks, and so on. The more agencies we have for extending credit the more likely the borrower is to get favorable terms for his credit; and I think that, in the interest of recovery, low long-term rates are necessary.

I believe, with low interest rates and an abundance of excess funds, that institutions with funds will wish to put them to work; that may tend to create some construction activity. I believe that the demand, today, for long-term amortized loans is not being entirely met throughout the country as a whole. I am not claiming that the eligibility feature of this legislation and the real estate feature, one of which is the corollary to the other, will bring about recovery; but they will create the machinery upon which recovery can be brought about.

If there were a demand for long-term credit for home construction or for other construction, and the facilities for providing it did not exist, that would be most unfortunate.

I may say this: That an increase in private expenditures for equipment and construction wait upon increased demands for products of industry. The increased demand depends on increased incomes, as a whole. Increased incomes wait upon increased expenditures in construction. There is your circle.

The impasse can be broken, I believe, only by the various Government activities, and if the impasse is broken, then there will have been created the machinery with which to help carry forward, just as in the case of the Federal Home Loan Bank Act machinery was created for the Home Loan banks to loan to the members of the Federal Home Loan Bank System. That will help in the mortgage field also.

There are many State banks which are not limited in regard to the proportion of their deposits which may be loaned on real estate and which have more than 50 per cent of their time funds in mortgages.

If there is a liberalization in the mortgage provisions, it will be less difficult for the nonmember banks to come into the Reserve System. There will be less pressure for liquidation of real estate loans.

On October 17, 1934, under the present law, the national banks had authority to lend up to $3,400,000,000. Under the new proposal, the limit would be about $4,400,000,000 for national banks, and about $6,800,000,000 for all banks. The total amount of actual loans on real estate by national banks was about $1,300,000,000 on October 17, 1934, and about $2,300,000,000 by all member banks; if real estate owned, other than banking premises, is included, the total for all member banks was about $2,600,000,000.

The section on real estate loans in the original Federal Reserve Act has previously been amended twice: once by the act of September 7, 1916, which was in the direction of greater liberality, and authorized loans on city real estate as well as farm land. It was amended again, by the McFadden Act of February 25, 1927, which authorized loans on city real estate for five years, instead of one year, removed the prohibition against banks in central reserve cities making real estate loans, and increased the aggregate amount of real estate loans which might be made by any national bank, from one-third of its time deposits to one-half of its savings deposits.

With reference to the broadening of eligibility requirements, it is not proposed that twenty-year mortgages as such be eligible for rediscount. The wording of the eligibility provision is to the effect that the Federal Reserve banks, subject to regulations of the Board, be authorized to discount for member banks any commercial, agricultural or industrial paper, and to make advances to member banks on promissory notes, secured by any sound asset. All borrowing from the Federal Reserve bank is done on eligible paper, on the discount basis, with recourse, and all the bill does is to broaden the borrowing privilege, so as to give to the Reserve banks the power to lend to member banks on the member bank's note for a period of 3, 6 or 9 months, according to the regulations that the Board may make, those notes to be secured by bonds, mortgages or loans secured by collateral, with such margin as the Reserve banks may consider adequate to make the loans safe and sound to the Reserve bank.

The fact that banks cannot borrow except for short periods of ninety days or perhaps six months, would not deter them from making long-time loans. The banks today can borrow on Government bonds only on a fifteen-day basis but they can renew. Banks are certainly not expected to make real estate loans and to borrow funds from the Federal Reserve banks in order to make additional loans. Banks should not loan beyond the amount of their available funds; the privilege of borrowing from the Reserve banks is for the purpose of enabling the banking system to meet temporary fluctuations in their deposits and to meet withdrawals due to unusual conditions that may develop.

It has been suggested that the proposed provision authorizing a national bank to acquire second or subsequent liens on real estate would permit a bank to take a first mortgage on a piece of property, and then subsequently a junior mortgage. I believe that a bank should be prohibited from making a loan secured by a junior lien in the first instance; but if a bank already has a loan, even an unsecured commercial loan or a collateral-secured loan, the bank is justified in taking as additional security a second lien on real estate, provided conditions develop in which the loan, which was adequately and properly secured, or was made to a concern with ample resources, becomes a doubtful loan. In such cases the bank may take a second mortgage or take any other security that it can get; in fact, banks have always done that.

It has been suggested that one of the reasons for no bank failures in Canada during the depression was the fact that real estate loans are prohibited. In the first place, I do not agree with the assumption that a mortgage is a more frozen asset during deflation than any other bank asset. The assets of banks become frozen when every bank wants to dispose of its assets to meet the demands of its customers for money. The only liquidity that can be provided for a banking system is through the central bank. Furthermore, the Canadian banking system is very different from the American banking system. There are a few very large banks in Canada with many branches, and the eastern section, the creditor area, supplies the credit to the debtor area which includes the interior provinces. I have been told that had the interior sections of Canada not been tied into the creditor area, or the eastern section, they would have had the same kind of bank trouble that we had in this country.

The Canadian system had only a fraction of the credit contraction that we had in this country. Had our credit contraction been thirteen per cent, as it was in Canada, we would not have had the banking collapse that we had. The credit contraction in the British banks during the depression was negligible. The total amount of deposit money and currency outstanding remained almost uniform during the period of the depression in Great Britain. Things might have been different here also, had the Federal Reserve System been in a position to loan against sound assets. The extraordinary demand for money, that is, for currency, would not have developed.

As I understand it, and I am not an authority on the subject, the Canadian banks and the British banks do not loan on real estate. Again this is the result of a difference in the banking structure. The savings funds in Great Britain are largely built up, as I understand it, in savings and loan associations and mutual savings and loan associations, which furnish the real estate credit. If our banking system were a large branch banking system, such as the Canadian system or the British system, it would be a much easier problem to segregate investments or savings funds from the commercial banking system. But so long as we have unit banks operated under the laws of forty-eight different States and the National Bank Act, these unit banks have two functions: the function of providing check money through deposits, and the function of investing the community's savings or investment funds.

Demand deposits representing our deposit currency should be invested in short-term paper, so far as possible, and in Government securities. But when it comes to investment funds, interest-bearing funds, it seems to me that we have another problem, and it is entirely different from the problem in Canada or in any other country.

I understand that it has been shown by investigation, that the greater number of bank failures occurred in the Federal Reserve districts where real estate mortgages were the smallest percentage of banks' assets and that it was also found that the investment in securities, in bonds, has a close relationship to bank failures.

It has been asked if there is a provision for the Federal Reserve banks to dispose of real estate loans they might accept as security for advances to member banks. There would be no occasion for the Federal Reserve bank to dispose of these loans, so long as the member bank that borrowed the money was solvent. The member bank would owe the Federal Reserve on its bills payable, secured by mortgages. If the member bank should fail, the Federal Reserve bank would be required to liquidate real estate mortgages or to collect or sell them, just as any other asset. It would liquidate any asset or loan of the member bank which it held just as the member bank would undertake to liquidate the loan of an insolvent individual or corporation borrower.

I believe that the details of the proposal on real estate loans should be modified. The specific legal percentage limitations which are rigid in their application present many perplexities. In some regions and at some times a loan of 75 per cent of the value of the real estate is conservative, while at other times a 50 per cent loan may be too liberal. Furthermore, a rigid legal limitation of aggregate loans to 60 per cent of the amount of savings deposits would work a hardship on many State banks. We find that some of the State member banks and many of the State non-member banks already have real estate loans outstanding in excess of 60 per cent of their time funds. I am recommending that the proposed bill be amended so as to give the Federal Reserve Board the power to determine the conditions of real estate loans by regulation.

It has been suggested that this recommended change in the proposal would be far more acceptable to the bankers as a group if the law limited the amount of the loan to 60 per cent instead of 75 per cent of the actual value of the real estate; that is, the Board would be permitted to make rules and regulations with reference to real estate loans, with the limitation that no loan made after the passage of the legislation or after the promulgation of the Board's rules and regulations should exceed 60 per cent of the appraised value of the property.

I see no objection to this suggestion. I believe the banks would not make new loans of more than 60 per cent on the appraised value in any case. The 75 per cent limitation was suggested, not with the expectation that the banks would make new loans up to this limit; but that it would enable them to carry the real estate loans which they have, which, owing to depreciated values, may be in excess of 50 per cent or even 65, 70 or 75 per cent of the actual value of the property. The proposed 75 per cent limitation would permit them to carry the loans they have and to extend them over a long period on an amortized basis of payment; otherwise they would bring pressure on the borrowers, because the examiners bring pressure upon the banks, to reduce these loans to the 50 per cent limit. Borrowers might thus be forced to turn to the Government, through the Home Owners' Loan Corporation and the Farm Credit Administration.

I would like to see the banks able to carry the real estate loans they have, even though they are in excess of 50, or 60, or 70 per cent, and to refund those loans. However, I think a 60 per cent limitation is desirable for new loans and I recommend that in giving the Federal Reserve Board authority to make rules and regulations for real estate loans, such a limitation be put upon that authority.

Summary of Proposed Modifications

There follows a summary of the modifications which I have recommended in Title II of the bill.

1. Section 201. The appointment of governors and chairmen and of vice-governors of the Federal Reserve banks shall be approved by the Federal Reserve Board every three years rather than annually, so that their terms in these offices may coincide with their terms as Class C directors.

2. Section 202. On the admission of insured nonmember banks, the Board shall have authority to waive not only capital requirements, but all other requirements for admission, and the Board shall be permitted to admit existing banks to membership permanently with capital below that required for the organization of national banks in the same places, provided that their capital is adequate, or is built up within a reasonable time to be adequate, in relation to liabilities to depositors and other creditors.

3. Section 203(2). The pension provision shall be modified so that any member of the Board, regardless of age, who has served as long as five years, whose term expires and who is not reappointed, shall be entitled to a pension on the same basis as though he were retired at seventy. That is, he is to receive a pension of $1,000 for each year of service up to twelve.

4. Section 204. 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.

5. Section 205. Authority over open-market operations shall be vested in the Federal Reserve Board, but that there would be created a committee of five representatives of Federal Reserve banks, selected by the governors of the twelve Federal Reserve banks, and the Board shall 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.

6. Section 209. The Board shall not have the power to change reserve requirements by Federal Reserve districts, but only by classes of cities. For this purpose banks shall be classified into two groups: one comprising member banks in central reserve and reserve cities, and the other all other member banks. Changes in reserve requirements, therefore, would have to be either for the country as a whole or for the financial centers, or for the country districts.

7. Section 210. The conditions under which real estate loans may be granted by member banks shall be left to the discretion of the Federal Reserve Board to be determined by regulation. No real estate loan hereafter made shall exceed 60 per cent of the appraised value of the property; but this shall not prevent the renewal or extension of loans heretofore made.

Factors in Stable Business and in Recovery

Stable business.—The depression, to my mind, was not brought about through a shortage in the volume of money; and it would not have been possible to have avoided the depression by an increase in the volume of money after 1929. It might have been possible to have deferred or delayed the depression; but so long as we had an inequitable distribution of wealth production, so long as our capital production facilities were out of balance with the buying power of the people, the velocity of money was sure to slow up and a depression was inevitable.

In this connection I want to refer to an account entitled "Too Much Thrift Held Slump Cause," concerning a report of the Brookings Institution, which finds that the excessive savings went into speculation. It seems to me that this report has a very important bearing on the question of the quantity of money and the velocity of money.

"The institution, in the third of a series of investigations to ascertain whether maldistribution of income is a primary cause of the depression found that the first need is for greater spending for goods rather than more savings.

"Money going into savings, the report . . . points out, is not immediately spent for consumption, and the rapid growth of savings in the 20's resulted in too much money going into speculation and not into actual buying of goods.

"The report disputed several traditional economic concepts. Theoretically, according to one school of thought, savings go into the expansion of plant and other physical facilities but the institution found that so much money was saved that there was a plethora.

"Instead of going into either consumption goods or capital goods, it went into speculation which served to inflate the prices of securities and to produce financial instability.

"In announcing the report the institution cautioned that it did not suggest the individual of moderate means should, as a matter of policy, save less, but that 'the problem is one of aggregate savings in proportion to aggregate consumption.'

"The phenomenon of an excessive supply of savings is, the report said, something new. In the past there has usually been a dearth of savings, with resulting difficulties in expanding the nation's productive facilities.

"The report further disputed the theory that business expansion begins with expansion of capital goods, holding rather that such expansion begins after people begin to buy.

"The report noted that 'a large part of the savings of individuals and business corporations has gone to finance Government deficits' since the depression."

The same institution, as I recall, gave figures of the distribution of the national income—I think it was for 1929—showing that one-tenth of one per cent of the families at the top of the list received the same income as 42 per cent of the families at the bottom of the list; or, in other words, the average income, per family, at the top, was equivalent to the average income of 420 families at the bottom. The one-tenth of one per cent, of course, were unable to use their entire income in consumers' perishable and durable goods; and they, therefore, had to find an outlet in the investment field, or in the field of capital or producers' goods, until we reached a point where our capacity to produce was all out of relationship to our ability to consume, but not our capacity to consume.

Our problem is no longer one of production, which it was for generations, while we were developing the country, while we were a debtor nation, and while we had a rapidly increasing population.

Our problem is one of distribution. By distribution we mean not the distribution of the existing wealth, but the distribution of the wealth production as it is currently produced; and the most effective way to accomplish that, in times of prosperity, is through the income tax system. I think that one of the greatest mistakes that was made during the post-war period of prosperity, was to reduce income taxes, rather than to maintain them at the high war point, and to use the funds for reduction of the Federal debt.

The monetary factor is one of the three important control measures of our capitalistic system. The volume of money can largely be controlled through a banking system.

The distribution of funds which is a factor in their velocity must be controlled through the income tax system, and employment must be regulated through a public works system.

When the volume of money is adequate to support a certain price level for a given volume of production, and unemployment begins to develop and prices begin to decline, it is likely to be because productive facilities are out of balance with the consumers' buying power, and velocity of money is declining.

The purpose of our public works system is to keep up production when private business fails to keep up full employment. The loss to the nation, when the national income declines through unemployment, is a loss we cannot afford.

No monetary policy alone by simply attempting to regulate the volume of money will maintain a stable national income. So long as there is an inequitable distribution of wealth production, which results in excessive saving, we will have depressions. Only by pulling back that part of our savings that we cannot profitably use in new capital goods and using those funds to give employment to those who become unemployed, can we maintain a balance.

The tax system, the income tax system, must be worked in and timed with the money system. When private credit is expanding and there is a budget surplus the Government debt should be reduced. Reduction of Government debt at a time when there is a rapid expansion of private debt tends to offset the inflationary effect of increasing private debt. It is very important that the problem of income taxation and the operation of a central banking monetary policy be properly coordinated. A substantial increase in taxes at the present time which would bring into the Treasury money which would otherwise be spent, would be of no particular help to our economy as a whole. The time to increase income taxes is when incomes are such that taxes will produce substantial revenues, in other words, during the up swing.

I believe that there is only one way by which we will get out of the depression and that is through the process of Government spending until such time as private spending and private credit expand. The expansion of private credit depends upon the will and the ability of private interests to borrow and spend. Until people are put to work through private borrowing and spending, the Government must do the borrowing and spending.

The Government must be the compensatory agent in our economy through the money system, through the tax system, and through a public works system.

Capitalism, sooner or later must pay whatever it may cost, through the tax bill, to provide employment for people who are employable, and to provide an adequate, decent living for those who are unemployable. The sooner we begin to recognize it when unemployment develops, the less the cost will be. We have never questioned the duty of the Government to protect its citizens, no matter what the cost, against the encroachment of a foreign enemy. We have no more reason to question the obligation of the Government to protect the citizens, through insuring them employment, when private capitalism fails to insure that.

I do not know that I could agree that if we had levied sufficient taxes during the war, a large part of our present financial difficulties would have been avoided. I do not think that the financial troubles of the present are due to the war. In 1929 we were not lacking in any material things that we had before the war and after the war. We had replaced every physical loss and we had increased our total man-power and our capital production facilities.

Certainly, during the period of the war, we did not consume, as a nation, more than we produced. As a matter of fact, we did not impoverish ourselves at all, because we used much less than we produced and furnished the allies a tremendous amount of goods, which resulted in the inter-allied war debts.

If the resources of the nation had been mobilized in the interests of the nation, for war purposes, we would not have needed inflation, we would not have needed the credit that was extended. Our present situation indicates we are just as able now, in this country, to meet the problems of the depression as we would be to meet the problems of war. No one would question the fact that our ability to fight a war depends upon the men and materials and our capital facilities in the form of factories, system of transportation, and so on. In this economy of abundance, the question of money would not be involved in connection with our ability to fight a war. Neither is our ability to fight the depression a problem of money.

Debt and business fluctuations.—In the past we have had periods of prosperity accompanied by the process of building up debt and then periods of depression accompanied by the process of bankruptcy and extinguishment of debt. I believe this has been more or less true of all capitalistic countries.

It may possibly be less true of France and of Great Britain than of this country. In recent years the British appear to have exercised better control over their money system than we have. The volume of money in Great Britain remained very stable during the period of the depression, while in this country a third of our deposit money was wiped out through liquidation of bank loans and through bank closings.

I do not agree that it is impossible to have permanent prosperity with the existing banking system, if, in connection with its operation, a taxing system is recognized as an adjunct in helping to bring about a more equitable distribution of income during periods of increasing business activity and public spending is used to insure employment during periods of deflationary tendencies. When the community begins to pay its debt to the banks, it extinguishes money, deposit currency, and the process of deflation which may get under way is more or less self-generating and is very difficult to stop. The Federal Reserve System can reduce rates, create excess reserves and broaden eligibility requirements so as to make it unnecessary for banks to bring pressure to collect debt. When the community's volume of money is rapidly contracting, this means that unemployment is developing. The compensating factor is the budget deficit, through which the volume of money is kept up and funds are used to give employment when unemployment develops in private business.

I believe that it is possible to have prosperity under the system whereby money is created through bank credit and is extinguished by the paying off of bank credit. Whether there are other ways of getting prosperity I am not prepared to say.

There has been an intimation that all debts are created and carried by banks, and if in some way we could create money without bank credit we would prevent people from getting into debt. It is true that the bulk of the medium of exchange under the present system is created by an expansion of bank credit. However, a large part of the debt of the country is not bank debt. The debt that the banks create in creating money is, in fact, not much more than 10 per cent of the total debt; and it is by no means the burdensome part of the total debt. The whole system of capitalism is built up on a basis of debtor and creditor relationships and you cannot take people out of debt simply by finding some method of creating money other than bank credit.

Money is created in our present system by banks loaning to corporations, to individuals, and to the Government. During the past two years there has been no increase in the supply of money as the result of the banks lending to individuals or to corporations. The credits which the banks have extended to others than the Government are less now by several hundred millions than they were right after the banking crisis. The Government has been forced to supply the money deficiency by reason of the other creditors being either unable or unwilling to supply it. As a matter of fact, the money supply would have actually diminished since 1933 had the Government not made up the deficiency, and greatly exceeded it, by its borrowing and spending. Had it not been for the Government's budgetary deficit, I do not believe the deflationary processes would have stopped.

But the banking system, as I have indicated, is not responsible for trapping the people into debt. This system of Government lending agencies, of which the Home Owners' Loan Corporation, the Farm Credit Administration, and the Reconstruction Finance Corporation, are the most important, are the greatest creators of debt that we have in the nation today.

There is no question that a debt can be supported only when the national income is sufficient to support it. The trouble was that our national income went down in a hurry, and it went in that direction through the process of bankruptcy and foreclosure; but debt was adjusting itself through that process so that it could be supported by the national income.

There are two ways by which the burden of debt may be adjusted during a depression. One way is through deflation which wipes out a large part of existing debts through the process of bankruptcy. The national income at the present time is not sufficient to support the existing debt structure; and that is possibly one reason why we are not getting recovery today. Liquidation and the pressure of debt are still very great, and act as a millstone around the neck of the economic system.

The only other way to get recovery that I can think of is by a process of reflation.

After 1929, we allowed nature to take its course, and went through a period of liquidation and bankruptcy until we had extinguished a third of our deposit money supply and until we had fifteen or sixteen million people out of employment, and until the quoted value of the resources of the country was less than the debt. In other words, we liquidated down to a point where we had created a condition of general insolvency as measured by the ability of the people through the national income to support the debt structure.

The deflation was finally stopped because of the unrest and the suffering it caused, and also because it was affecting both the debtor and the creditor class. The job of completing the deflation process was so difficult that it could not be faced, and there was only one other course open. In order to save the system of capitalism and to maintain order, the Government was forced to step in, even under Mr. Hoover.

The first effort was made through the organization of the Reconstruction Finance Corporation, not for the purpose of directly relieving unemployment, but for the purpose of using Government credit to take over debts, to provide the necessary support for the railroad system, the banking system and the insurance structure. That measure and similar steps taken by the Government through other emergency credit agencies which have been set up have stopped deflation but have not been inflationary. The greatest portion of Government credit used during the depression has not been of an inflationary nature, because it has represented a transfer of the debt from where it was to a Government agency.

I believe it has been very generally recognized, certainly since March, 1933, when the banking structure collapsed, that it was not practical or possible to continue the process of deflation, without causing great political and social upheavals. The situation had reached the limit of human endurance by way of unemployment and all of the other attendant ills of deflation.

Reflation was desired and expected. The only way that reflation can be brought about is by increasing the means of payment, either currency or bank deposits, in the hands of those who will spend faster than production increases. The amount of the excess reserves held by the banks, the low discount rates, and hence the low rates that prevail for commercial paper, and the low yields on high grade bonds, industrial and municipal, and on Government securities, are indicative of the excess supply of money and credit in relation to the demand for it.

In order to expand the use of money which is necessary for recovery, either those holding deposits in banks must be willing to spend their funds, which would increase the velocity of the total existing deposits, or borrowers who can command bank credit must be willing to go to the banks and borrow funds and spend them, or a combination of both is necessary. If, in the first instance, owners of funds spend their funds, there would be an improvement in business through an increase in the velocity of the existing deposits. If new loans are made there would be an increase in the volume of money as well as an increase in the velocity of money. In the absence of an increase in the velocity of the funds held by the banks, or an increase in the volume of private credit extended by the banks, the Government has been required to inject an increased flow of funds into our system through using its credit. Government spending has the same effect as private spending. It is somebody's income. Everyone's spending is somebody's income.

As far as the currency system is concerned, it depends on whether or not the currency is distributed so that people can spend it. If distribution is inequitable to the point where a great majority of the people have no money to spend, it would not make any difference whether you used a currency system or some other system. The buying power has to be in the hands of people, under any kind of money system.

Relation of public works to private business.—I believe that, under capitalism, the Government cannot compete with private business without socializing the particular field of private business. Government spending should be in the field of socially beneficial, public, noncompetitive activities, either directly or through grants to cities, counties, and States, for use in the same field.

I have no brief to offer against the Government entering those fields which, in the public interest, may be better handled if owned and operated by the Government than if operated privately. But I do believe that when the Government steps in beyond the exercise of its regulatory powers, as a competitor, the natural effect is that all private investment in that field stops; and that the field must be absorbed, sooner or later, by the Government.

Government debt and recovery.—I have no fear of a 40 billion dollar national debt. Government credit cannot be considered in the same way as we consider individual or corporate credit. When the nation borrows it is a question of the nation borrowing from itself, so long as it is a creditor nation.

When we speak of a future debt of 40 billion dollars, it seems to me it is only reasonable to deduct from the 40 billion dollars any assets which the Government may have to offset the debt. We cannot say that the loans which the Reconstruction Finance Corporation has made are entirely uncollectible; and in considering the debt, we should also take into account the balance in the Treasury and the profit from devaluation of the gold dollar.

The debt is less than 23 billion dollars today when the Treasury balance and the offsetting assets are taken into account. That is less than four months of the normal national income of this country.

There follows a statement of the debt of the United States and of the assets held by the Reconstruction Finance Corporation and other organizations, as of January 31, 1935.

(In millions of dollars)

Gross public debt	28,476
Net balance in general fund (excluding balance of increment resulting from reduction in weight of the gold dollar)	1,519
Net debt	26,955
Proprietary interest of the U. S. in governmental corporations and credit agencies	
I. Financed wholly from Government funds.	
Reconstruction Finance Corporation	2,321
Commodity Credit Corporation	41
Export—import bank	14
Public Works Administration	269
Regional Agricultural Credit Corporations	90
Production Credit Corporations	113
All other	506
Total	3,354
II. Financed partly from Government funds	1,120
Total	4,474
Increment from reduction in weight of the gold dollar	2,812

The indebtedness of Great Britain, expressed in dollars, is 35 billions, and it takes 5½ per cent of the present national income of 19 to 20 billion dollars to support the British debt, whereas it would require less than one per cent of our normal national income to support our Federal debt.

There follows a statement comparing public debts in the United States and the United Kingdom.

The kind of comparison most frequently made between public debts of two countries is in terms of debt per capita. The most recent authoritative figures of this kind were prepared by the Treasury for the Joint Committee on Internal Revenue Taxation. For national debt per capita, that is, the debt of the central government alone, the figures originating from that source are $850 for the United Kingdom and $215 for the United States. The debt per capita for all public bodies, including central governments, counties, municipalities, school districts, etc., is $991 in the United Kingdom and $370 in the United States, or about two and a half times as much in the United Kingdom as in the United States. Only very tentative estimates can be made of the national income in the two countries for the year 1934, but such information as we possess indicates that the national income in the United Kingdom was about $430 per capita as against $400 per capita in the United States. In all these comparisons the rate used to convert the British into the American monetary unit is $5.00 to the pound.

Because of the very difficult questions connected with selecting the proper rate of exchange between two currencies in making comparisons of this kind and because the income of a country is more important than its population in considering questions as to the burden of its public debts, per capita figures of the kind just given may be misleading. For this reason the figures below on the relation of interest on public debt, public debt and national income are presented. National income as used here means the total money incomes actually paid to all the inhabitants of a country.

Net central government debt after deduction of Treasury balances, stabilization funds, and other assets, is 38 per cent of national income in the United States and 158 per cent in the United Kingdom or about four times as much of the national income in the United Kingdom as in the United States.

The debt of all public bodies, that is, the net central government debt plus the debts of all other civil divisions, is 74 per cent of national income in the United States and 194 per cent in the United Kingdom, or about two and one-half times as much of the national income in the United Kingdom as in the United States. In round numbers, the net debt of all public bodies in the United States is $37,000,000,000. If it was as large in relation to our national income as the British public debt it would be $97,000,000,000.

Interest on the central government debt is 1.6 per cent of the national income in the United States and 5.4 per cent in the United Kingdom. Interest on the debt of all public bodies is 3.3 per cent of the national income in the United States and 8 per cent in the United Kingdom.

The following are the figures on which these comparisons are based:

As of 1934	*United States (billions of \$)*	*United Kingdom (billions of £)*
Gross central government debt....	27.9	6.9(a)
Net central government debt (after deduction of Treasury balances, stabilization funds, and other assets)	19.4	6.3
Debts of all other government bodies	17.6	1.4
Total public gross debt...........	45.5	8.4
Total public net debt............	37.0	7.7
National income	50.0	4.0
Interest paid by central government	817	215
Interest paid by all other government bodies	844	105
Total interest paid on public debt..	1,661	320

(a) Excluding war debt.

While I am not apprehensive about the Federal debt, I am concerned about the present national income. You cannot increase the present national income by diminishing Government expenditures. It is the total expenditures of the nation that create the national income, and when the community, as individuals and corporations, does not spend, then the Government must.

If Government spending increases the national income, it increases the ability to pay taxes, and I believe in the Government spending to increase the demand for goods up to a point that will prime the pump. I do not know how much the Government will need to spend to prime the pump. We will know that the amount is adequate when unemployment is rapidly diminishing, owing to the demand for goods, as a result of increasing purchasing power and spending.

I am as anxious as anyone to see the budget balanced. The budget can only be balanced, however, out of the national income. The national income can only be increased by employment. I should say that it might be desirable to balance the budget over a five-year period, but I do not think it need be fatal if it is only balanced over a ten-year period.

When the conditions that make the deficit necessary are corrected and employment and national income increase, Government revenues will increase and the deficit will disappear. As private bank credit expands, and the velocity of existing funds held by corporations and by the people in banks increases, a condition of fairly full employment may be expected. At that time income taxes should be increased and not decreased, and Government obligations should be reduced as the community's obligations are increasing. This would create a compensatory condition in the money system which would help to iron out the tremendous cyclical movements of business.

It has been my philosophy that, if Government expenditures are sufficiently large and are made fast enough, they will reduce the total amount that the Government may be required to spend. Last year there was about a 40 billion dollar deficiency below normal in national income and about a 3 billion dollar pump-priming process.

I do not consider the transfer of the existing debt from private holders to Government credit agencies as a pump-priming process. Most of the increase in the Government debt which reflects expenditures of the Reconstruction Finance Corporation is due to lending, rather than spending. For instance, $1,000,000,000 of the increase in the Government debt went into the purchase of preferred stock and debentures of the banks and $800,000,000 went to the receivers of closed banks as loans against their assets, in order to hasten their liquidation. There are also loans to insurance companies, railroad companies, mortgage companies, and so forth. In fact, the entire Reconstruction Finance Corporation operation is a huge credit-extending operation, and the loans will largely be recoverable.

These expenditures stop deflation, but the actual amount of the budget deficit which represents Government spending to increase the buying power of our people has not been sufficient to stop the process of deflation and to give the momentum necessary when the size of the pump is considered. By that I mean that with 10 or 12 million unemployed, buying power canont be sufficiently increased by a three-billion dollar spending program.

I would prefer that the lending should be done by the private credit system, but when there is an emergency such as in 1932, which requires the creation of the Reconstruction Finance Corporation, it becomes necessary for the Government to lend in order to save the credit structure.

Character of Money in Our Economy

What is money?—Money includes bank credit, that is demand deposits in commercial banks, and currency. More precisely, bank credit in this sense includes deposits subject to check, exclusive of bank float and interbank deposits, plus United States Government deposits. It excludes savings deposits which are similar to building and loan money.

Lawful money includes national bank notes, which are to be retired, United States notes or greenbacks, silver certificates, silver dollars, and minor coin. With the retirement of the national bank notes, the amount of lawful money (figures as of January 1, 1935) will be reduced to approximately $1,500,000,000 which includes silver certificates, $702,000,000; United States notes, $346,000,000; silver dollars, $32,000,000; subsidiary silver, $309,000,000; and minor coin, $130,-000,000.

The national bank notes amounted to $888,000,000 on January 1. There are still Federal Reserve bank notes in circulation, but the Federal Reserve banks have recently paid off their bank note liability and these notes are now liabilities of the Treasury.

Federal Reserve notes outstanding on January 1, 1934, amounted to $3,520,000,000. After the retirement of the national bank notes, Federal Reserve notes will represent the greater proportion of the currency in use.

The retirement of national bank notes will make no difference in the amount of money in circulation. Federal Reserve notes will be substituted for the national bank currency; and it will be done unconsciously, because people holding national bank notes will use them in the course of business, just the same as they would use Federal Reserve notes or silver certificates. There is no distinction made in the use of the currency. As the national bank notes become mutilated, the banks will send in the old bank notes which will be deposited in the Reserve banks and new Federal Reserve notes will be sent to the member banks in place of the bank notes. The Federal Reserve banks will send in the mutilated national bank notes to the Treasury and the Treasury will destroy them; whereas, in the past, they would have issued new bank notes. Thus, the national bank notes will gradually pass out of existence as they become mutilated and, as they pass out of existence, Federal Reserve notes will take their place. It may take a year or more before the whole process is worked out.

There is no difference between currency and checking accounts so far as their functioning as money is concerned. They both serve as a means of payment. Currency is used largely as a matter of convenience in meeting payrolls, in retail buying by the man with a small income, where the checking account is too expensive or is not wanted. The use of the check has been greatly diminished as a result of service charges and the check tax. People cash checks for larger amounts and pay bills with currency rather than pay all small bills with checks.

We use the bank check more than any other country. Of course, a bank must be in a position to meet the demands of its customers for payment of deposits in currency. While banks were closing during the depression a great many people and corporations wanted their deposits in currency and the amount of currency outstanding exceeded all-time records for the use of currency even when business was very active. It exceeded seven billion of dollars, at a time when our business activity was about 50 per cent below normal, showing that a very substantial amount of that currency was drawn out, not for current use, but because of fear of loss through bank failures. When people found they could get currency if they wanted it, confidence was reestablished in the banking system, and the amount of currency outstanding greatly diminished.

We do not need more currency in circulation at the present time. In my judgment it is impossible at the present time to force out and to keep in circulation more currency than is now outstanding, except for seasonal changes in currency requirements.

I do not believe that it is practical at this time to abandon the present system of creating money by bank credit. It is my view that we should attempt through this legislation to make the existing system of banking more responsive to the needs of the country than it has been, and also to exercise a greater degree of conscious control over the creation and the extinguishing of money, and thereby attempt to create a greater degree of business stability than we have had in the past.

Income velocity.—What is termed "income velocity" is the relationship of the national income to the volume of money. In 1929 there were 26.4 billion dollars of money. The national income was 82.3 billion dollars, according to the Department of Commerce estimate. This estimate represents the income paid out by economic enterprises, including Government units, as compensation for services rendered, as dividends, interest, rents and royalties, and as profits withdrawn by entrepreneurs. It corresponds roughly to the money value of all goods and services produced, which would include all kinds of goods, consumers goods and capital goods, less duplications representing goods and services used in various stages of production; these include such duplications as those involved in the value of wheat that is sold to the miller, that the miller then sells to the wholesaler and that the wholesaler sells to the retailer. The total national income was 3.12 times the volume of our currency and checking accounts, which indicated what is termed an income velocity of 3.12.

In 1933, when the national income was 46.8 billion dollars, and our deposits and currency had diminished to 19.9 billion dollars, the income velocity was 2.35.

I would estimate that, in 1934, with a national income somewhere between 50 and 55 billion dollars and with an average volume of money of around 23 billion dollars, the income velocity was a little over 2. Deposits and currency increased by about 4 billion dollars from 1933 to 1934; the volume of deposit currency showed a substantial increase as the result of three factors: the budgetary deficit, gold imports, and the reduction of currency in circulation as the result of dehoarding. About 1.3 billion dollars of gold came into the country in 1934 to take care of the unfavorable trade balances of the rest of the world. The only way foreign countries have been able to take care of their unfavorable trade balances has been to pay us in gold. There would have been a greater increase in money as a result of the three factors mentioned above had there not been a shrinkage of loans and investments of banks, other than in Government bonds.

The increased volume of money during 1934 has not increased the national income in proportion because the increase in volume of money has been accompanied by a decrease in the velocity of money. At the same rate of velocity that existed in 1928 and 1929, with the present volume of money, the national income would now exceed 75 billion dollars; this indicates that increasing the volume of money does not necessarily increase the national income proportionately. It seems to me that the reason for that is quite obvious. The distribution of the ownership of money determines whether or not it is going to be put into use. Money is put into use by corporations and individual investors, who are led to believe that there is a profit in the use of funds.

Money is created by debt. By that I mean that the banking system, through the process of extending credit, increases bank deposits. In the absence of individuals and corporations who are willing and able to borrow at the present time, the banks have created additional funds by purchasing Government bonds which has resulted in increased bank deposits. You cannot have velocity of the means of payment unless you first create a means of payment, but you may create a means of payment, and if it is in the hands of those who are unwilling to spend it, you do not create business activity.

The relationship between national income and money was very stable from 1923 to 1929, at about 3 to 1. I imagine that during the war period and the depression in 1920 and 1921 there were some changes in the relationship. A table of the available data appears on page 50.

STATEMENT ON NATIONAL INCOME, MONEY AND INCOME VELOCITY

Year	I National Income —Copeland[1] (billions)	II National Income Dept. of Commerce (billions)	III Money[2] (billions)	IV Income Velocity based on Copeland (I ÷ III) (times per year)	V Income Velocity based on Dept. of Commerce (II ÷ III) (times per year)	VI Percentage change in income —Copeland	VII Percentage change in income Dept. of Commerce	VIII Percentage change in money	IX Percentage change in income velocity—Copeland	X Percentage change in income velocity—Dept. of Commerce
1921	56.8	–	21.7	2.58		–		–	–	
1922	60.3	–	21.5	2.78		+ 6.2		− 1.2	+ 7.8	
1923	68.9	–	22.6	3.01		+14.3		+ 5.5	+ 8.3	
1924	70.2	–	23.1	3.01		+ 1.9		+ 1.8	–	
1925	74.5	–	24.6	2.99		+ 6.1		+ 6.7	− 0.3	
1926	78.8	–	25.3	3.08		+ 5.8		+ 2.9	+ 3.0	
1927	80.9	–	26.0	3.08		+ 2.7		+ 2.8	–	
1928	83.3	–	26.4	3.12		+ 3.0		+ 1.3	+ 1.3	
1929	87.0	82.3	26.4	3.26	3.12	+ 4.4		+ 0.1	+ 4.5	
1930		75.8	25.4		2.98		− 7.9	− 3.8		− 4.5
1931		63.3	23.8		2.66		−16.5	− 6.3		−10.7
1932		49.7	20.5		2.42		−21.5	−13.9		− 9.0
1933		46.8	19.9		2.35		− 5.8	− 2.9		− 2.9
1929–1933							−43.1	−24.6		−24.7

[1] Less imputed non-monetary incomes.
[2] Deposits subject to check plus cash outside banks as of June 30.

Metallic monetary standard.—The answer to the question as to whether we should have a metallic standard for our money would require considerable discussion. Many opinions have been expressed; but I do not think the question has been answered. The fact that the important countries of the world have been wedded to gold by experience and habit for so long a time makes it a very difficult matter to divorce money from gold.

As far as the monetary standard of this country is concerned, we are required by law to maintain gold reserves for currency and deposits in the Federal Reserve System, forty and thirty-five per cent respectively. To the extent that gold is not being paid out it might be said that we are not on gold; on the other hand, to the extent that we are requiring the same gold reserves, it can be said that we are on gold. The export of gold is permitted under license, so that internationally we are on gold. The dollar has been fixed at a certain price in relation to gold.

I stated that our monetary system gave us trouble when we had to redeem everything in gold. By that I mean that when people demanded payment in gold, since gold was the reserve for our money system, it did not take the withdrawal of very much gold to force a suspension of gold payments and an embargo on gold.

I think we were forced to suspend gold payments not so much by withdrawals as because of our price and debt structure and the remedial measures that were absolutely necessary. Gold was leaving the country very rapidly; not only that, but it was being drawn out by corporations and individuals at a rapid rate. At the time we suspended gold payments we had lost a great deal of gold, and we were obliged to adopt legislation that would result in still larger withdrawals. It was evident that we might soon have reached a position where it would have been necessary to dispense with gold payments and to put an embargo on gold. Under the circumstances it seemed undesirable to give preference to those people and corporations that demanded payment in gold.

Prior to the establishment of the Federal Reserve System, we had panics when we could not even pay in currency. I remember the panic of 1907, when they suspended payment in currency and used clearing house certificates.

Of course, there is in this country and in the world only a fraction of the gold that would be required to meet all gold obligations, but that is always the condition. Gold works all right so long as no questions are raised about redemption, but in case of panic there is not enough gold and payments have to be suspended. Gold has not proven to be a very satisfactory measure of value since the value that the people are interested in is the buying power of money measured in goods and services.

Objectives of Monetary Policy

Stable prices.—I think that a stable price level is desirable. Wide and rapid fluctuations in prices tend to create conditions that are unfavorable to business stability.

I should say, however, that I do not know of a way to maintain a stable price level, and at the same time to maintain stable business conditions. Prices are part of the consideration and I think that every effort should be made to maintain stable prices, but stable prices should not be the sole and paramount objective. We might have a stable price level on the basis of some price index, and yet have a great deal of unemployment. Nobody would be satisfied if we reached a 1926 price level and continued to have a national income of 50 billion dollars instead of 80, and 10 million people remained unemployed. This can happen. For example, the price level in England was very stable from 1931 to 1934, but the amount of unemployment fluctuated considerably and was large throughout the period.

I do not know to what extent open-market operations and changes in discount rates have in the past had an effect upon the price level. It is true, I think, that under certain conditions, a reduction in interest rates and an increase in the supply of money would be effective in increasing business activity, just as an increase in interest rates and a reduction in the quantity of money would tend to restrict business activities, slow up borrowing, and possibly start a process of liquidation. I do not believe that anyone can determine the precise extent to which open-market policy can be responsible for recovery or for depression.

It is assumed that, if the volume of money in relation to total production is kept at a certain ratio, a uniform or fixed price level will be maintained. It seems to me that this assumption overlooks the income velocity, which is an element as important in our economy as is the quantity of money. As I have indicated elsewhere, there must be a more equitable distribution of income than existed in 1928 and 1929, in order to keep up income velocity and to prevent production capacity from getting out of balance with consumer buying power.

I do not know what monetary policy could possibly be pursued to bring about and maintain a fixed price level. Changing prices come from factors over which we do not have anything like complete control. We can exercise an influence through monetary action; but I do not think that we can exercise absolute control, unless we undertake to fix prices by legislation and to regulate production accordingly. Even then, I doubt if we could maintain stability of the price structure as a whole.

The controlling of production and the fixing of prices can tend to create whatever price level is desired. By the operation of the National Recovery Administration and the Agricultural Adjustment Administration, you can restrict production and bring about a rise in prices; but it seems to me that we are more interested in a maximum of production and of consumption in the country as a whole. That is far more important than the price level, although the question of prices naturally has to enter into the problem.

If the price level were placed in the law as an objective for the Federal Reserve Board to reach as a result of monetary action, and the other factors were left out, we might get the result of having a stable price level without any of the other results we want. I believe that the price level is less important than employment. I think the most important element is total production, because that is the real measure of wealth.

After all, the factor of greatest importance is the buying power of the people, as a whole. When the national income is increasing faster than production, prices rise and production is stimulated thereby; and when the national income is diminishing, prices decline and production is diminished thereby. Therefore, it seems to me that the problem of the national income is a determining factor with reference to prices and production. So, rather than an arbitrary fixation of prices, if we could get an increase in the national income, we would get an increase in production and in prices. During the period from 1923 to 1929 we had stable prices, because we had reasonably full employment; and then after 1929 our national income started to decline and prices and production went down. Changes in the value of the dollar since 1929 have been brought about primarily through decrease in the national income, which in turn was brought about by the inequitable distribution of income.

Swedish experience with managed currency.—The Swedish experience with money management is one of the most interesting that we have in the world today and possibly has been as successful, or is looked upon as being as successful as that of any other country. The governors of the Swedish bank made the following statement in February 1932:

> "It follows that when forming its policy in view of fluctuations in the price level the Riksbank cannot but take into account the causes of such changes in prices. For it is essential to determine whether price movements are caused, e. g., by increased tariffs, altered exchange rates or a tendency to inflation on the domestic market which may be looked upon as primary in relation to exchange rates. In any such analysis of price conditions, naturally other prices indices besides the Riksbank's own index of consumers' prices will also be taken into consideration. Obviously, in their endeavor to create as stable economic conditions as possible, the Governors are also taking into account other factors than mere changes in the price level, particularly conditions affecting productivity and stocks in various industries."

Professor Ohlin, a Swedish authority, says, in surveying the Swedish experiment in an article in Index, volume 8, "A business cycle policy that aims at as full and regular a utilization of the productive forces as possible, that is a maximization of the real national income per head of the population over a long period, is bound to take many other factors into account besides the development of prices; that is to say, it can not be based on the idea of stabilizing any particular price level, especially if the latter has been brought by an immediately preceding depression, out of equilibrium with the other parts of the price system."

Stable business.—The proposed bill is designed to create a condition of stable business, so far as this can be done through monetary policy. The important thing today is not so much, as many people believe, to increase the volume of money, as it is to increase the velocity of money that is already in existence.

In the existing law the Federal Reserve Board is not charged with the responsibility of creating a condition either of stable prices or of full employment. As I understand it, the responsibility of the Federal Reserve System is to supply the credit needs of commerce, agriculture and industry. Simply to attempt to meet these credit needs does not meet the monetary problem.

Personally, I would not like to see the law include a specific objective for the Board on the basis of a fixed price level. I would suggest that, in lieu of a fixed price level, the bill include the following statement of the objectives toward which the Federal Reserve Board would be required to exercise its powers: "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."

I am trying to avoid a rigid requirement in the law that may be impossible of accomplishment, and hence may cause embarrassment. I would like to see flexibility in the law; because I do not believe that we can deal with our monetary, economic and social problems, and they are all interrelated, as an exact science. There are too many emotional factors to contend with, and in dealing with the problems of business stability, stable prices, full employment, and so forth, it is necessary to take into account factors other than purely the mathematical or mechanical factors of money.

It may be of interest in this connection to consider the preamble of the recent law creating the Bank of Canada. It does not specify a fixed price level, but it does fix an objective:

> "Whereas it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion."

Monetary Control

Limits of monetary control.—It is contemplated through this legislation to centralize the responsibility and the authority for control over the volume of money.

I think there must be a control over the money system. About 90 per cent of our payments are made by checks on deposits, which is credit money; and it is necessary in the public interest to exercise control over money. It is not necessary, however, to control the credit relationships of individuals among themselves, nor the credit corporations extend on accounts.

There is no exact relation between the quantity of money and the volume of business that the country does. The volume of money is an important factor, but the use of that money is an equally important factor in determining the amount of business. In a period of great business activity and full employment an effective means of controlling inflation is to reduce the quantity of money. A small reduction in the quantity of money through open-market operations would tend to be effective in certain periods in decreasing business activity. Excess reserves would be wiped out so that the banks would be forced to borrow from the Federal Reserve banks; and that would restrict credit and raise interest rates and thus would tend to slow up the volume of business. However, the past four or five years have been a period of great deflation, during which loans held by the banks and bills held by the Reserve banks were allowed to run off and the volume of money was reduced at a terrifically rapid rate. From 1929 to the period of the bank holiday about one-third of our total bank deposit money was extinguished, largely through the liquidation of bank credit. This liquidation was forced upon the banks in part by their inability to meet the withdrawals of depositors by borrowing from the Federal Reserve banks on their sound assets.

The control over the volume of money and credit that the Federal Reserve Board can exercise through the three instruments of monetary control, open-market operations, discount rates, and changes in reserve requirements would not necessarily result in an expansion of the amount of money in use in a depression such as we have at the present time. You may create excess reserves through open-market operations, but unless the borrowers are willing to borrow from the banks, and the banks are willing to lend to borrowers, you would not create a further increase in the money supply. The reserves of member banks would be increased, which would tend to induce the banks to lend and to bring about a reduction in interest rates, making for cheap money, but there must be borrowers who are willing and able to borrow before additional money will be created.

It would be fine if the national income could be increased merely by an increase in the volume of money. I do not believe that is possible. I do feel, as I have said before, that the volume of money is an important factor. Excess reserves such as we have today, which bring down the rate of interest, should tend to stimulate credit expansion; whether we can bring about recovery, time alone can tell. That is one of the factors and one of the elements that will help make for recovery if private credit expansion can induce recovery.

So long as most of our money supply is created by the willingness of private citizens and corporations to borrow from banks, the control of deflation is much more difficult than that of inflation. If there is too much borrowing from banks and, as a result, the means of payment increases faster than production, the raising of discount rates and the selling of securities in the market would discourage further expansion of private borrowing from the banks and would retard the inflationary process. On the down side, the reduction of rates and the creation of excess reserves would tend to slow up liquidation and would tend to encourage the use of credit.

I think the bill would give the Board a control of the volume of money on the up side, but it would not give such a complete control of the volume of money on the down side. I think that the System has less influence on the velocity than on the volume of money. I think the velocity of money is influenced more by the tax system than by monetary policy. Velocity slows up as business activity declines, or as deflation develops.

The three powers of monetary control, open-market operations, discount rates, and reserve requirements, put into the hands of the Federal Reserve Board a power to control inflation. And they also put into their hands the power to prevent deflation, so far as this can be done by the creation of excess reserves and by the reduction of interest rates. There is no action that the Board itself can take that will induce individuals and corporations to borrow the excess funds which the banks may have as a result of the Board's action in creating these excess funds.

Location of monetary control.—The agency which exercises monetary control should represent the nation as a whole and should not be under the domination or control of any group or groups. It is my view that the Federal Reserve Board should be as independent as it is possible to make it and should be charged with the responsibility for monetary policy in the public interest. It would be the responsibility of the Board to determine what are unstable business conditions. This Board should not be considered a political body. The law makes the Board a non-partisan body, on which political parties as such are not represented and appointments to which are for terms of 12 years.

The bill will centralize authority for monetary policy in the Federal Reserve Board. The Board at the present time has authority over the discount rate, and under emergency legislation, has the authority to declare an emergency and to change reserve requirements, subject to the approval of the President. This bill proposes to place in the Board, with the advice of the governors, the third function of monetary control, that of open-market operations, which, at the present time, is placed in a committee of governors, subject to the approval of the Board, and finally, subject to the decision of the twelve Federal Reserve banks as to their participation in the program recommended by the governors and approved by the Board.

I cannot see how it is possible for Congress to operate a money system except through a body such as the Federal Reserve Board, or some other board that they may create for the purpose of carrying out the wishes of Congress, as provided in legislation which Congress passes.

I do not think the proposed legislation in any way takes away from Congress the sovereign power which it has and should retain. It simply delegates to a body which should represent the nation and the interests of the nation, the carrying out of the mandates of Congress. The Board is in session all of the time; Congress is in session part of the time. The Board, which is appointed by the President, is required to operate in accordance with legislation which may be amended from time to time. There is nothing to prevent Congress at any time when it is in session from giving further instructions to the Board through legislation.

Under the bill, the Federal Reserve Board will exercise all the powers of a central bank, so far as monetary policy is concerned. This is desirable and necessary. The Federal Reserve System, however, is not and will not be controlled by the Administration. Administration control over the Board will not be increased.

I am contending for a central body, charged with responsibility for monetary control, in the public interest. Whether it is to be the Federal Reserve Board or some other board is for Congress to decide. But what I am advocating is that the power and the responsibility for monetary policy be placed in a body that is charged with the public interest, and if it is felt that the Federal Reserve Board is a political board and that in the matter of monetary policy it will be dominated by political expediency, rather than by public interest, then there should be some changes. But I do not think that under this legislation the Federal Reserve Board would act on the basis of political expediency rather than of the public interest.

There is a great difference between thousands of banks acting independently and a small board charged with the responsibility of monetary control. In the first place, the bankers acting independently have no way of expanding money, and they have no way of stopping the contraction of money, even if they so desire, because they have no control over the issuance of money, such as is held by the Federal Reserve System. In other words, the independent, private, commercial bank is not charged with central bank functions. I feel that a board, charged with the responsibility for monetary policy, is more likely to assume that great responsibility and to discharge its duty in the public interest than can be expected of the banking system on the basis of the past experience.

A question is raised as to the meaning of credit control in the interests of the nation. I believe I do not need to go beyond the statement of the President in whose Administration the organization of this System was set up. Woodrow Wilson said of the purpose of the System: "The control of the system of banking and of issue . . . 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." The theory was that the Federal Reserve Board and the chairmen of the Reserve banks, who were appointed by the Board, were the representatives of the Government, or the people through the Government. The Federal Reserve banks were to be controlled by their boards of directors.

Monetary control in the past.—I would not say that we have had control in the past as compared with the control proposed in this legislation. I think one of the principal difficulties with monetary control has been that we have not placed the responsibility definitely upon any one body, and given that body the power and authority to carry out its responsibility.

We did not have a statutory Open Market Committee until the Banking Act of 1933 created a committee of twelve members, one selected by the directors of each Federal Reserve bank, and charged that body with responsibility for the initiation of open-market operations, and gave to the Board the power of approving or disapproving recommendations of the committee. But even after the Board had approved the recommendations, one or all of the twelve banks could refuse to participate in the operation.

The Board has not been charged by law with the duty of formulating open-market policy and has acted in these matters without a clear mandate of law. The Board has attempted to influence the money market through changes in discount rates, that is, through its right to approve of the discount rates, and it has even changed discount rates on its own motion.

The need for concerted action in open-market operations was recognized in 1922. Until then there was no recognition of the fact that the supply of money could be affected by open-market operations. There was no special machinery for open-market operations in the original Federal Reserve Act. In 1922, when some of the Reserve banks were buying securities to improve their earnings, it was observed that these purchases influenced the situation in New York, and it was realized that the 12 Reserve banks, acting independently, in buying and selling for their investment accounts, had a real influence on the money market. At that time, a voluntary committee of governors began to work together, in order to coordinate the buying and selling for the Reserve banks.

I do not know to what extent the Board has actually had a monetary policy; I have been on the Board, as you know, for a very short time and I am not familiar with the detailed history of the work of the Board. After 1929 the Reserve banks were increasingly restrictive in the kind of paper on which they would extend credit and the law put limitations on the type they could take. It is a debatable question as to whether or not, by acting sooner or more vigorously in the open market, they could have stopped the period of deflation. Some will argue that had they acted more vigorously and sooner, when there was a tremendous shortage of funds due to hoarding and due to the gold that was taken out of the country, they would have turned the tide of deflation.

The governors of the Reserve banks discussed the problem, and also met here in Washington with the Board. Discount rates were reduced and securities were purchased in the market beginning with the autumn of 1929, but more vigorously after the passage of the Glass-Steagall Act in February, 1932.

In view of the fact that the entire banking structure collapsed and had to close completely, however, it is difficult to imagine how anything very much worse could have happened.

What the Board may have done is a matter of record, and it would appear in the record, from the unemployment and the fluctuations in business activity, that whatever may have been done fell short of creating stable conditions. Whether a condition of business stability can be brought about by monetary policy, only time can determine; and, as I have already stated, monetary action has its limitations, and has to be considered in connection with the tax program and Government expenditures.

The Federal Reserve System is not an emergency system. It is a system that certainly should be able to regulate the volume of money and, if the banks and the money system under capitalism cannot meet an emergency independently, the Federal Reserve System is the only agency we now have to do it. The System contributed very greatly toward the financing of the extraordinary expenditures of the war, in the absence of sufficiently large revenues from taxes.

The System is a great improvement over the banking organization that preceded it. It has been very helpful in the clearing of checks and has speeded up immensely the clearing of financial transactions throughout the country.

Local autonomy of Reserve banks.—The proposal would leave the different Federal Reserve banks authority to operate independently in local matters, such as that of extending credit to member banks. Whether or not credit will be extended to a member bank, and upon what basis, will be determined, as in the past, by the regional Federal Reserve banks. The Board will only make the rules and regulations governing the general basis upon which credit can be extended. Furthermore, it is proposed in this bill to give the Board power to liberalize the basis upon which the Reserve banks can extend credit to the member banks.

The Federal Reserve System has always been expected to perform certain functions of a central bank. It was originally set up on the basis of a certain regional autonomy, due, I suppose, in part, to the opposition in 1913 to centralization in this country, and due, also, in part, to the size of the country and to the different economic conditions that existed in the different regions. The Reserve Board was set up as a coordinating agency for these 12 banks, which have 25 branches.

The proposed bill in no way changes the physical structure. The ownership of the Federal Reserve bank is left with the member banks. In most of the countries of the world, the central bank is a privately owned institution; instead of being owned by the banks, it is owned by the public.

No change is proposed in the number of directors of the Reserve banks, and the majority, six of the nine, will continue to be selected by the stockholders of the member banks and a seventh director, who will be both chairman and governor, is to be elected by the directors, subject to approval by the Federal Reserve Board. However, a limitation is being put upon the terms of service of these directors.

It is proposed that the appointments of governors should be approved by the Board, in order that there will be a more direct and responsive relationship between the Reserve banks and the Federal Reserve Board, so that the Board's coordination of the System will be through the governor, rather than through the chairman and agent. This is the reason for the proposed combination of the offices of governor and chairman. Such coordination would be further effected through the proposed control over open-market operations by the Board which is the primary feature of the legislation.

There are, however, many important functions that the Federal Reserve banks have outside of open-market operations, and it is not proposed to take away from the regional banks the functions which they now have. As a matter of fact, if the Board is given the authority to delegate duties, as is proposed in the bill, I believe that some duties would be delegated to the regional banks beyond the responsibilities they now have. The regional banks carry the reserves of the member banks and pass upon the credits to these banks. It is through the regional banks that the Board operates in approving banks for membership, in issuing voting permits, in examining banks, in the matter of reduction of capital structure, and in the matter of consolidations. All of the important relationships with the banks and the public in the districts are handled by the Reserve banks. It is not proposed to take away any of these functions or to attempt to centralize them in the Federal Reserve Board.

Government ownership of Reserve banks.—The individual member banks are the present owners of the Federal Reserve banks. The ownership, however, is quite different from that of the average private bank and of most private corporations. The member banks are limited to a 6 per cent return on their capital and the board of directors of a Reserve bank must get the approval of the Federal Reserve Board on certain matters.

Personally, I see no objection to requiring that the earnings of the Federal Reserve banks in excess of the 6 per cent dividends to member banks, be turned over to the Government after the surplus of the Reserve banks has reached an amount equal to its capital. It is now provided in the law that, in case of liquidation, any surplus remaining, after the payment of all debts, dividend requirements, and the par value of the stock, shall be paid to and become the property of the United States.

I believe that ownership of the stock of the Federal Reserve banks by the Government would be of no particular advantage in the operation of the Federal Reserve System. Ownership of the bank is not so important as the way the bank is set up and the responsibility with which it is charged. If the management of the banks and the personnel of the Board consist of efficient men, ownership would make no difference. If, on the other hand, men were selected for purely political reasons, rather than with reference to their qualifications, and if they were made to feel subservient in exercising their judgment, then the System would be inefficiently operated.

I believe that, through the adoption of the provisions of this bill, the control would be made effective and responsibility would be fixed. The System should be operated as effectively in the public interest as if the Government owned the stock. It gets down to a matter of human intelligence. I see no reason why management under Government ownership would insure that the System would be operated in the public interest any more than would be the case when the members of the Federal Reserve Board are appointed by the President of the United States, as is now provided, and when the governors and chairmen of the individual banks are selected by the local directors of the bank, subject to the approval of the Federal Reserve Board.

I believe there is a great advantage in keeping regional ownership and interest in the Reserve banks.

Most of the central banks of the world are privately owned. The bank which is just being set up in Canada, after a good deal of investigation and study, is owned by the public.

If the Government were to take over the ownership of the Reserve banks, the United States Treasury would have to purchase from each member bank its stock in Federal Reserve banks. The Government would be required to raise the funds for these purchases. If the funds were raised by borrowing, the Government would carry the cost of the interest on the debt issued. This would tend to offset the dividends paid on the capital stock purchased.

Inflation.—The condition of inflation has to come about through increase in the volume and velocity of money either by Government spending or by private spending, or by a combination of both. The difficulty in discussing inflation is that so many people think of inflation as something unsound; they think of worthless money. What I mean by inflation is an increase in the general price level; an increase in employment and an improvement in the business situation would give inflation at the present time. With the excess reserves now available, if credit expansion should commence and should continue, business activity and a price level substantially higher than in 1926, 1927, 1928 or 1929 could be achieved. Total deposit money would be increased beyond any amount that we ever had before.

We have had a good deal of talk for a year or two about the fear of inflation. If there were any real fear of inflation, it would be evidenced by an increase in the value of equities. Prices of stocks would be going up, high-grade bonds would be going down instead of up, and the rate of interest that would be paid on long-term municipal, Government and other securities would be increasing rather than decreasing. Likewise, real estate values would be increasing rapidly, and rents would be going up. In other words, if there were the fear of inflation that we hear so much talk about, money would be shifting from deposits into things, and there would soon come a demand for increased credit, because it would be profitable, with increasing prices, to use credit to buy things.

I am not much of an authority on the subject of what has happened throughout the history of the world with reference to the matter of inflation. What study I have given to it applies more to recent developments, particularly since the war. In my opinion, the conditions in this country at the present time are in no way parallel with the conditions in those countries that have had inflation.

All of the inflation talk in this country for three years has been largely imaginary. It is true that, based upon existing excess reserves of the banks, there is a possible means of creating a tremendous credit inflation. That does not mean that you are going to get that inflation. In the first place, in order to get inflation people and corporations must be willing to use bank credit. Then it also would be necessary that there be no control exercised after private credit began to expand to a point where prices were going up rapidly and production had reached a peak. Unless the people in this country are put in possession of money through jobs or without jobs, so that the means of payment increases, and, unless people and corporations with money will spend the money that they have, we can not get inflation.

I do not believe that it is going to be so easy to get inflation. Certainly efforts have been made now for several years to get it; but from all indications we are as far from it now as we were two or three years ago.

Inflation can not be obtained merely by changing the gold content of the dollar or by silver legislation, unless the result of such changes will actually put money in the hands of people to spend, and unless it induces the holders of existing money to spend. Otherwise the volume and the velocity of money will not increase, both of which are necessary in order to get inflation. We are trying to induce the borrowing and lending of money upon which recovery is based. We are talking about the fear of inflation or reflation, when, as a matter of fact, that is what we want.

In my opinion a general increase in prices which would mean inflation could be controlled through the powers that this legislation would provide for the Federal Reserve Board. I think that the control of inflation is a far less difficult problem than the control of deflation.

Government Debt and the Banks

This bill was not drawn for the purpose of assisting the financing of the Government; as a matter of fact the Government is having no difficulty with its financing.

The Government bonds held by the banks of this country are a somewhat smaller proportion of total assets than is the case for the English banks. Thirty-nine per cent of the assets of the member banks are invested in Government obligations, compared with 41 per cent for the English banks. Forty-four per cent of the total outstanding Government bonds are in the member banks and in the Reserve banks, and 39 per cent of the assets of the member banks are invested in Government bonds, whereas in Great Britain 15 per cent of the total Government bonds outstanding are held by the London clearing banks and the Bank of England, but that represents 41 per cent of the resources of the British commercial banks.

In purchasing offerings of Government bonds, the banking system as a whole creates bank deposits, or new money. Considering the banking system as a whole, when the banks buy a billion dollars of Government bonds as they are offered, the banks credit the deposit account of the Treasury with a billion dollars and debit their Government bond account a billion dollars, and they create, by a bookkeeping entry, a billion dollars of bank deposits.

The Government then draws out those deposits and disburses them. Amounts paid out by the Government are for the most part immediately redeposited in banks, and therefore total deposits of the banks are not changed; but the ownership of the deposits is transferred from the Government to individuals and corporations, who can spend it or use it to reduce their debts. In this way purchases of bonds by the banks help to rebuild the country's buying power.

Substitution of currency for Government bonds.—The Government because of its sovereign power is able, if Congress so wills, to finance its operations by payment of currency for its obligations, and it could go so far as to take up its bonds by paying out currency.

The result of that operation, in so far as the bonds were purchased from others than banks, would be that bank deposits and reserves would increase. Holders of Government bonds other than banks include insurance companies, savings banks, hospitals, educational institutions, charitable institutions, trusts, individuals, etc.; currency paid to all such holders would be deposited in the banks increasing both deposits and reserves. If the Government paid its bills in currency, that currency would be disbursed, the money would come into the banks to the credit of individuals and corporations and thus deposits and reserves would also be increased. To the extent that the bonds were purchased from banks, reserves would increase and deposits would not.

If currency were substituted for bonds, the reserves would be greatly in excess of what they now are; because the banks would not have the deposits invested in Government bonds but would be carrying those deposits as excess reserves. If present holdings of Governments by the banks were taken up by currency, the reserves of the banks would increase by about eleven or twelve billion dollars. These reserves, in addition to the excess reserves of two billion now held would increase excess reserves to, say, thirteen or fourteen billions, simply by taking up the existing bank holdings of Government bonds.

The further point I raise is that the banks would not be willing to handle deposits without being able to invest them at interest. About 39 per cent of the total loans and investments of banks is represented by Government bonds. There is no question that you can not take away from the banking system 39 per cent of its present investments in view of the fact that they are not operating very profitably today.

If, however, currency were substituted for Government bonds and reserve requirements were increased to offset the increase in reserves, which might become necessary if inflation developed, the banks would be unable to perform the services which they now perform in the handling of business of their customers, in the clearing of financial transactions and in the keeping of individual and corporation accounts, without making service charges that would compensate them for their loss of income or interest on the Government obligations. Why would a bank take demand deposits and become the bookkeeper for the community funds, for every individual that carries an account, and act as a collection agency for the purpose of clearing and facilitating individual business transactions all over the nation, unless that institution could make by service charges what it formerly earned in its investments in Government bonds?

It may be interesting to see just what the Government is paying the banks. There have been some exaggerated statements made on this subject; it has been claimed that the banks are getting as much as $1,000,000,000 a year in interest on Government securities. As a matter of fact, the total interest paid on the national debt during the calendar year 1934 was $817,000,000. Under the most generous estimate that you can make on the basis of the obligations held by member banks, they received only about $260,000,000. For all banks, the estimate would be $320,000,000 as a maximum.

Furthermore, in connection with the question of substituting currency for bonds, I wish to point out that there are expenses in connection with issuing currency and keeping it in circulation. It may be interesting to note that the cost of keeping the greenbacks in circulation, today, is more per annum than the present rate that the Government is paying on its 182-day Treasury bills. It is estimated that the cost of keeping the greenbacks out is about fifteen hundredths of 1 per cent per annum, while the 182-day bills are issued on the basis of eleven hundredths of 1 per cent per annum. In the case of the greenbacks the destruction is rather rapid so that they have to be reprinted; the costs also include shipping them out and shipping them back, insurance charges, express charges, personnel, accounting, and other expenses.

The cost of Federal Reserve notes is less than that of the greenbacks because the denominations are large; Federal Reserve notes include no $1 bills.

It has been suggested that the substitution of currency for Government bonds would tend to create inflation. Of course the existing excess reserves of about two billion dollars should tend to bring about inflation and that has not happened. The rates on bankers' acceptances, commercial paper, high-grade bonds, and Government bonds are now lower than at any time in the history of the country. But I do not believe that increased reserves, beyond the present excess, would induce any more borrowing.

If we begin to get recovery and private credit begins to expand, and the banks increase their investments in securities, and the funds go into the capital markets for building new capital facilities, by the time the banking system had used up the present excess reserves of two billion dollars, the volume of money would be far in excess of anything that the banking system has ever had. With that volume of money and with the income velocity that we had in 1927, 1928 and 1929, it seems to me there could be a great inflation, without using any increase in the reserves, which might be brought about by substituting currency for Government bonds. In fact it would be necessary to exercise monetary control by open-market operations, or by raising reserve requirements, before the present excess requirements were entirely used up.

Relation of banks to Government financing.—It seems to me that it is desirable and necessary that there be cooperation between the banking system and the Government, in the interest of preserving the existing banking system. The Government spends only those funds which the Congress appropriates. The Congress that has the power to make appropriations also has the power to create a means of providing the funds with which to finance expenditures. Furthermore, expenditures authorized by Congress will not be deferred if funds from taxes and other sources have not been provided to meet them. Congress has the power to create the means of providing money in case the private banking system fails to do so. This would be likely to jeopardize the existing banking and credit structure.

I think it would be extremely unfortunate for the bankers if a situation were reached when the Government, having a continuous budgetary deficit, was unable to get the cooperation and support necessary from the Reserve banks and the bankers, for the reason that it would probably result in the issuance of currency rather than of bonds to pay for the budgetary deficits and there might be a possibility of the Government taking over the banking system. Certainly if we were in a war and the private system failed to meet the emergency demands of Congress, the means for financing would be provided otherwise. I think that, in the interest of the banking system, it is necessary that the banks cooperate in helping to finance the program of the administration in power.

Relation between Government debt and currency.—I think there is absolutely no relationship between the Government debt and the amount of currency or of Federal Reserve notes in circulation. If there were no Government debt there would be the same amount of currency in circulation.

It was interesting to note, in looking over some charts relating to other countries, where the debts have greatly increased, of Japan in particular, that the amount of currency has not varied by 5 per cent. And the same thing would show for this country; our debt has increased during the last two years and the amount of currency outstanding has come down as the debt has gone up.

Currency has increased, as compared with four years ago, owing largely to three causes. One is the decreased use of checking accounts, as a result of service charges, the check tax, and the reduced incomes of people, which have caused many to use currency instead of checking accounts. Another cause is the reduction in the number of small banks throughout the country; there are many small communities which formerly supported banks and which today do not and cannot possibly support banks, thus requiring the use of more currency in those communities. There is also still a considerable amount of currency hoarded.