

February 8, 1935

MEMORANDUM ON PROPOSED BANKING LEGISLATION
RELATING TO FEDERAL RESERVE SYSTEM

The chief purposes of the proposals for changes in our banking laws, in so far as they relate to the Federal Reserve System, are the following:

1. To accelerate the rate of economic recovery.
2. To make our banking and monetary system, which was designed under the conditions prevailing prior to the World War, more responsive to our present and future economic needs.
3. To prevent a recurrence of conditions that led to the collapse of our entire banking structure in the spring of 1933.

The banking system of this country has been put to a severe test and has not stood that test. It has not been able to stand up under the strain of the depression or to lend effective support in the fight against it. On the contrary, the banking system has proved to be an element of weakness in our economic structure that has aggravated and prolonged the worst phases of the depression. And it still impedes the rate of recovery.

The explanation of this is not to be found only in the excesses and abuses that characterized our banking practices in the recent past, nor in the present relative inertia of the banking system, nor by an assumption that bankers are less eager than other men to hasten the progress of recovery. The fact that the banking system has proved to be inadequate is to be explained, in large part, by the fact that our banking structure has remained essentially unchanged throughout an epoch of far-reaching economic changes both in this country and in the world at large.

The principal measures contemplated in the proposed legislation, therefore, are designed to remedy deficiencies now inherent in the banking structure itself. In this connection it is proposed to make the Federal Reserve System, which is the cornerstone of the banking structure, more responsive to our national economic needs. It is also proposed to make our commercial banks better adapted to meeting the credit requirements of industry, commerce, and agriculture, under the changes that have taken place in our economic system since most of our present banking laws were enacted.

Underlying the proposed changes in the banking laws are fundamental economic and monetary considerations, the widespread influence of which has not been adequately understood. In fact, the lack of an adequate understanding of these fundamental considerations was an important factor in bringing about the disastrous collapse of our economy which culminated in the closing of all the banks in the spring of 1933.

Fluctuations in production and employment, and in the national income, are conditioned upon changes in the available supply of cash and deposit currency, and upon the rate and character of monetary expenditures. The effect of an increased rate of spending may be modified by decreasing the supply of money, and intensified by increasing the supply of money.

Experience shows that, without conscious control, the supply of money tends to expand when the rate of spending increases and to contract when the rate of spending diminishes.

During the depression the supply of money did not expand and thus moderate the effect of decreased rates of spending, but contracted rapidly and so intensified the depression. This is one part of the economy in which automatic adjustments tend to have an intensifying rather than a moderating effect. If the monetary mechanism is to be used as an instrument for the promotion of business stability, conscious control and management are essential.

At the present stage of economic developments, main reliance for bringing about a rise in the national income must be placed upon increased governmental and private expenditures. The most important role of monetary control at the moment, therefore, is assuring that adequate support is available whenever needed for promoting and accelerating recovery.

Two supremely important duties are likely to devolve upon the reserve administration in the future. The first is assuring that a recovery does not result in an undesirable inflation. The second is assuring that a recovery is not followed by a depression. If recovery is allowed to develop into inflation, it is certain ultimately to lead to another depression. To regain prosperity without excesses, and thereafter to maintain business stability, are the two immediate objectives of monetary policy.

In order that the reserve administration may endeavor, with some prospect of success, to render prompt support for emergency financing in case of need, to prevent the recovery from getting out of hand, and to prevent the recurrence of disastrous depressions in the future, it is essential that the authority of the Federal Reserve Board be strengthened. As matters now stand, the Board is charged with responsibility for monetary developments in this country, but lacks the clear and explicit authority for determining the country's monetary policies.

An essential step in giving the Board this authority is to give it a controlling influence over the System's open-market operations, for these are by far the most important instrument of Reserve policy. By these operations reserves may be given to or taken away from member banks; and it is on these reserves that deposits are based. It is not too much to say that the power to control open-market operations is the power to control the expansion and contraction of bank credit, and thus in large measure to control the country's supply of money.

In the present administrative organization, the power to initiate open-market policy rests with the twelve Federal Reserve banks, which act jointly through the Federal Open Market Committee established by the Banking Act of 1933. The Federal Reserve Board has no representation on this Committee. It is given only the power to approve or disapprove open-market policies recommended by the Committee, and to prescribe the regulations under which the open-market operations are to be carried out. However much the Board may desire an energetic buying and selling policy it has no authority under the law to initiate such a policy.

On the other hand, the ability of the Open Market Committee to give effect to policies that it recommends is dependent both on the approval of the Board and on the willingness of the Reserve banks individually to participate in the operations.

It is difficult to conceive of a legal arrangement more calculated to result in conflict, obstruction, and delay. The fact that it may not have done so in the past is manifestly not an adequate reason for perpetuating diffusion of authority in a matter so vital to the nation's economic life.

Under the existing arrangement, 128 persons are in various degrees ultimately responsible for determining open-market operations and other System policies. These persons are the 8 members of the Federal Reserve Board, the 12 Governors of the Federal Reserve banks, and the 108 directors of the Reserve banks. There is no reason to suppose that such an unwieldy organization will in the future be any more effective in bringing about business stability than it has been in the past. Furthermore, a complete stalemate resulting from a cleavage of opinion between the Board and the Reserve banks is always possible.

The need is obviously for concentration of authority and responsibility for open-market operations in a small committee representing a national point of view and having a majority of its members chosen from the Federal Reserve Board. This is provided for in the proposed legislation without in any way impairing the autonomy of the Federal Reserve banks in matters of local or regional concern.

Another anomaly in the present administrative organization of the Federal Reserve System is the arrangement in respect of the Reserve bank Governors. The Governors are the principal executive officers of the Reserve banks, and their positions are of major importance in the System; yet they are not even mentioned in the Federal Reserve Act, nor is their appointment subject to the approval of the Federal Reserve Board. It is, therefore, proposed to recognize the office of Governor in the law, to combine this office with that of Chairman of the Board of Directors, and to make the appointment subject to the approval of the Federal Reserve Board.

To facilitate the carrying out of national policies, it is proposed to remove certain of the restrictions that are now imposed on the Federal Reserve System by the Federal Reserve Act, but that experience has shown to be detrimental and impracticable. These restrictions are largely predicated on conditions that prevailed when the Federal Reserve Act was adopted in 1913, and were wisely imposed on a system that was new and untried; but in the course of time the circumstances that gave rise to them have diminished in importance or greatly altered.

A conspicuous example in this respect is the rigid definition of the kinds of paper that the Federal Reserve banks are permitted to discount. Changes in the country's economic life, notably in the methods of financing business enterprise, have materially reduced the volume of short-term, self-liquidating paper of the classes to which the discount privileges of the Reserve banks are largely restricted by law. In times of stress, therefore, when the help of the Federal Reserve System has been most urgently needed,

many banks, though holding sound assets in their portfolios, have been devoid of the particular kinds available under the law for borrowing at the Reserve banks.

The undue severity of the limitations on eligible paper was finally recognized, and they were removed temporarily by emergency legislation; but this action was not taken until much harm had been done to the business of the country and unwarranted hardship and loss suffered by bank depositors. Furthermore, there is at present considerable evidence that these limitations are proving an impediment to recovery. New loans of a type that commercial banks have customarily made in the past are now refused, not because the applicants do not possess sound assets, but because the sound assets that they do possess are technically ineligible for rediscount. There is also still a tendency among many banks to remove from their portfolios paper that cannot be immediately liquefied by recourse to the Federal Reserve banks.

For these reasons it is proposed that the legal limitations on eligibility be removed and authority be given to the Federal Reserve Board to determine by regulation the character of paper that shall be eligible for discount at the Reserve banks.

Another of the proposed changes in the Federal Reserve Act would dispense with the requirement for segregation of collateral behind Federal Reserve notes, without in any way altering the present requirement of 40 per cent reserve of gold certificates. When there was a foreign drain on the country's gold in 1931-1932, the requirement for segregation of collateral caused serious difficulty by tying up gold over and above the 40 per cent required reserve. The situation was met for the emergency by permitting the pledge of United States Government obligations as collateral against Federal Reserve notes; but the authority of the Reserve banks in this matter is only temporary.

Since Federal Reserve notes are prior liens on all the assets of the issuing Reserve bank, and are in addition obligations of the United States Government, the requirement for segregation of collateral serves no useful purpose and adds nothing to the safety of the notes. It has been erroneously asserted that to dispense with the requirement for segregation would give the Reserve banks power to issue notes without adequate backing. This is not the case. The Reserve banks have two principal classes of liabilities: deposits and notes. Back of these, in addition to gold and lawful money, are the Reserve banks' bills and securities. Either notes or deposits can be increased through the acquisition by the Reserve banks of an acceptable asset. Their total can be increased in no other way. It is at the time the asset is acquired that the determination is made that it is good enough to be held by the Federal Reserve bank; and this determination is made without reference to whether the asset is ultimately to become backing for a deposit liability or for a note liability. The deposits of the Federal Reserve banks are the reserves back of all deposits of member banks. Assets that are good enough to constitute the backing for deposits of the Reserve banks are also good enough to back Federal Reserve notes.

Furthermore, a holder of a deposit with a Federal Reserve bank

has the right to withdraw it in notes at any time, and consequently the Federal Reserve bank should be in a position to use the asset acquired at the time the deposit was created as backing for the notes into which this deposit is convertible.

Neither the elasticity of our currency supply nor the safety of Federal Reserve currency is in any way affected by the proposed change in the law. Its only practical effect is to eliminate the cumbersome and useless requirement that certain specific collateral be segregated, and held at considerable expense and in a privileged position, as backing exclusively for Federal Reserve notes.

The proposals relating directly to member banks of the Federal Reserve System are few in number, but vital to speeding recovery. Their purpose is to make it more feasible for banks to meet the present requirements of mortgage borrowers and to participate more aggressively in a revival of activity and employment in the construction industry. The changes proposed would authorize banks to use a larger proportion of their assets for mortgage loans than is permitted by existing law, to lend up to 75 per cent of the property value and for a term up to twenty years on properly amortized first mortgages, and to make such loans without regard to the local geographical limits to which the existing law confines them.

These changes would put an end to restrictions in the existing law that practical experience has plainly shown to be injurious to banks and mortgage borrowers alike. The effect of these proposed changes would enable commercial banks to take an effective part in the reopening of the mortgage market, and to give their unstinted support, in a manner not now possible for them to that branch of industry in which the opportunity for meeting both a social and an economic need is now greatest.