

“THE BANKING BILL OF 1935”

ADDRESS BY

MARRINER S. ECCLES

GOVERNOR OF THE FEDERAL RESERVE BOARD

BEFORE THE ANNUAL CONVENTION

OF THE

PENNSYLVANIA BANKERS ASSOCIATION

AT

SCRANTON, PENNSYLVANIA

THE BANKING BILL OF 1935

Critics of the proposed Banking Bill of 1935 have now had full opportunity to present their views. It is my purpose today to discuss briefly the objections that have been raised.

One cry raised against the bill is that it is based on a new, untried and unsound theory. Let us inquire what that pernicious theory is. It is, in a nutshell, that the authority and responsibility for regulation of the money supply of the country should be entrusted to a public body and exercised in the public interest. This is not a new theory. In its essentials it is nearly as old as government itself. One of the first powers conferred by the Constitutional Assembly upon the Congress of the United States was the power to coin money and to regulate the value thereof. This bill carries out the purposes of this constitutional provision by recognizing the well-known and unquestionable, though not altogether unquestioned, fact that bank deposits subject to check are money in the same sense as coin and currency. Some of our critics have attempted to maintain that deposits are not money. But this is quibbling over words. The spending of a dollar by writing out a check has just as much effect on the demand for goods and on prices as the spending of a dollar of currency. Regulation of the volume of money, therefore, must include regulation of deposits as well as of currency.

It is true that up to the war there was no provision for regulation of the volume of deposit currency for the purpose of achieving given objectives. We relied upon the workings of the automatic gold standard. At no time since the war, however, has the gold standard been automatic. We did not dare to allow our system to expand to the limits permitted by the enormous gold inflow after the war. Neither can we tolerate the expansion made possible by our present huge supplies of gold. I am, moreover, confident that we would never again tolerate such a drastic deflation as resulted when foreign central banks drew gold away from us in 1931. The automatic gold standard, in other words, is gone, and I see no early prospect of its return. The only alternative to violent upward and downward fluctuations in our money supply, with its accompanying disastrous effect on business activity, is an effort to create adequate machinery for regulating changes in the volume of bank deposits. We are today confronted with a condition, not a theory. However much in theory you may prefer an automatic gold standard, what you have is a situation which contains the basis of a more drastic inflation than we have ever

experienced in this country. If we are not to allow this to happen, we must have the machinery for counteracting it and we must be prepared to use this machinery.

Since we are committed to regulation, there are two questions which we must ask ourselves and attempt to answer. The first is, does the system as now constituted offer the best possibilities for the successful formulation and prosecution of monetary policy? The second is, where should the authority and responsibility for national monetary policies be placed?

I wonder how many of you appreciate how unsatisfactory the set-up of the Federal Reserve System is from an administrative point of view. Do you realize that the authority and responsibility for open-market operations, the most important instrument of monetary policy, is diffused in varying degrees throughout 14 separate bodies, composed of 128 men? What private business, let me ask you, could be successfully managed with such a diffusion of authority and responsibility? What other public or private business anywhere has such a cumbersome organization as this for the making of vital decisions of policy?

This system has been described as one of checks and balances. This is true in the sense that it checks or retards necessary action and leaves the public interest in a precarious balance. It is a system that leaves nowhere a clear and unmistakable responsibility for the decisions taken—nowhere a clear and unmistakable responsibility for the ultimate effect of these decisions on business conditions and employment.

If we really want to make conditions as favorable as possible for the successful formulation and prosecution of monetary policy, it appears obvious that the authority and responsibility for such policy must be inescapably fixed on a small clearly defined body. The question is, how shall this body be constituted? If the decisions of this body affected only bankers and no other class in the community, I would unhesitatingly say that the controlling body should be elected by bankers. But the fact is that decisions of the Reserve administration affect the economic well-being of everyone in the community. As Mr. Aldrich remarked in his recent testimony before the Senate Committee, "This bill is not the business of the banks, except as they are concerned in the welfare of the nation as a whole."

You, as bankers, know very well that individually you have little or nothing to do either with the amount of deposits your customers leave with you or with the use that is made of those deposits. All you can do individually is to try to make as large and as profitable loans and investments as you can with due regard to safety. You are

by profession retail or wholesale merchants dealing in credit, and money; you create as much money as your opportunities for lending or investing afford and as much in ordinary times as your reserves will permit. You have no power individually to influence the volume of money that is created. Your function is a private business function; but the regulation of changes in the total volume of money is a public function.

You are told that since the Reserve banks deal with your money you should have some say in its investment. But this argument will not stand examination. When the Reserve banks buy securities they do not do so with existing money; they create new money for the purpose, and this increases your reserves and your deposits. When they sell securities, you lose deposits and reserve funds. The Reserve banks, in other words, are not agencies for the investment of member bank funds; they actually create and destroy money. Neither are open-market operations a regional or local matter. Their effect cannot be confined to a single district, but is nationwide and affects all classes.

In this connection, I should like to quote from an article by Mr. A. P. Giannini in the current issue of the magazine *Today*. He puts very well the point I have been trying to make. He says, "Let us, as bankers, strive to serve the interests of our depositors, borrowers, and stockholders, as ably as we can, and place the responsibility for the determination of what is really public policy unequivocally in a public body. That is not only the proper attitude for bankers to take, but from a purely selfish point of view it is the most prudent. The sooner we recognize that to provide the country with a sound and flexible medium of exchange is a public trust and not a private privilege, the better it will be for us."

The position I am taking is far from recommending that the Federal Reserve Board be given control over the activities of banks. On the contrary I want to preserve the opportunity for banks to conduct their own business in their own way, subject only to a careful regard to safety. It is only the regulation of changes in the total volume of money that I believe should be entrusted to a public body.

It has been said that the banking bill proposes to destroy the regional autonomy of the individual Reserve banks. This is not true. In fact, far from destroying their regional autonomy, the bill in a variety of ways increases that autonomy in all purely regional and local matters.

Much is made of the fact that it is proposed to give the Federal

Reserve Board power of approval once every three years over the appointment of Reserve bank governors, but our critics have ignored the powers that the Board now has and would relinquish under the terms of this bill. The Board now appoints three directors including the chairman of the board. Under the bill, one, and in many cases two, of these directors will be appointed by the local board, subject only to approval by the Federal Reserve Board once every three years. The Federal Reserve Board now has the power of direct appointment of all the officers and employees in the Federal agents' and in the chairmen's divisions in the Reserve banks. Under the terms of this bill all employees of the Reserve banks will be locally appointed. Under the bill the Federal Reserve Board will have only one link with the selection of the personnel of the Reserve banks, namely, approval of the governor, who will also be chairman of the board of directors and will be the chief executive of the bank.

I ask you to note carefully that it is not proposed to have the Federal Reserve Board appoint governors. That is reserved for the local board of directors. It would not be possible, therefore, for the Federal Reserve Board to force any person on a Reserve bank as governor if he were not acceptable to the local board of directors. If, after a governor has been appointed and approved, the local board of directors is not satisfied with him, it need not reappoint him, and the Federal Reserve Board could not force his reappointment.

Without the minimum of authority over the local personnel provided in the bill the Federal Reserve Board could not discharge its responsibilities in supervising and coordinating the activities of the Reserve banks and in seeing that national credit policies are effectively carried out by the regional banks. The Federal Reserve Board, as you know, has little or no direct contact with the banks or the public. It works almost entirely through the Federal Reserve banks and it must have at the head of these banks men that are acceptable to itself. It is surely not being too optimistic to expect that there are at least twelve people in this country who would be acceptable both to the Federal Reserve Board and to the boards of directors of the twelve Federal Reserve banks.

It has been stated or implied by critics that the Federal Reserve Board under the terms of the bill would acquire new powers over the relationship between the Reserve banks and their member banks. I want to say emphatically that there is nothing whatever in the bill that would impair in any way the independence of the Reserve banks in this respect. The extent to which the Reserve banks make advances to member banks will continue to be determined by the boards of directors of the Federal Reserve banks. The Federal Reserve

Board has no power, and will have no power, to force a Reserve bank to make loans to member banks.

The Federal Reserve Board now has the power and responsibility of defining paper that is eligible for rediscount or as a basis of advances. At the present time, however, this power is circumscribed by rigid requirements laid down in the law. Under the proposed bill all sound assets of banks may be made available as a basis of borrowing from the Reserve banks. The Board, however, will not have any authority to determine what assets, in addition to being eligible, will be acceptable to the Reserve banks from the credit standpoint. The banking judgment of the Reserve banks will continue to determine that.

What we have attempted to do in this bill is to work out a proper division of powers between the Federal Reserve Board and the Federal Reserve banks, giving the Federal Reserve Board increased authority and responsibility for the determination of national policies, and at the same time strengthening the autonomy of the Federal Reserve banks in matters of regional and local concern. In this connection, I should like to draw your attention to a provision in the bill which has excited little comment. It is to the effect that the Board may delegate the exercise of certain powers to its representatives. It was inserted for the purpose, among others, of enabling the Board to delegate to the Reserve banks the exercise of many powers which the Board is required to exercise now, but which it will be able under the new law to delegate to the Reserve banks. Such powers include the granting of voting permits to holding company affiliates, the permission to directors to serve more than one bank, and many other matters in which the closeness of the Reserve banks to the local situation makes them better able to reach current decisions than is possible for the Federal Reserve Board in Washington.

The attack on the banking bill most frequently resorted to by its opponents takes the form of raising the spectre of political domination. It is said that under this bill monetary policy would be formulated by a political body for political ends. The fact is that there is nothing in the bill which changes in any way the relationship between the Administration and the Federal Reserve Board. In fact, various provisions in the bill are expressly designed to strengthen the independence of the Federal Reserve Board and to insulate it from pressure to adopt policies on partisan grounds. The term of Board members remains at twelve years, and under the recent Humphrey decision of the Supreme Court the members cannot be removed by the President except for cause. It is proposed to have the Governor serve at the pleasure of the President, but this has always been the

case. The bill as passed by the House proposes that if the Governor is not redesignated as such by the President he may either retain his membership on the Board or resign, and if he resigns he may resume his banking business without being obliged to wait for two years. This is designed to make it easier to obtain as governors capable men with banking experience.

Independence of the Federal Reserve Board will be increased by the bill in the first place by granting future Board members pensions and higher salaries. There is also proposed a change in the qualifications for Board members which should tend to secure the best-qualified people in the country. Under existing law almost anyone could meet the qualifications for Board members. They must merely represent industry, commerce, finance, or agriculture. This, in fact, is not a qualification, but an attempt to have a body representative of all the different elements of population except labor. It is better to have all the members of the Board represent the nation as a whole and to require that they be fitted for their duties by training or experience. That is proposed in the bill. The fact that the law would give specific instructions as to the end toward which credit policy should be directed would also add to the Board's independence. If, in the future, the Board should be subjected to pressure to use its powers for political purposes, it would have the support of the law in refusing to yield to such pressure. With the additional powers and responsibility conferred upon the Board, enhanced prestige should also follow.

I think that any fair-minded person considering these facts would come to the conclusion that there would be less possibility of the Federal Reserve Board being swayed by partisan motives in the future than there has been in the past. And what has been the record in the past? It is one of which the Federal Reserve Board may well be proud. Our opponents have had to resort to insinuations and innuendoes; they have been unable to unearth a single scrap of evidence that the Board has ever been swayed by political motives. Mr. Ogden Mills, who made a bitter attack upon the bill last week, incidentally stated that from 1921 to 1933 the Reserve Board made a fine record of independence. He stressed, in particular, that in 1929 the Secretary of the Treasury was consistently outvoted on the Federal Reserve Board. If, therefore, with lower salaries and no pensions, and the lack of a specific objective, the Board has made so fine a record of integrity in the past, I have no doubt whatever in my own mind that with pensions, higher salaries, a specific objective, and enhanced prestige, the Board will remain independent from political pressure of the undesirable sort in the future.

We cannot, of course, stop our critics from calling the Federal Reserve Board a political body. But if they do that they must call all our independent commissions political. If the Interstate Commerce Commission is a political body and its members politicians; if the Federal Trade Commission, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, and similar governmental agencies are political bodies and their members politicians, then the Federal Reserve Board is a political body and its members politicians.

There has been no evidence of this, however, since these various agencies of the Government were established; no evidence that they have been actuated by either political or private interests rather than by the public interest. The men chosen to fill these offices, judicial or administrative, are chosen by the President, by and with the advice and consent of the Senate. That is the method we have adopted in our form of government. That is the method we have adhered to in the banking bill.

In disposing of the political domination argument, I have, I think, disposed of many of the other objections to the bill. Thus, it is said that the purpose of the bill is to compel the Reserve banks to finance the deficits of the Government. This argument is rather ridiculous in the face of the fact that the Government is having no difficulty whatever in financing its requirements and does not anticipate any. Just as soon as the national income increases sufficiently—and it is being increased—the Government expects to have no further deficit. The banking bill would have been introduced in Congress if the Government had been running a surplus instead of a deficit.

Some people who do not approve of the Government's spending program feel that if the banking system were under banker control it might be made so difficult for the Government to borrow that it would have to cease spending and balance the budget at once. That, I assure you, is the most dangerous and irresponsible argument that any group of bankers could present. Congress, which has the power to appropriate money, has also the power to find means to raise it. Make no mistake about that. If you disapprove of the Government's policy you must resort to the ballot to make your opposition effective. To attempt to hinder the Government in carrying out the mandates of Congress and in raising the funds necessary for the purpose is to invite disaster for the banking system.

Some of the critics of the banking bill have asserted that if the German Government had not been able to borrow from the Reichsbank there would have been no inflation in Germany. This is so incredibly naive that I cannot help feeling that those who advance

this argument have their tongues in their cheeks. If the German Government were prepared to appropriate the money, do you think for a minute that it would not have been prepared to change the Reichsbank law if borrowing from that bank had been prohibited, or even of issuing its own notes? Both England and France borrowed heavily from their nominally independent central banks, and the British Government issued its own notes in the war.

I am not, please note, proposing that the Federal Reserve Board must be subservient to the Treasury. Far from it. What I am insisting upon, however, is that Congress, which has the power to appropriate money, has also the power to raise it. If we are to avoid disastrous fiscal policies we must rely on Congress and the Administration, and not place our faith in some legal provision of the banking law that can be changed overnight.

It has been suggested that the proposal to have monetary policy determined by a public body marks a radical departure from central banking practice in other countries. This is a simple question of fact, and the facts are known. In Japan, Sweden, Germany, Switzerland, New Zealand, Finland, Australia, and Norway, both the governor and all, or a majority of, the directors are appointed by the government. In various other countries the governor is either appointed by the government or his appointment is subject to approval by the government. The Bank of England is always cited as the outstanding example of an independent central bank. It is common knowledge, however, that the Bank of England works in close cooperation with the Treasury and would not attempt to embark upon any policy opposed to the wishes of the government of the day. Viscount Snowden, the former Labor Chancellor of the Exchequer, has stated that, "I do not see that it would make any difference to the management or policy of the Bank of England if it were nominally made into a state bank—for all practical purposes it is that now." He further states that "No important departure in policy is ever taken by the bank without consultation with Treasury." (Mr. Lloyd George's *New Deal*, p. 42.)

Against the provision in the bill which would remove the requirement of specific collateral against Federal Reserve notes, it is urged that this would permit the issue of Federal Reserve notes regardless of the needs of business, that it would result in inflation and the debasement of the currency. Such criticism displays a complete ignorance of the facts. The theory that Federal Reserve notes should be secured by eligible commercial paper in excess of the forty per cent gold requirement is an old theory, and a tried theory, and a demonstrably unsound theory. It was early discovered that there

is no necessary connection between the requirements of the community for notes, the requirements of commercial borrowers for loans, and the requirements of member banks for loans from the Reserve banks. I need not dwell on this. As bankers, you are perfectly familiar with it. We are predominantly a deposit-using country, and the amount of notes outstanding is determined mainly by the needs of consumers. Reserve banks pay out notes only on demand to member banks. Suppose the Reserve banks bought \$100,000,000 of securities and paid for them with notes. What would happen? After the sellers of the securities recovered from their astonishment, they would immediately summon armored cars and rush the notes off to the banks. These banks, in turn, would send them back to the Reserve banks.

Some of our critics have admitted that we cannot keep outstanding more notes than the community requires, but have maintained that the removal of specific collateral would permit greater open-market buying operations by the Reserve banks. This is true. But the fact is that the restraint on open-market operations by this method occurs at the wrong time. These restraints do not restrict inflation. In 1919-1920 Reserve banks possessed an abundance of paper eligible as collateral against Federal Reserve notes. It was at a time of severe deflation, such as 1931, that the specific collateral provision limited the power of the Reserve banks to carry out open-market operations that were needed in order to arrest the course of a terrific deflation. The purpose of this provision is to remove a condition that has in the past and may in the future aggravate a deflation. It should never again be necessary for the Reserve banks to watch thousands of banks and businesses fail while they wait for Congress to convene to pass emergency legislation permitting them to place Government bonds behind Federal Reserve notes.

Another line of criticism of the banking bill is that it would result in a deterioration of the quality of banking assets. On this ground proposed changes in the eligibility and real estate provisions are attacked. The first point to be mentioned in this connection is one that I, from my experience in banking, have well in mind. It is that no matter how desirable short, self-liquidating commercial loans may be, they are not available in sufficient quantity to afford an adequate outlet for the banks' funds.

There are, I know, some writers who have a theory that bank loans should be restricted to such paper, and that the Federal Reserve Act should be designed with this in mind. But again I would remind you that we are confronted with a condition and not a theory. We are legislating not for an ideal system to be constructed anew but for

one that actually exists. If banks are to make a living and serve the borrowing needs of their communities, they must make longer-term loans. If they are to be permitted to accept savings deposits, they should also be permitted to make real estate loans under proper safeguards. We are simply recognizing hard facts, and are endeavoring to make it as safe as possible for banks to serve adequately their own interests and the interests of their communities. We most emphatically are not proposing that banks should make poor loans. For the first time it is proposed to write the phrase, "sound assets," into the Federal Reserve Act, and if experience means anything, assets will have to be sound before the Reserve banks will accept them as collateral for advances.

As bankers, I should think that you would heartily approve of a step which looks toward the substance rather than the form of loans; to their quality, rather than to their maturity. I recently had occasion to have an examination made of the form of the assets of all national banks that were suspended in the years 1930-1932, and discovered that on the call dates immediately prior to suspension, real estate loans comprised only 11 per cent of total loans and investments; securities held, 30 per cent; loans on securities, 18 per cent; and all other loans, 41 per cent. The bulk of the latter was nominally short-term. It is obvious that a large proportion of paper that is in form short-time commercial paper does not protect the solvency of a bank.

Some people have criticized the objective of monetary policy which has been suggested in the bill to the effect that the Federal Reserve Board shall use its powers to promote conditions conducive to business stability, so far as may be possible within the scope of monetary action. It has been said that this is economic planning and that it arouses unwarranted expectations. I fail to see the force of such criticisms. It appears to me patently desirable that, if Congress delegates its money-issuing powers to the Federal Reserve Board, it should also give instructions as to the end toward which those powers should be exercised. The present objective—the accommodation of commerce, agriculture, and industry—is vague to the point of meaninglessness, and in effect is no objective. I think that all of us, regardless of how much importance we attach to the effectiveness of monetary policy, agree that business stability is a desirable objective. It does not follow, because we cannot achieve stability through monetary action alone, that we should not do all we can through monetary action to promote conditions conducive to stability. The two most recent central banks, those of Canada and the Argentine, both have legal objectives similar to the one we are proposing.

As a last line of defense, opponents of this legislation have proposed the creation of a commission of experts who would review the whole field of banking legislation at leisure and would then make a report to serve as a basis for reform. The bill, they say, was hastily and even surreptitiously drawn; there is no emergency now, and therefore time should be given for further study. I am glad of this opportunity to state that this bill was neither hastily nor surreptitiously drawn. It was prepared in consultation with persons who have been associated with the System for many years, and was based on the experience of the Federal Reserve System during the past twenty years, and particularly during the depression. Treasury officials and leading bankers were also consulted.

Whether there is an emergency now is a matter for difference of opinion. I should think that the fact that automatic rules and guides to policy are a thing of the past; that we have the basis of the greatest banking expansion we have ever experienced; that we are beginning to pull out of the worst depression we have ever had and are entering upon a period which, we may be confident, will differ from anything we have had in the past—I should think all these factors consitute what may legitimately be called an emergency in the sense of being a good reason for prompt action in perfecting the machinery that will be called upon to meet many new and urgent situations.

The proposal for further time to study the bill displays misconception of its nature. Its provisions are not such as would be changed by the collection of more factual data. They either rest upon our past experience and upon facts that are well known; or they concern matters of principle, on which we should be as well prepared to have an opinion today as we would be in five years' time.

The matter of principle at stake is this: shall we attempt to make conditions as favorable as possible for efficient control of monetary policy by a public body in the public interest, or shall we perpetuate the present system of diffused authority and responsibility, of checks and impediments to effective control? That, gentlemen, is the issue on which I should like you to examine carefully and critically the case for and against the banking bill. If you will examine the arguments objectively and dispassionately, and avoid hysteria and emotionalism, I am confident that you will accord the Banking Bill of 1935 your warm support.