COPY

UNITED STATES SENATE

Committee on Finance

May 17, 1938.

Honorable Marriner S. Eccles, Chairman,
Board of Governors of the Federal Reserve System,
Washington, D. C.

My dear Mr. Eccles:

Every depression produces an inevitable crop of agitators out in the country who have no trouble in whipping up a substantial attack upon the American monetary system. Our present experience is no exception to the rule. My part of the country is once more full of earnest souls who familiarly insist that we should rid ourselves of the Federal Reserve Banking System and - of course - substitute greenbacks for bonds. There are always two fundamental points that are stressed by agitators in this field.

I have my own answers for them; but I have often wondered whether the Federal Reserve Board itself should not undertake to make available some sort of an authentic statement which might contribute to a more rational state of public information on these related subjects. I think there is a real service to be rendered in this connection; and it seems to me that it ought to come from some authoritative source like the Federal Reserve Board. Needless to say, there is not a remote element of partisanship in this suggestion.

Here are the two constant propositions which these monetary agitators always persuasively stress and with which they always win a sympathetic popular hearing.

The first proposition is that the Constitution of the United States requires the Congress that it "shall coin money and regulate the value thereof", and that Congress abdicates this constitutional function under the existing Federal Reserve System.

The second proposition is that as a result of this abdication, private banking - operating through the medium of the Federal Reserve System - is the actual controller of "coinage and values" and that private banking takes a profit to itself through the exercise of this public function.

I shall be greatly interested in seeing an authentic answer to these two propositions from the Federal Reserve Board in some form or other. I am not suggesting that you should take cognizance of all this agitation or that you should join issue with any of these agitators. But I should like to see the Federal Reserve System provide - abstractly -

what it conceives to be the authentic answer to these attacks upon its own foundations and its own existence. Of course I am assuming that you can produce an answer. I have produced a great many answers in my own time and in my own way. But the misconceptions persist and multiply, and I think there is a distinct public service to be rendered in making the constitutional theory of the Federal Reserve System authentically plain to the American people in some fashion that brings the matter to the levels of popular understanding.

If anybody has the facilities to do this sort of a job, it is certainly your Board. At the very least - for the benefit of my own purposes - I should appreciate a letter discussing these two principal propositions from your point of view.

With warm personal regards and best wishes,

Cordially and faithfully,

(Signed) A. H. Vandenberg

June 14, 1938.

Dear Senator Vandenberg:

Your letter of May 17 is of much interest to me and to the other members of the Board of Governors, for it raises fundamental questions of public interest. I appreciate, as I know my colleagues do, your interest in having a correct statement of the facts with which to meet misleading and damaging propaganda that jeopardizes not merely our banks but our entire economic structure and, in the final analysis, our democratic institutions.

You state that in your part of the country there is agitation to abolish the Federal Reserve System and to substitute greenbacks for bonds, and that the advocates of this course make two main points: first, that, although the Constitution gives Congress the power to "coin money and regulate the value thereof", Congress has abdicated this power; and, second, that in consequence of this abdication, private banking, operating through the medium of the Federal Reserve System, is the actual controller of coinage and values and thereby takes a profit to itself through the exercise of this power.

We are constantly bombarded, as you are, by those who imagine that all the complicated problems of our economic life can be solved by monetary magic. Unfortunately, the problems are not so simple. The failure on the part of many groups to understand how our economic system functions increases the difficulty of finding practical solutions to the vital problems that confront us.

One of the most conspicuous and arresting facts of the situation as it exists now and has existed since the banking holiday is that we have an abundance, not a scarcity, of money and of funds seeking investment in profitable and productive outlets. It would be supposed that in the presence of this fact those who imagine that a mere increase in the volume of money would assure full employment and prosperity would at least reexamine their arguments. I doubt whether in all history there has ever been such a convincing demonstration of the falsity of the theory that mere creation of a vast volume of funds will of itself produce or maintain prosperous conditions.

The vital point which is so strangely overlooked by the quantity of money theorists is that in order to have prosperity we must not only have an adequate supply of money but it must be put to active use for productive enterprises.

The great need now, as has been the case ever since the late twenties and, indeed, throughout much of the so-called prosperous era is to draw upon our existing human and material resources and put them to productive use. Our problem is not and has not been in any sense one of an inadequate supply of money and credit. We have today, for example, as you are aware, a larger volume of currency and bank deposits than we had at the peak of the boom in 1929. Interest rates have been and continue to be at unprecedentedly low levels. This would not be the case if there were a scarcity of money. It is a scarcity of money, together with demand for it, that makes interest rates rise.

Excess reserves of the banking system are and have been very much greater than they were throughout the period of the twenties. At present they exceed $2,500,000,000, and by the end of the year they are likely to exceed $3,500,000,000, which is greater than they ever have been in all history. Excess reserves represent idle money. In their present proportions, they represent credit resources on which business could draw practically without limit if business were able or willing to use these resources for productive purposes.

In my judgment, one reason why bank credit is not flowing adequately into productive business channels is because the banks are under too severe restrictions in their lending and investing operations. This is due both to Federal and State bank examination policies and to the Regulation of the Comptroller of the Currency governing investments by member banks. As to loans, many would-be borrowers cannot get deserved accommodation by the banks, not because the bankers are necessarily at fault, but because of the restrictions imposed upon them. While larger units of business can obtain ample bank credit, there are numerous cases where sound local businesses need working capital or fixed capital on longer terms than the banks can make without being criticized by most bank examiners who have been trained in the school which identifies liquidity with soundness. Similarly, the Comptroller's Regulation in effect confines permissible bank investments to registered securities that are given approved ratings by recognized rating firms and that have a wide and active market. Thus many local industries of small and medium size, which cannot stand the costs of registering and issuing securities for general public offering but which are perfectly sound risks, are denied access to that type of credit which is available to larger business units through the purchase of their securities by banks. Without questioning the necessity for regulations in the field of investment securities, I am confident that it is a mistake to prohibit member banks from purchasing sound securities of local businesses. I have urged that the Comptroller's Regulation be revised so that bank lending and investment policy can meet changed conditions and present day requirements of business and industry. In a recent address, I stated: "Bankers cannot justly be held responsible for such restrictive governmental banking policies as confuse soundness with liquidity or true worth with current depressed market values. I favor modernization of these practices and regulations, to encourage the bankers to meet changed credit conditions and needs within their own communities, and thus to discourage the alternative which is multiplication of governmental agencies set up to provide credit accommodation that the banking community could and should in normal times be adapted to extend to the public."

Thus while the actual and potential supply of funds is unprecedented, and the trouble is by no means a lack of such resources, monetary policies which have aimed at providing this abundance of money are frustrated when, at the same time, examination and investment policy remain restrictive and, indeed, are exactly contrary to monetary policy. It is for this reason that I have likewise contended that bank examination and investment policies must be closely coordinated with monetary policy. Otherwise, the result is likely to be the stalemate that now exists in the case of many sound but small business men who would obtain credit and put it to productive use, and to whom the bankers would make loans, but for the fact that the Government's underlying policy of creating ample credit at reasonable rates for the encouragement of legitimate business is balked, in the cases I have indicated by restrictive rules and regulations.

I have digressed from discussion of the specific points raised in your letter since I felt it necessary to emphasize that even in the field of credit control, which is generally entrusted to the Federal Reserve authorities, improvement and coordination of the activities of different branches of the Government is necessary. This situation indicates the urgent need for amendments to the banking laws to insure correlation of policies among the various banking and other financial supervisory authorities.

But, aside from the obstacles just described to the flow of money into productive enterprise, the principal reason why this flow is held back is that business and industry generally see no way to use funds profitably. They are not sure of finding a profitable market for their products. And this condition cannot be remedied until consumers have sufficient incomes to buy those products.

Lack of recognition of this fact lies behind much of the monetary agitation, particularly that directed against the banking system and against the methods of financing the requirements of the Government.

Our banking system has developed its present pattern since the beginning of the Republic and while no one familiar with it would contend that it has attained perfection or has yet approached the ideal, it has been adapted, step by step, in accordance with American principles and traditions of democratic government and to avoid too great a concentration of or an abuse of power. So many safeguards against these evils have been established over the years as to present other difficulties, such as those arising from divided responsibilities. Yet, with all of the admitted faults, the system is infinitely preferable to one which completely abandons the basic principles upon which democratic governments were long ago established and have since been maintained. Similarly, the procedure whereby the Government issues its securities, pays interest upon them, and repays them at maturity, has been established out of long experience.

The Government represents all of our people. Its debts are the debts of all of our people. When we as a people, acting through our collective medium of government, borrow money, we are borrowing from ourselves, and when we pay interest on or pay back the principal of the debt thus created, we are paying ourselves. The money required to pay the interest and to pay back the principal is raised by taxation levied broadly on the basis of ability to pay.

What is to be gained by doing away with this established process? If the Government is not to pay interest, then it can no longer borrow from its citizens. Certainly they cannot be asked to lend their savings without any return whatsoever—not if we are to preserve a democratic system of private capital. The Government would have to fall back, then, upon issuing currency. Currency is used only for a small part, not more than 10 per cent, of our business transactions. The heart of our system is the extension and contraction of credit in accordance with the requirements of commerce, industry and agriculture. But let us suppose that the Government were to issue more and more currency in order to meet its current obligations and also to pay off its bonded debt entirely, as some of the advocates to whom you refer have proposed. The recipients of the currency, if they are on the relief rolls, for example, would spend the money as they do the cash they receive now, but ultimately it would find its way into the hands of some merchant or producer who would deposit it in his bank, and the bank in turn would forward the cash to the Federal Reserve bank where it would add to excess reserves. Or, if the recipient is the holder of a Government bond which he is obliged to exchange for currency, he might possibly spend some of the currency, or he might endeavor to buy some other security which would return a yield on his capital, or he might deposit the currency in his bank, which in turn would forward it to the Federal Reserve bank, but in every case the currency ultimately would find its way to the Federal Reserve banks and add to excess reserves.

Suppose that the entire national debt were to be paid off in this fashion. About $34,000,000,000 of the Government debt is represented by Treasury securities held by banks, insurance companies and other corporate and individual investors. To replace these securities with cash would mean that the cash would flow into the Federal Reserve banks and build up excess reserves by $34,000,000,000, or to a prospective grand total of more than $37,000,000,000. There is no way in which any such deluge of excess reserves could be kept within control to prevent them from being used as a basis for a reckless inflation. Under our system of so-called fractional reserves, for every dollar of excess reserves they have the banks can lend approximately seven dollars. Thus, $37,000,000,000 of excess reserves, if used as a basis for loans, would be capable of expanding into some $250,000,000,000 of bank loans, an astronomical figure that, if ever realized, would mean the wildest inflation imaginable. Yet the figure serves to illustrate the absurdity of the proposal to pay off the Government's debt in cash.

Assuming that the banks would not indulge in any such orgy of inflation--and, as I have pointed out, there would be no way to control the situation--then all that would be accomplished by the proposal, is that the holders of Government securities, whether they be individuals or insurance companies, or savings and other banks, would receive cash for their Government securities and this cash they would try to invest in some other interest-bearing obligation, presumably one issued by a private corporation, and if they failed to find a satisfactory investment they would deposit the cash in the bank. In any event, the currency would finally find its way back to the banking system, because no more currency will remain in circulation than the public needs for pocket, payroll and a few other purposes.* The heart of the American financing system is credit--not coins or paper money. They are the small change. The great bulk of business is done by bank checks.

After the money was deposited in the bank it would probably be added to the already redundant amount of funds that fail to find a satisfactory investment outlet. The effect would be to bid up to larger and larger premiums the existing supply of such investments, which are even now at extremely low yields.

The creation of more idle funds would not create more real wealth. It would not lead industry to produce more of the necessaries and comforts of life which our people need or want. It would not help to distribute among the people of the country the needed and wanted things, housing, clothing, food, and all the infinite variety of other products, which our economy could and should produce.

Furthermore, the use of the printing press by the Government would remove all restraint on public expenditures. When the Government prints money someone has to pay for what it buys. Production does not increase and in the exchange of goods some group in the population must bear the cost of uncompensated acquisitions by the Government. Who pays in the first instance depends on circumstances, but ultimately it is paid for by those least able to bear the cost. For inflation inevitably follows this course, and the burden of inflation, through loss of buying power of money, falls heaviest on the poor who spend all their earnings to meet the cost of living. It is far cheaper and more equitable to pay for Government expenditures out of taxes, to which contributions are in accordance with ability to pay, than to pay for them by inflation, which destroys the value of the pay envelope, the savings account, and the insurance policy.

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*The reasons for this are explained in more detail in "The Currency Function of the Federal Reserve Banks", copy of which is attached.

There is no question whatever as to the sovereign right of the Government to abandon tried and tested principles and to issue greenbacks. What is at issue, is not the right of the Government to do virtually what it pleases with its currency. The issue is whether the Government shall adhere to principles established through long and often bitter experience or throw those principles to the wind in favor of the printing press methods that we as a nation have discarded, but that have led some countries to financial ruin.

As I have indicated, the basic fallacy of the groups to whom you refer appears to be that of mistaking money for real wealth. The Government might, and certainly constitutionally could, flood the nation with paper currency, unbacked by anything other than the air we breathe, and limited only by the ability of the presses to turn out the printed money. Yet that would not add one dollar to our real wealth. It would not better the lot of our people. It would serve only to engulf all of us in a ruinous inflation and collapse. Possibly a few shrewd speculators might benefit by that, but for the great mass of our people it would be utterly disastrous.

Stripped of the specious profundities about the constitutional right of the Government to coin money, the argument for abandonment of the established principles on which this Government has always stood leads to the same end as the bolder, franker cry for an unlimited inflation. That would be the inescapable outcome, unless it be argued that the Government would be as likely or more likely to avoid the pitfalls of reckless, inflationary issuance of its non-interest bearing obligations, than is the case today when it is committed to pay the interest and principal on its debt. Experience disproves that argument. Governments have too often been tempted to travel this path to national bankruptcy when all restraints were removed. That is why the proponents of greenbacks also would abolish the Federal Reserve System, which was created nearly a quarter of a century ago as a means of assuring elasticity of our money system and at the same time to prevent abuses and to impose restraints against reckless inflation and speculation. It is not surprising that those who want greenbacks also want to remove even such limited restraints against inflation as Congress has given to the Reserve System.

This background serves to indicate the answer to the two propositions you set forth as characteristic of current monetary agitation: first, the argument that Congress has abdicated its constitutional right to coin money and regulate the value thereof; and, second, the contention, that as a result of this abdication, the private banking system reaps large profits. Both contentions are false.

Under the division of powers between the Legislative, Executive and Judicial branches of the Government provided for in our Constitution, it is not the function of Congress to execute the laws. It is the function of Congress to make the laws and the function of the Executive branch of the Government to execute them.

When the authors of the Constitution provided that Congress should have power to coin money and regulate the value thereof, they did not mean that Congress should set up mints and printing presses in the Capitol and operate them itself. They meant that Congress should pass laws regarding the coinage of money and regulating the value thereof and leave it to the Executive branch of the Government to execute these laws, and this is exactly what Congress has done.

The right of Congress to entrust to administrative agencies the execution of the laws which it enacts is as old as the Republic. It has never been seriously questioned. It has been so long recognized and established by the courts as to be beyond serious controversy. Similarly, the Congress has a right to assign execution of its will to whatever agency it cares to select or create. In so doing, the Congress frequently selects an executive agency of the Federal Government, such as the State, War, Navy or Agriculture Departments. Or it may select an independent agency, for whose operations it appropriates the necessary funds, such as the Federal Trade Commission or the Interstate Commerce Commission. Congress assigns the execution of its power to coin money, for instance, to the Treasury Department, and, in recent years, has given the President a limited authority to determine the gold value of the dollar. In all such cases, Congress has not abdicated its power. Congress has only done what it constitutionally has the right to do: It has set up or used existing administrative agencies to execute its will, while retaining the power to take back the authority or to place that authority elsewhere. Abdication of a power means its surrender. Congress surrenders none of its power to coin money and fix the value thereof. It simply designates the Treasury as the instrument of its will and power to coin money.

In exactly the same way, Congress has established the Federal Reserve System as an independent agency to carry out its mandate in connection with the terms and conditions upon which member banks may create credit currency. The only important point of difference between creation of the Reserve System and creation of the Interstate Commerce Commission as independent agencies to carry out the will of Congress is that the expenses of the former are paid out of the earnings of the System, while the expenses of the latter are paid out of the Treasury. Congress ordained that this difference should exist in respect to the Reserve System as a further safeguard of its independence of action in the exercise of the delegated authority of Congress. At the same time, Congress has the power to abolish the System, to change it, to require that its expenses be paid in some other manner, and to appropriate the earnings and surplus of the System. In fact, Congress has exercised this power by appropriating to the Federal Deposit Insurance Corporation fund approximately $140,000,000 from the surplus of the Reserve System built up out of earnings. By no stretch of the imagination can this be called an abdication or surrender of a constitutional power by the Congress. It is, as in innumerable other cases, an assignment by Congress of the execution of an unquestioned and fully retained constitutional power.

As for the question of the profits of the banking system, so far as the Federal Reserve System is concerned, it is not and never has been operated with a view to making profits, and in this respect differs fundamentally from the usual commercial bank. Such profits as have accrued to the System through its operations, from which reserves have been established to cover contingencies, from which expenses of the System have been paid, on which franchise taxes have been levied at times by Congress, and which have been appropriated by Congress as in the case of the Federal Deposit Insurance Corporation fund, have been derived as an incident of and not as a result of the objective of the System's operations.

The System's operations are intended to serve the general public welfare. Such operations are a part of the financial mechanism necessary in all modern governments. To abolish the System would not do away with the necessity for creating some similar mechanism to perform the credit and supervisory functions which Congress has deputized the System to perform. Opinions may differ as to whether some other mechanism might be better, but the right of the Congress to create the Reserve System as the agency for the performance of these essential functions cannot be seriously challenged.

Accordingly, there is no substance whatever to the assertion that Congress has abdicated its constitutional powers by authorizing the Reserve System to carry out its will, and, by the same token, the argument that thereby private banking improperly derives a profit falls to the ground. The assumption that the Reserve System, created by and existing at the will of Congress, is a privately-owned System springs from a misconception of the facts. The major monetary, credit and supervisory powers of the System are exercised by a Board of Governors, nominated by the President and confirmed by the United States Senate. All national banks are required by law to be members of the System, and State banks are admitted to membership under specified conditions laid down by the Congress. All of these member banks are required by law to subscribe a proportional amount of their capital to the Federal Reserve banks in their respective districts, on which subscription a rate of return, fixed by Congress and changeable at the will of Congress, is paid. What is, in fact, a compulsory contribution by the member banks is termed a purchase of stock, but this designation is misleading since no member bank is permitted by law to trade in the stock or to enjoy various other privileges which are usually associated with stock ownership.

In any case, regardless of whether the member banks are required by law to subscribe to this unprivileged stock or whether some other device be substituted for the subscription, the matter is relatively unimportant, for it would make no real difference to the proper functioning of our economic system if this detail were changed. The effort of agitators to raise this bugaboo obscures the true meaning of their attacks, which, if successful, would undermine the foundations of our economic institutions.

They would destroy to no purpose the established first principles upon which our Government and all solvent governments have operated for centuries. They would do away with the Reserve System created out of long experience and adapted, step by step, over the past quarter of a century. Yet doing away with it would not do away with the necessity for a similar medium to perform essential functions for the Government and the public at large. They would, in the end, destroy our banks, our savings, insurance, and other fiduciary institutions, for the day that the Government abandoned interest-paying and turned to the printing press would mark the beginning of the end of the basic principles upon which our economic institutions are founded.

Permit me to express again my appreciation of the spirit in which you write and your desire to help the public to distinguish between sound principles of government and of economics that have been established by centuries of experience and proposals which could only bring disaster to the great mass of our people.

Sincerely yours,

(Signed) M. S. Eccles

M. S. Eccles,
Chairman.

Honorable Arthur H. Vandenberg,
United States Senate,
Washington, D. C.

Attachment.