Released for publication
Morning papers, June 24, 1935

The Banking Bill
Considered in the Light of
1927 - 1929

By A. C. Miller

Member, Federal Reserve Board

Pronounced differences of opinion regarding the amendments to the Federal Reserve Act proposed in legislation now pending in Congress, and more particularly the acute controversy which has arisen with regard to the contemplated change in the location of the responsibility for the exercise of the open-market authority in the Federal Reserve System, have sharpened interest in Federal Reserve history, and especially those episodes in its history that throw light upon the wisdom with which its open-market powers have been exercised in the past. The greatest interest has been shown in the episode covering the period 1927-1929. Severe judgment has been passed by many commentators upon the policies pursued by the Federal Reserve System during this interval.

Among these may be cited

(1) The opinion expressed by Professor Lionel Robbins, of the University of London, in his recent brilliant volume "The Great Depression":

". . . it was during this period (1927-1928) that the situation got really out of hand. Why did this take place?

HG
2561
.M6

[illegible]

"The answer seems to be that it was the direct outcome of misdirected management on the part of the Federal Reserve authorities. ."

(2) The view expressed in the editorial in the New York Times of Sunday, June 2, 1935, on the Banking Bill which appears to condemn not only Federal Reserve policies during the period 1927-1929 but also to charge the responsibility for the "unfortunate mistakes" to the Federal Reserve Board:

"It has naturally been asked, whether these drastic changes were suggested by the fact that the original distribution of authority, between Board and Reserve banks, had not worked well. Episodes have been cited, in the Reserve System's history, when the distribution of powers operated badly--the Board's refusal of a higher discount rate in 1919 to check the wild commodity speculation; insistence by the Board, in 1927, on a lower discount rate at the Chicago Reserve Bank, despite the evidence of growing speculation which the bank itself mistrusted, and the Board's rejection, early in 1929, of the New York bank's move to raise its rate and impose some obstacle to that year's ultimately fatal stock speculation. But the strange thing about this historical retrospect is that all three unfortunate mistakes were made at Washington, against the representations of the Reserve banks; yet that the new bill proposes to enlarge the power of Washington and to restrain the Reserve bank's initiative."

The view expressed in the New York Times editorial and frequently expressed elsewhere that during the period 1927-1929 the Federal Reserve banks were right and the Federal Reserve Board was wrong is based upon

partial and misleading information. Such statements are made either through lack of knowledge or in disregard of the following pertinent facts:

(1) That the Board's action in reducing the discount rate of the Federal Reserve Bank of Chicago in 1927 was in pursuance of a System policy initiated by the Federal Reserve Bank of New York and concurred in by all but one of the Federal Reserve banks;

(2) That the Federal Reserve banks took no action to check the growing tide of speculation between July 13, 1928, and February 14, 1929; and

(3) That the first formal proposal for an increase in the discount rate from 5 to 6 percent came to the Board on February 14, 1929, after the Federal Reserve Board had sent to all Federal Reserve banks under date of February 2, 1929, and had made public on February 7, 1929, a statement which undertook to curb speculative excesses by a method which has come to be known as "direct action."

Let it be admitted at the outset that as a straight proposition of law, so far as concerns the Federal Reserve Board, it must share the responsibility for any action taken by a Federal Reserve bank, whether mistake or otherwise, with respect to discount rates and open-market policies. Under the terms of the Federal Reserve Act, no change in

discount rates proposed by the Federal Reserve banks and no open-market policy proposed by the Federal Open Market Committee can be put into effect until it has been approved by the Federal Reserve Board; but it is clear that action originates with the Federal Reserve banks. The responsibility for initiative vests in them. The primary responsibility is, therefore, theirs; the secondary and ultimate responsibility is the Board's. This must be borne in mind in any attempt to locate in any other than a formal and legal sense the actual responsibility for errors charged to the Federal Reserve System in the critical period 1927 to 1929.

It is because of the bearing that a truer and fuller understanding of the manner in which the Federal Reserve banks and the Federal Reserve Board have discharged their respective responsibilities has upon pending banking legislation that a clearing up of these misapprehensions takes on urgency at this time. And it is because of this that I here propose to recite as briefly as I can the facts which are essential to an understanding of the course of Federal Reserve policy during the period 1927 to 1929. I shall endeavor to do this in a way that will make it easy to distinguish statements of fact from any comment I may offer on the facts. This done, I shall endeavor to draw conclusions that are relevant in my opinion to an understanding of the problem of Federal Reserve reorganization raised in Title II of the Banking Bill of 1935 now pending in Congress.

To facilitate brevity of exposition and to focus attention more quickly upon the material points I shall state and answer a series of questions.

(1) What was there in the economic and financial situation in 1927 that caused the adoption by the Federal Reserve System of an easy money policy during that year?

The record shows that in the summer of 1927 there appeared a downward tendency in industrial production (Chart 1) and that commodity

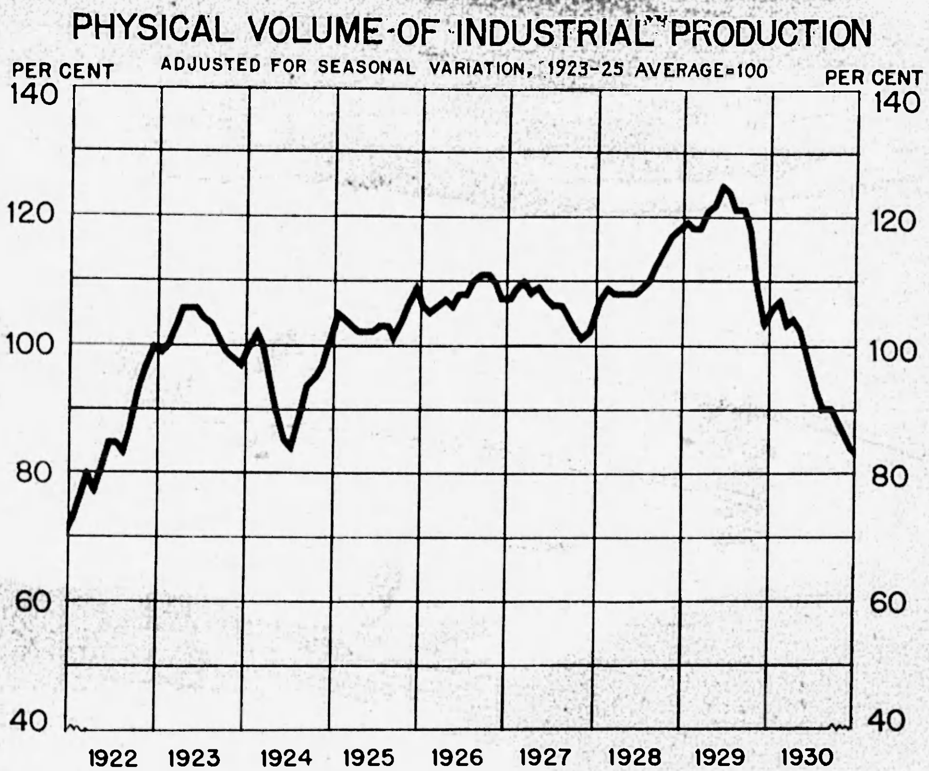

Chart 1

prices (Chart 2), which had been declining since the autumn of 1925,

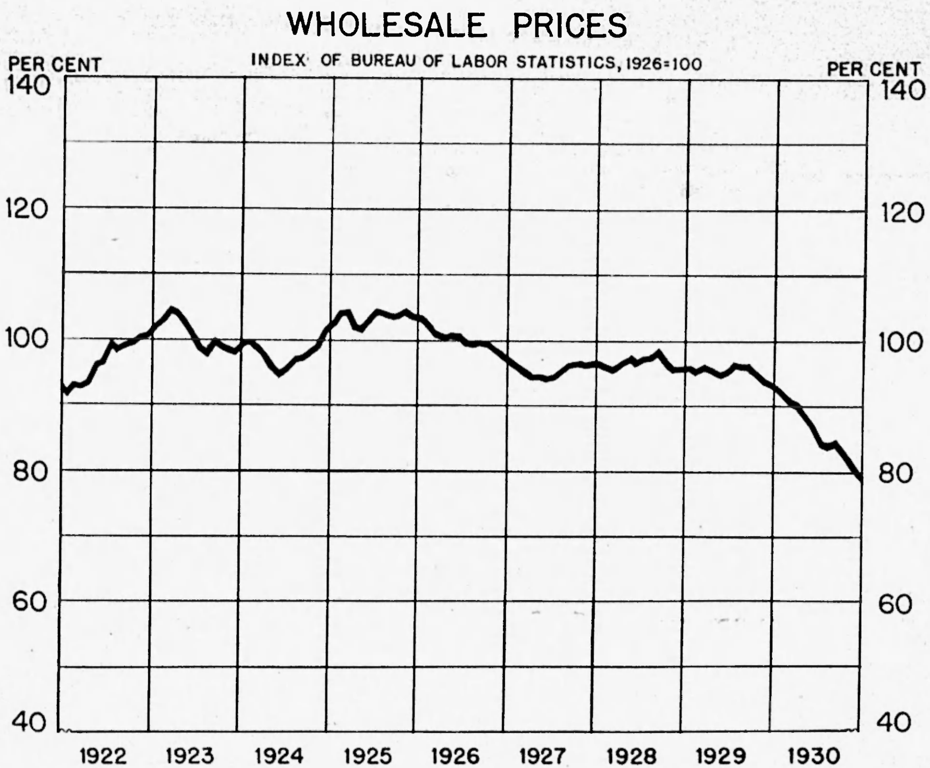

Chart 2

were at the lowest level in five years. There was apprehension that this downturn in business might foreshadow the coming of a depression. A marked decline in production and employment in the durable goods industries did, in fact, develop in the last half of the year.

In addition to disquieting domestic factors in the economic situation in 1927, the European monetary and financial situation, particularly as it might affect the United States, was far from satisfactory. European currencies, and particularly sterling, were showing weakness. It was fear[ed] that this would interfere with sales of our agricultural products in the

autumn months. Considerable concern was also felt regarding the position of the gold standard in those European countries which had already restored it and also regarding the prospects of its early and successful restoration in others which had the matter under consideration.

(2) What were the objectives of the policy then developed?

It may be said that the objective of Federal Reserve policy in 1927 was to set in motion such forces as the System could command to counteract the recessionary forces which were in evidence. To this ènd there was developed and adopted a policy of easing both the domestic and the international financial situation by purchasing securities in the open market and by reducing discount rates, thus cheapening the cost of credit to borrowing member banks.

To relate the sequence of these open-market operations and discount rate changes, without going into too much detail, the following summary will suffice:

The policy began in May 1927 with purchases of United States Government securities by Federal Reserve banks, which carried their holdings from $300,000,000 in May to $600,000,000 in December. As a result of these operations member banks were able to meet gold withdrawals of $200,000,000 and to increase their reserve balances by over $100,000,000 without being under the necessity of increasing their borrowings from the Reserve banks (Chart 3). Discount rates at all the Reserve banks were reduced from 4 to 3½ percent during the third quarter of the year.

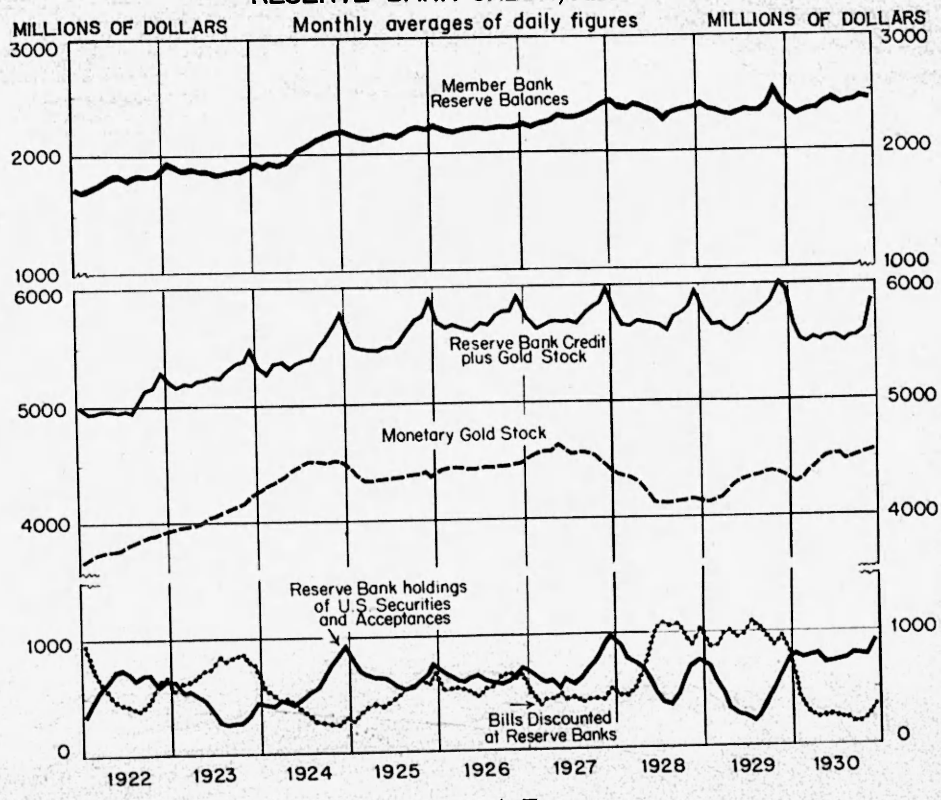

Chart 3

Money rates in the open market soon declined (Chart 4), sterling exchange advanced, and in time there was a considerable outflow of gold from the United States to other countries.

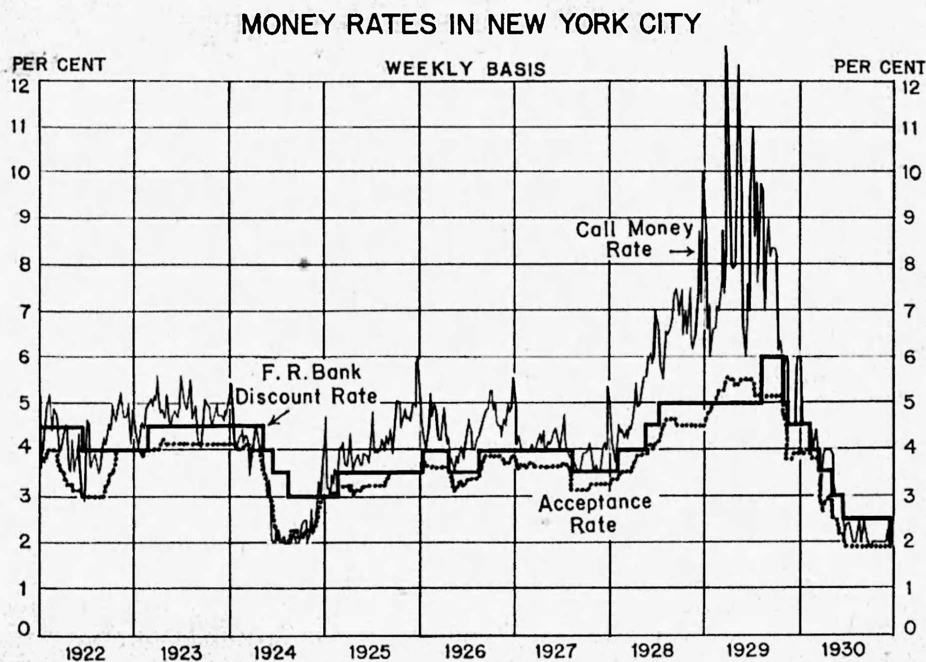

Chart 4

(3) Was the policy successful in achieving its objectives?

It was. The tide of business recession or depression, whichever it was, was arrested toward the end of the year 1927. The production curve turned sharply upward and except for a halt of short duration in the spring of 1928 maintained a steady ascent until the summer of 1929 (Chart 1). Prices of farm and related products showed a marked rise in the latter part of 1927 and in 1928 the general level of wholesale prices was characterized by relative stability. (Chart 2). The European currencies, notably sterling, strengthened and, in general, tension in the European financial situation was considerably relieved.

So far, then, as the policy of mid-summer 1927 was instrumental in resisting the forces of business depression, stimulating production, giving stability to the price level, and strengthening foreign currencies, it must be pronounced to have been successful. Were this all that there was to the episode, it might be regarded, as many felt disposed to regard it at the time, as a brilliant exploit in central bank policy and as a demonstration of the reasonableness of the belief, which existed in the minds of many economists and others at the time, that through well-conceived and well-timed monetary policy the terrors of the business cycle could be largely if not wholly removed and price stability and economic prosperity be insured under the operation of the Federal Reserve System. It will not be forgotten that by many the opening of the year 1928 was heralded as the beginning in these respects, as well as in many others, of a "new era."

Unfortunately the 1927 policy of the Federal Reserve had other effects besides those which were sought and intended. In the light of the longer perspective in which we can now view these other and further effects they stand out as the larger and more serious consequences of the policy then initiated and pursued. But before leaving the year 1927 there is a further question with reference to it which remains to be considered.

(4) Who proposed the policy pursued?

The policy above outlined was originated by the New York Federal Reserve Bank, or more particularly by its distinguished Governor, the

late Benjamin Strong. Brilliant of mind, engaging of personality, fertile of resource, strong of will, ambitious of spirit, he had extraordinary skill in impressing his views and purposes on his associates in the Federal Reserve System. His ideas began to develop in the spring of 1927, but his program was not shaped until after conferences with representatives of the three great European central banks, who visited the United States in the summer of that year. This program was then presented to the Federal Reserve System in informal conferences with Federal Reserve bank governors, proposed to the Federal Reserve Board and approved by it, and participated in by the Federal Reserve banks with dissent on the part of only one. The Federal Reserve Bank of Chicago was reluctant to fall in line with the reductions of discount rates that were being made at the other Reserve banks, and its rate was finally reduced by the Federal Reserve Board.

The general policy adopted at the time, therefore, was a System policy, conceived and initiated by the Governor of the New York Reserve Bank, but approved at a meeting in July participated in by the Open Market Committee, which consisted of five Reserve bank governors, by members of the Federal Reserve Board, and by two governors and one chairman of mid-western Reserve banks. It was not, as might be inferred from the Times editorial, a policy either developed or imposed by the Board on the Reserve banks against their will. It was distinctly a <u>Reserve bank policy</u>.

The Federal Reserve Bank of Kansas City reduced its rate from 4 to $3\frac{1}{2}$ percent on July 29; other Federal Reserve banks reduced their rates in quick succession, St. Louis on August 4; Boston and New York on August 5; Cleveland on August 6; Dallas on August 12; Atlanta on August 13; and Richmond on August 16. The directors of the Chicago bank, the second largest bank in the System, delayed action until the Federal Reserve Board reduced its rate on September 7, in accordance with the System policy. Thereafter, the Federal Reserve Bank of Philadelphia reduced its rate on September 8; San Francisco on September 10; and Minneapolis on September 13.

The reductions in discount rates, except in the case of Chicago, were authorized by the boards of directors of the respective Federal Reserve banks and approved by the Federal Reserve Board. The action of the Board in reducing the rate at Chicago was taken after funds began to move away from districts in which rates had been lowered, a development which appeared to jeopardize the achievement of the general objective of the System's policy, a necessary part of which was the maintenance of easy conditions in the New York money market.

(5) What further results ensued?

Effects of cheap and abundant credit during the autumn of 1927 were not limited to stimulating business and production and to sustaining the price level and the European exchanges. Cheap credit

gave a further great and dangerous impetus to an already overexpanded credit situation, notably to the volume of credit used on the stock exchanges (Chart 5), and to a further rapid upward flight of security

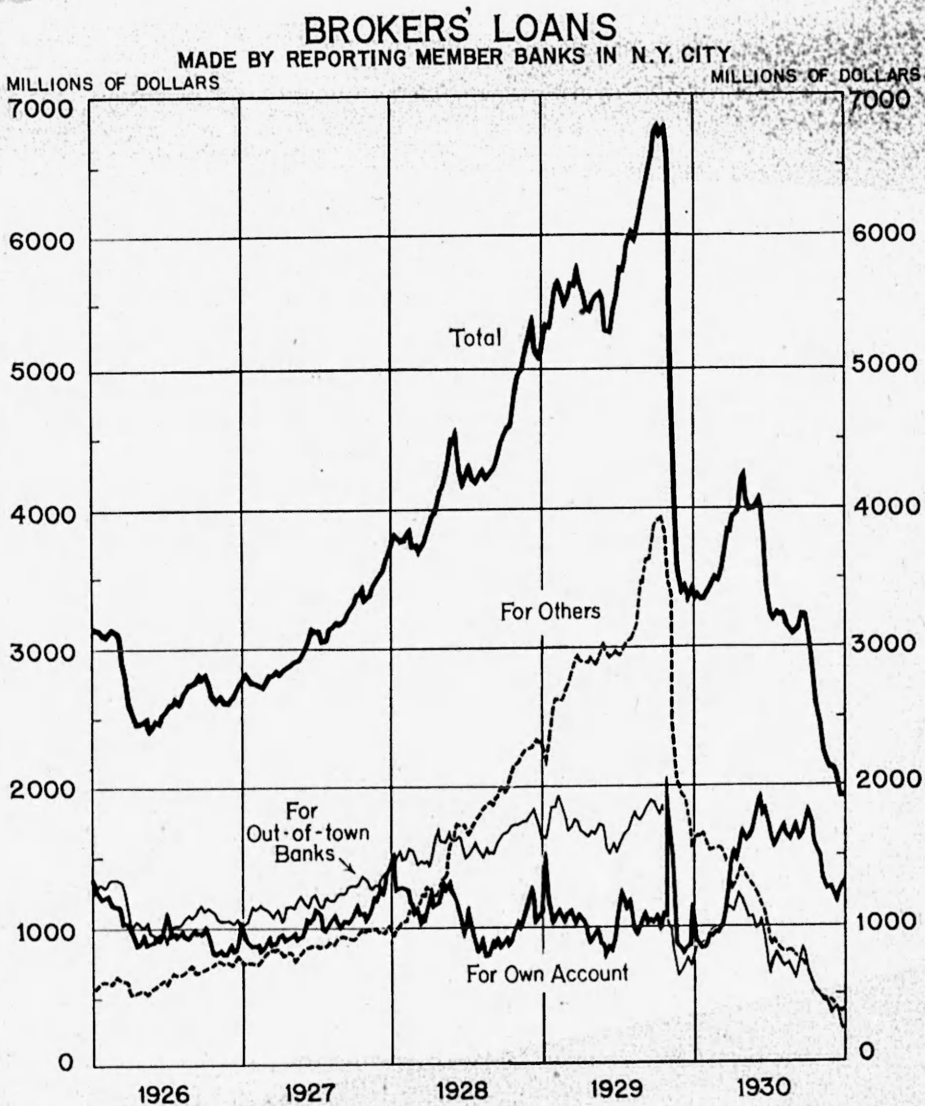

Chart 5

prices (Chart 6). In consequence, the Federal Reserve System was con-

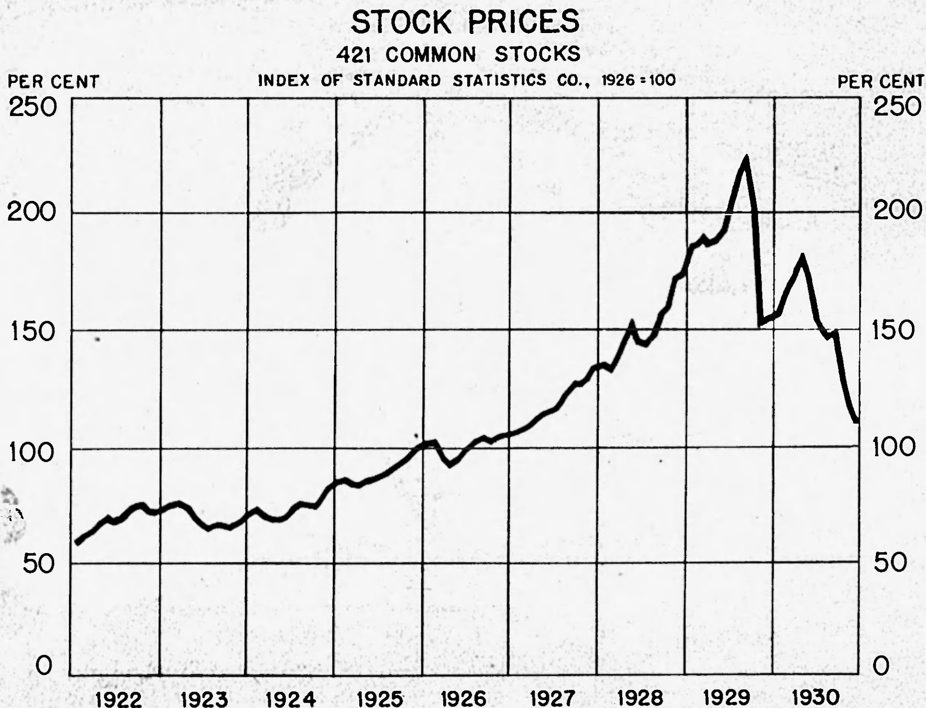

Chart 6

fronted toward the end of the year 1927 with the problem of getting control of the fund of credit which it had been instrumental in placing in the market and keeping it within the bounds of safety lest an uncontrollable and disastrous speculative situation should develop. In consonance with this attitude the Federal Reserve System abandoned the policy it had been pursuing of offsetting exports of gold by the restoration of a similar volume of credit to the money market through the purchase of United States Government securities, and allowed exportations of gold to exert their tightening

effect on the money market. The effect, however, in the situation then existing was not very considerable. The stock market expansion had acquired too much momentum. It was evident that its pull was too strong to be counteracted by gold withdrawals.

An added factor of adverse character arose out of the exigencies in connection with the conversion of the Second Liberty Loan. The Treasury found that actual cash outgo for redemptions in connection with its refinancing program outran its current cash intake and was, therefore, carried by the Federal Reserve banks for a period of about a month on overdraft in varying amounts up to as much as $200,000,000, with an average during the period of about $70,000,000, thus neutralizing to that extent the policy of the Reserve banks.

Total loans and investments of member banks during the second half of the year 1927 showed a pronounced upward movement. There was an active demand for funds in security markets, both in connection with speculative trading and with the issuance of new securities. There being an abundance of loanable funds, with no considerable demand for loans from business, the funds held by the banks went into investments and loans on securities. Bank loans to security brokers in New York increased during 1927 by about $600,000,000. (Chart 5)

RESTRICTIVE POLICY IN FIRST HALF OF 1928

In the first half of 1928 the Reserve System took successive measures to check the further expansion of bank credit. Approximately $400,000,000 of United States Government securities were sold from the System's

holdings. Discount rates were raised from $3\frac{1}{2}$ percent to 4 percent by all Federal Reserve banks between January 25 and March 1, to $4\frac{1}{2}$ percent between April 20 and June 7, and to 5 percent by 8 banks in July. Sales of securities by the Reserve banks and further loss of gold, amounting to $250,000,000, forced member banks to borrow at the Reserve banks. Bills discounted rose to over $1,000,000,000 for the first time since 1921. (Chart 3) Call loan rates rose to over 6 percent by the middle of the year. The increase in brokers' loans by banks was definitely checked. (Chart 5) Those by New York City banks for their own account declined considerably. Brokers' loans by non-banking lenders, however, attracted by high rates, increased more rapidly than before. The rise in stock prices was interrupted early in the year and again in mid-summer, but these were but brief interruptions. (Chart 6) Thereafter evidence was accumulating that the speculative boom had become so intrenched and was exercising such a pull that an increase in the cost of bank funds appeared to be no longer sufficient to check it and more extraordinary forms of control had to be considered.

Under conditions existing in previous stock market booms the measures adopted by the Reserve System might have been sufficient to check the speculative expansion, but this was a new situation. In the first place, the astonishing increase in the earnings of large corporations and the extremely low rates of interest at which money could be borrowed appeared to supply a basis for the high prices that were being paid for stocks of companies whose earnings were rising and whose dividend disbursements, not only through extra dividends but through regular dividends, were far

above the going price of money. To put the matter bluntly, the market was actively engaged in recapitalizing the values of securities on the basis of exceptional earnings and artifically low interest rates for money. Secondly, the fact that banks could in an emergency rediscount, as was not the case in stock market booms of the pre-Federal Reserve period, inclined the banks to feel that they could expand in the assurance that in case of need they could turn to the Reserve banks for assistance; and thirdly, the supply of non-banking funds available for "street loans" was larger than on any previous occasion. Consequently, whereas in earlier periods call money rates in a crisis rose to 20, 40, and even 100 percent, in the first half of 1928 the rate did not rise above 8 percent. Higher levels were reached later, but never over 20 percent, and that for only a few hours.

PASSIVE POLICY IN THE LAST HALF OF 1928

No further measures of restraint were adopted by the Federal Reserve System in the latter half of 1928. This was due in part to the expectation, based on previous experience, that the seasonal demands for funds in themselves would act as a tightening and restraining influence. There was also some fear that with money rates at the prevailing high levels crop-moving and other business activities might be severely handicapped.

These expectations were not realized owing to developments in the acceptance market. The Reserve bank buying rate for bankers' acceptances had been advanced, but at 4 1/2 percent was still below the discount rate. There was a heavy demand for acceptance credits at the time, and metropolitan banks were able to obtain Reserve bank funds at rates below the discount rate through the creation of acceptances and their sale to the Reserve banks. The banks, therefore, were able to expand their security loans without going further into debt at the Reserve banks. In fact, the purchase by the Reserve banks in the New York money market of acceptances in large volume enabled the member banks actually to reduce their indebtedness to the Reserve banks at the very period when restraint of speculation should have continued to be Reserve-bank policy. (Chart 3) Brokers' loans by both banks and others increased rapidly (Chart 5) and bank loans on securities to others than brokers also increased. Stock prices rose rapidly. (Chart 6) Money rates on acceptances and commercial paper did not rise in

this period but rates for "street loans" rose sharply, reflecting the intensity of the demand for such loans. (Chart 4)

In the face of these developments, the Federal Reserve System failed to pursue affirmatively the policy of restraint adopted in the early part of 1928. Taking the period from mid-summer of 1928 until the early days of February 1929, the policy pursued by the Federal Reserve System may be characterized in the light of all that is known now, and much of which was visibly in process then, as a policy lacking in strong conviction with regard to current developments profoundly affecting the Federal Reserve System, the banking system, and the economic and financial condition of the country.

In attempting to locate and assess responsibility for the delay and inactivity of the Federal Reserve System during the second half of the year 1928, the incontrovertible fact is that during this period as well as during the preceding year the leadership of the Federal Reserve System rested with the Federal Reserve Bank of New York. There is no attempt here to deny the responsibility of the Federal Reserve Board, without whose sanction no steps could be undertaken. But the responsibility of the Board was secondary. Its mistake was in waiting too long before assuming active leadership in firm intervention in the situation. A partial explanation for the hesitancy on the part of the Board at this time, in the absence of proposals for action from the Reserve banks, may be found in the Federal Reserve Act itself and in the tradition that had grown up in the System. This tradition was that initiative in credit policy should originate with the Federal Reserve banks, and that the

Board's function ordinarily should be to approve or disapprove proposals brought forward by the banks.

In the critical situation which developed in the second half of the year 1928 the Board followed the course of waiting for proposals by the Reserve banks to be submitted to it for review. No such proposals were made. It is true that on some occasions the Board had assumed a more positive attitude in the matter of the determination of discount rates, but on the last occasion on which it had aggressively intervened (the reduction of the Chicago rate in 1927) the reaction, both in public and governmental circles, had been generally unfavorable.

That the responsibility of the Federal Reserve Board was great, I would be the last to deny. But it erred chiefly in following the more customary course indicated by the law and by practice rather than adopting a bolder course which might have been possible under the law but was not clearly made the Board's responsibility.

Looking at the matter in a practical way, it will be recognized and it should not be overlooked in this connection that the unfavorable public reaction to the assumption by the Board in the Chicago rate controversy in 1927 of authority to force rate action by Federal Reserve banks was not calculated to stimulate its sense of responsibility for appropriate and timely Federal Reserve policy. There is a great difference between the power to initiate action and the authority to review proposals after they have been made.

No one can tell whether the policies of the Federal Reserve System in 1927 and 1928 would have been different had the Board had full

responsibility for action. But it is abundantly clear that acceptance by the Board of aggressive easing action proposed by the New York Federal Reserve Bank in 1927 and of complete abandonment of restraining action in the second half of 1928 proves that the Board, under the established tradition, was first too quick to fall in with a daring and dangerous proposal and later too slow to assume the leadership which was needed and was lacking at a most critical time. It is my belief that, if the Board had had full responsibility in the matter, it would not have adopted so readily the easing program of 1927 and would have acted more promptly in assuming leadership after July 1928.

But be this as it may, as things then were in the second half of 1928 the Board looked for the initiation of further measures of restraint to the Federal Reserve banks and they, in turn, depended on the leadership of the Federal Reserve Bank of New York. And New York's leadership proved to be unequal to the situation.

An inquiry why Federal Reserve bank leadership erred during this period would make an illuminating and most instructive contribution to the problem of how to secure a more continuously effective leadership and responsibility in Federal Reserve administration. One observation may be made and that is that the supercharged atmosphere of the country's great financial and speculative center is not one which can be said to be conducive to sustained detachment of mind and interest or to a clear perspective with regard to current developments and their implications when the tempo is as swift as it was in this period of optimism gone wild and cupidity gone drunk. However this may be, it is a fact that

while the attitude of the Federal Reserve banks was one of tolerance and temporizing and the Federal Reserve System as a whole was, as I have elsewhere stated, "drifting" in the midst of a perilous situation that called for intervention, the Federal Reserve Board was growing more and more anxious at the course of developments. Ultimately its anxiety reached a point where it felt that it must itself assume the responsibility of intervening in the dangerously expanded and expanding speculative situation menacing the welfare of the country. This it did early in February 1929.

BOARD'S DIRECT ACTION POLICY IN 1929

On February 2 the Board directed a letter to the Federal Reserve banks and on February 7 it issued a statement to the public carrying the substance of the letter previously addressed to the banks, in which, after expressing its anxiety with regard to current developments, it laid down an interpretation of the Federal Reserve Act under which it was stated: "The Federal Reserve Board neither assumes the right nor has it any disposition to set itself up as an arbiter of security speculation or values. It is, however, its business to see to it that the Federal Reserve banks function as effectively as conditions will permit. When it finds that conditions are arising which obstruct Federal Reserve banks in the effective discharge of their function of so managing the credit facilities of the Federal Reserve System as to accomodate commerce and business, it is its duty to inquire into them and to take such measures as may be deemed suitable and effective in the circumstances to correct them; which, in the immediate situation, means to restrain the use, either directly or indirectly, of Federal Reserve credit facilities in aid of the growth of speculative credit." This interpretation was the basis of what soon came to be known as the policy of "direct pressure." It was, in brief, a method of exercising restraint upon the speculative credit expansion then in process by restricting the borrowings from the Federal Reserve banks by those member banks which were increasingly disposed to lend funds for speculative purposes.

It should be particularly emphasized and noted that not until the Board thus declared its own attitude and the position which it deemed appropriate for the Federal Reserve System as a whole did the Federal Reserve banks come forward with proposals for discount rate action looking to restraint of credit. It was on February 14, twelve days after the Board's warning letter, that the Federal Reserve Bank of New York submitted to the Federal Reserve Board its recommendation that its discount rate be raised to 6 percent. This was the first proposal for an advance in discount rates to reach the Board after the 5 percent rate was established in July of the preceding year.

Thereupon an acute controversy extending over a period of months developed between the Federal Reserve banks and the Federal Reserve Board with reference to the respective merits of the policies of control through discount rate advances and through "direct pressure." It is the theory of discount rate advances that they increase the cost of credit to borrowing member banks and thus tend to restrain borrowings. In ordinary circumstances, and especially when the discount rate of a Reserve bank is abreast of or above going money rates in the market, the method of controlling an expanding situation through discount rate increase has frequently proved efficacious. But in such a situation as existed in the opening months of 1929 with the rate for call money fluctuating between 6 and 20 percent, it would have been necessary to step up Federal Reserve bank rates to unprecedented levels in order to catch up with the rapid ascent of rates in the open money market.

To have done that would have involved damaging disorganization of the whole structure of commercial money rates, with economic consequences that could not be accurately foretold and might easily in the then existing situation have proved disastrous. A prompt and energetic stepping up of the discount rate in the earlier stages of a pronounced credit and speculative expansion might have been relied upon to exercise an effective restraining and corrective influence, but when the rate of speculative expansion had attained such speed and the thirst for credit had attained such intensity as was the case at the beginning of the year 1929 and earlier, control through discount rate increase, to put the matter mildly, is at best to be regarded as a frail reliance and a dubious expedient.

In the circumstances which existed at the time when the Board made its announcement with regard to "direct pressure" the speculator did not ask what was the cost of money but whether he could get it at any price. The increase of rate might even have been a relief to the speculative market inasmuch as it would have carried the suggestion, whether so intended or not, that money would be forthcoming from the Federal Reserve banks so long as the stipulated price for it was paid. "Direct pressure," on the other hand, works as the name indicates, by direct control of member banks instead of indirectly through money rates. As applied in 1929, it put the member bank, which was seeking Federal Reserve credit facilities in order to support or increase its extensions

of credit for speculative uses, under pressure by obliging it to show that it was entitled to accommodation, and leaving undisturbed such member banks as were borrowing in the usual course from their Federal Reserve banks for meeting commercial requirements. It was, in brief, a method of exercising a discriminating control over the extension of Federal Reserve credit such as the purely technical and impersonal method of bank rate could not do. "Direct pressure," furthermore, is a more flexible method of control, capable of easy adjustment, if circumstances should demand. By comparison, the discount rate is a more formal device, and one that in a rapidly shifting scene is rigid and clumsy. Pressure can easily be increased or diminished through direct action. Change of discount rate, because it is a more formal and public proceeding, takes on the aspect of a signal indicating change of direction or change of policy, and therefore is less likely to be invoked promptly as soon as indications of changes in the situation become discernible. To put it bluntly, though not elegantly, control by rate action in a speculative gale of such fury as swept the United States in 1929 is a good deal like spitting against the wind.

The Board's opinion that "direct pressure" would afford not only a method more appropriate in the circumstances than a discount rate increase but also one likely to prove highly successful in putting an effective pressure upon the hitherto expanding volume of speculative credit was vindicated by the in-

fluence this policy exerted shortly after the beginning of its application.

From the beginning of February until the end of May brokers' loans by reporting member banks declined by about $650,000,000; and although brokers' "loans by others" continued to increase, the total of brokers' loans showed a net decline in this period. (Chart 5) Money rates increased sharply. (Chart 4) Stock prices, which had been rising rapidly, fluctuated within a comparatively narrow range. (Chart 6)

By the middle of June it became apparent that in the then existing psychological and economic situation continuance of unremitting pressure on the market, particularly with the known heavy financial requirements of many leading industrial undertakings at the approaching end of the fiscal year, might precipitate a catastrophe. The Board, after a conference with a delegation of New York Reserve bank directors, decided to relax for the time being but not to abandon its "direct pressure." It was moreover then becoming evident that the stock market was reaching a point where it would collapse of its own weight, and that the principal concern of the Federal Reserve System should be to prepare itself to help the banks and the country to absorb the imminent shock as soon as it occurred.

It is not without significance in current discussions as to the proper distribution of authority between the banks and the Board, that during the tension occasioned by the acute differences

over the leadership of the Federal Reserve System in the six months following the Board's declaration of its position of February 2, 1929, the five members of the Board who took the responsibility of formulating the attitude and policy for the Federal Reserve System were opposed by a minority of their own membership, including the Secretary of the Treasury, the Governor and the Vice-Governor, by the twelve Federal Reserve banks and, finally, by the Federal Advisory Council and many, but by no means all, of the largest member banks. This was a formidable opposition. Nevertheless the Board adhered to its position, firm in its conviction that it was pursuing the only proper and effective course of action, belated though it was, which was open to the Federal Reserve System at the time. That it did not err in its judgment from a public point of view seems sufficiently established by the fact that several of the most important amendments written into the Banking Act of 1933 with regard to the Federal Reserve System were based upon the attitude of the Board as expressed in 1929 and the procedures then developed. This was a ratification by the Congress of the United States of what had been undertaken by the Board in the early months of 1929 in the face of determined resistance.

CONCLUSION

Looking at the record of this period 1927-1929, as thus briefly recited, certain conclusions, I believe, will suggest themselves to anyone who is seriously interested in drawing from this chapter of Federal Reserve experience lessons which are pertinent to the pending discussions with regard to the modification of the Federal Reserve System. More particularly these lessons have a bearing on that phase of the proposed legislation which would provide a more definite concentration of authority over the open-market policy of the Federal Reserve System by placing the ultimate responsibility with the Federal Reserve Board in place of the existing system which divides responsibility by vesting the power to initiate policies in the Federal Reserve banks and the power to ratify or veto them in the Federal Reserve Board. The first of these lessons clearly points to the inadvisability of a division of responsibility in a matter of such vital national moment. In its actual working, whatever might be said for the existing system theoretically, it has not produced a satisfactory result, as the 1927-1929 experience appears clearly to demonstrate, and it has not done it, in my opinion, because the responsibility has been divided.

Unity of responsibility, my experience with the Federal Reserve System has demonstrated, is essential to the ceaseless concern and vigilance which are necessary for timely and vigorous action in matters of central banking policy and administration.

THE LESSONS OF THIS EXPERIENCE

Looking at the record for the period 1927-1929, as thus briefly recited, certain conclusions appear to suggest themselves to anyone who is seriously interested in drawing from this chapter of Federal Reserve experience lessons which are pertinent to the pending discussions with regard to the modification of the Federal Reserve System, and more particularly that feature of the proposed legislation which would provide a more definite concentration of responsibility for the open-market policy of the Federal Reserve System:

(1) The authority to initiate policies carries with it the opportunity to exercise leadership and involves a far greater degree of responsibility than the mere authority to approve or disapprove policies initiated by others.

(2) The body which initiates a policy should be under obligation to watch its consequences and to inaugurate a change whenever circumstances make it advisable. In other words, responsibility should be continuous.

(3) The judgment of the bankers or of officers of Federal Reserve banks regarding national credit policies has proved itself not to be infallible, and they cannot always be trusted to reverse their policies promptly when the public interest requires such action.

(4) The authority to initiate national credit policies should be concentrated in a single body which should have definite responsibility to the public not only for the initiation of policies but also for following them through, watching their effect and initiating

changes or modifications when the public interest requires.

WHERE SHOULD RESPONSIBILITY BE PLACED?

This brings us to the question in what body should such authority and responsibility be concentrated.

It is my conviction that it should be lodged in a body, no matter how constituted, having a national viewpoint and owing undivided allegiance to the general public interest. Its judgment should not be warped by the viewpoint of any particular section of the country or by the special interests of any particular group. It should be an impartial, independent body with a keen and continuous sense of public duty and a point of view sufficiently detached to avoid having its judgment as to long-time policies swayed by the popular clamor of the moment.

PLAN ADOPTED BY HOUSE OF REPRESENTATIVES

The pending banking bill in the form in which it was passed by the House of Representatives provides for the creation of an Open Market Committee consisting of five representatives of the Federal Reserve banks, which would have power to propose open-market policies and changes in discount rates and reserve requirements. The final authority over these matters and the final responsibility for them, however, would be vested in the Federal Reserve Board, which could approve or disapprove the policies recommended by the Open Market Committee, and could also initiate open-market policies, changes in

discount rates and reserve requirements, and would have definite authority to enforce any policies initiated or approved by it with respect to these matters. At the same time, the Board would be required to consult with the Open Market Committee and obtain its views before initiating such policies.

This would insure consideration of the banker viewpoint but would vest final power and responsibility in a national body responsible to the country as a whole. It would provide concentration and continuity of authority and responsibility and would enable the public to know at all times exactly whom to hold responsible for national credit policies.

DEFICIENCIES IN PLAN ADOPTED BY HOUSE

With all the undoubted merit that it possesses, this plan has nevertheless been the subject of criticism and, in my opinion, reveals deficiencies which should be corrected before final legislation is enacted. These deficiencies and criticisms and the measures which I have suggested for their correction may be summed up as follows:

1. Committee merely advisory

Under the House plan, the Reserve banks are given a merely advisory status in connection with the formulation of open-market policies, instead of the status which they now have of responsible proponents of open-market plans.

As not infrequently occurs where a body has a merely advisory function, it may reasonably be expected that the advisory committee representing the banks will not take the same deeply serious interest and make the same conscientious effort to do its best and fight for its conviction as would a committee with authority, and therefore with definite responsibility for the exercise of judgment leading to action.

I have, therefore, proposed that the Open Market Committee should have authority and responsibility to initiate open-market policies, subject to review, modification, and determination by the Federal Reserve Board; but that the Federal Reserve Board should be given its full share of responsibility by having authority to initiate policies as well as authority to approve or disapprove, with or without modification, the policies initiated by the Committee.

2. Limited Reserve bank representation

Even in the advisory status given to the Reserve banks, under the plan adopted by the House of Representatives, only a limited number (5) of the Reserve banks would have a voice in the proceedings.

In a matter of such vast consequence to the whole country, this is to be regarded as a grave defect, one indeed which was recognized by the Federal Reserve Board itself and the Federal Reserve System pretty generally when the Board in 1930 enlarged the membership of the then existing Open Market Committee from a membership of five to a membership including representatives of all the Federal Reserve banks.

It should not be overlooked that there is no science of open-market policy. Determination of such policy is at best a matter of judgment in which many factors other than merely economic factors must be reckoned with. There is no invariable yardstick for measuring even the economic factors, still less is there one for measuring the imponderables. Wisdom in these matters may in the future, as has sometimes been the case in the past, proceed out of the mind of the spokesman for one of the smallest and outwardly least important of the Federal Reserve banks. There is an advantage in giving to the discussions of open-market policy questions a broad base by letting each Reserve bank have a voice.

It will not be overlooked in this connection by students of American political and social development that the original structure of the Federal Reserve System follows in its regional character the analogies of our American structure and history. By adherence to this principle we can avoid any occasion or pretext for sectional animosity or the suspicion that the credit policies of the Federal Reserve System are not <u>national</u> in their source and inspiration. America is still American; and a strong, vital, and organic American nationalism must derive much of its real strength and enduring solidity from the contribution derived from a vigorous and robust spirit of local and regional self-respect, when it is accorded an opportunity to participate in the making of national policy in any field and especially in the field of credit and currency administration. It

is in the financial field that the sentiment against any form of oligarchy is particularly and justifiably deeply rooted in the American nature.

I have, therefore, proposed that the Open Market Committee should continue as it has since 1930 to include in its membership a representative of each of the twelve Federal Reserve banks, in order that every region may continue to have equal representation.

3. <u>No safeguards</u>

The plan adopted by the House offers no safeguard against hasty or ill-advised action by the Federal Reserve Board itself when it acts on its own initiative.

This seems to me to be a very serious defect in the House plan. Action looking to a "loosening up" or to a "tightening up" of the country's money supply ought to be undertaken only upon pretty clear indication of its advisability. To adjust correctly the amount of the country's monetary supply to its economic needs is a far from simple problem. Mistakes are costly and sometimes disastrous: witness the effect of the fluctuating course of Federal Reserve policy from 1927 to 1929.

Credit is an organism and interference with its workings at any point, unless interference is necessary, may occasion unexpected reactions elsewhere in the organism which will sooner or later manifest themselves in disturbance of function. At times over-stimulation may lead to speculative excesses and their consequences. At other times,

an insufficient supply of money may work painful and disastrous industrial restriction.

I propose that, when the Federal Reserve Board assumes the initiative, and, therefore, the sole responsibility, in the exercise of the open-market authority of the Federal Reserve System, its action shall require more than a mere majority vote of the Board to become effective. Following the precedent already established in the Federal Reserve Act in analogous matters, I propose that, whatever be the number of the members of the Board, such action shall require the affirmative vote of one more than a majority of the Board's entire membership. In the present Board of eight members, this would require six votes. If the Board were reduced to five members, the requirement would be four votes.

As a further safeguard to insure well-considered action, I have proposed that the Board be required to make a contemporaneous record not only of every vote taken on the subject of open-market policy but also of the reasons underlying its action. Furthermore, I propose that the contemporaneous record both of the vote and of the reasons be published annually by the Board in its report to Congress.

4. No strengthening against political influence

It does nothing to strengthen the position of the Board against the impact of external influence, which has been characterized in current discussions as political influence but which may also take the form of the special influence of financial interests or groups.

When all is said and done, the plain truth is that men are the stuff of which Government is made. No statute however ingeniously contrived can protect the country completely against the consequences of the exercise of administrative discretion weakly conceived and weakly carried out. The law can, however, provide conditions favorable to the exercise of its best intelligence by an administrative body. Concentration of an inescapable responsibility in the hands of a body composed of men of character and high purpose can do much to quicken its intelligence, strengthen its resolution and cultivate its capacity for wise selective judgment and the habit of prompt and decisive action.

What then can the new banking legislation do to improve the situation of the Federal Reserve Board and insure a more competent performance by the Federal Reserve System in the field of open-market policy should the Federal Reserve Board be invested with ultimate authority and responsibility?

My answer is to make the Board master in its own house by giving it an assured position of complete independence both in law and in fact. So far as can be done by statute law, it should be immunized against any form of interference, pressure or influence, be its source financial or political.

In order to give the Federal Reserve Board a position as nearly immune from such influences as possible, I have proposed that members of the Board should, if not immediately then in due course, be

appointed for longer terms of service, that they should not be removable except by impeachment, that members reaching the age of seventy should be given an allowance on voluntary retirement, that the title of the Federal Reserve Board should be changed to the Board of Governors of the Federal Reserve System, and finally that the executive head of the Board should be a chairman elected by the Board instead of a Governor appointed by the President.

If all this were done, I doubt that there is any place or body where the all-important open-market authority and responsibility of the Federal Reserve System could be lodged with a surer prospect of competent exercise than with the Board of Governors of the Federal Reserve System, but I would not look with favor upon the concentration of this great power in the hands of the Federal Reserve Board unless and until the Board is given a position of unassailable independence.

5. Unattainable objective

One further objection lies against the bill as passed by the House of Representatives. It is one which is intimately related to the exercise of the open-market authority. Specifically I refer to the objective of Federal Reserve policy laid done in the House bill, which reads as follows:

> "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."

To analyze and discuss this proposal at all adequately would unduly prolong this paper. But it is my belief that this objective, on the one hand, undertakes too much and, on the other, provides far too many loopholes or excuses in case the Reserve System fails to achieve the objective.

That the Federal Reserve Act must contain an objective and particularly an objective for the guidance of the open-market policy of the System cannot be gainsaid. Such a definition is essential, but it should confine itself to the probably useful and attainable. For this purpose I have proposed a guide or principle to read as follows:

> "The time, character and volume of all Open-Market operations of the Federal Reserve System under Section 14 of this Act shall be governed with a view to supporting and re-enforcing the credit and discount policies of the Federal Reserve System when this may be necessary in order to aid in the establishment and maintenance of sound banking, credit, financial and economic conditions."

This would subordinate the open-market policy of the Federal Reserve System to its general credit and discount policies, to be determined by considerations of national economic welfare. What is more important, it would further provide an additional safeguard, so far at least as statute law can do it, against subordination of the national economic interests as conceived and interpreted by the Federal Reserve Board to the fiscal needs of the Treasury or to the political wishes of the administration in power at the time.

AGAINST COMPROMISE PLANS

There is little or nothing to be said in my opinion in favor of the many proposals that have been made for the establishment of a new body within the Federal Reserve System to be vested with authority and responsibility for open-market policy, discount rates and changes of reserve requirements. All of these plans contemplate a body composed of representatives of the Federal Reserve banks and of the Federal Reserve Board. They differ from one another mainly in the proportion of the representation accorded to Reserve banks, running from a minimum of two bank governors and three Board members to five bank governors and all of the eight members of the Federal Reserve Board.

Overlooking differences in detail, these plans are all based upon compromise. And the compromise grows out of the distrust with which the contending interests with respect to banking legislation regard one another. The banker and those who go along with him distrust government control because they fear it will in the end prove to be political control. On the other side are those who distrust banking and financial control because they feel that it will in the future, as has been so often demonstrated in the past, be animated by short-sighted and selfish considerations.

To join such discordant elements in the same body in the expectation or even the hope that out of their differences will come a useful formulation of national monetary and credit policies is to ignore the lessons of the experience which has been recited above. Such a body would be lacking in the singleness of purpose and undivided devotion to a public trust which should be the principal characteristic of any body to which

is entrusted an important power affecting the economic welfare of the nation. Being born of a feeling of distrust between two conflicting forces, it would tend to perpetrate and accentuate such distrust in all of its proceedings. "A house divided against itself cannot stand."

The radical defect in these proposals is that they give bankers potential control without legal responsibility, through the device of putting them in a position where they could control the decisions of the Committee by obtaining the support of one or at most two members of the Board.

There is nothing new about the proposal. The Aldrich plan contemplated a central banking system of the bankers, by the bankers, for the bankers. They would have controlled it completely. When President Wilson insisted upon the creation of the Federal Reserve Board, a public body to supervise and direct the affairs of the regional banking system contemplated by the Federal Reserve Act, the bankers sought representation on the Board. They obtained much support for this idea in Congress. The issue was carried to the White House, where President Wilson promptly settled it adversely to the bankers.

This was twenty-two years ago, when the Federal Reserve System was just being created and there had been no experience demonstrating the power for good and for evil that can be exercised by Federal Reserve credit policy. It would indeed be an ironic reversal and a queer "new deal" if the ground that was won during the birth of the Federal Reserve System should now be sacrificed by admitting banker representation to the body to which is entrusted the determination of national credit and monetary policies.

SUMMARY

1. In view of current discussions and controversies in connection with the Banking Bill of 1935, it is worthwhile to review the experience of the Federal Reserve System in 1927 to 1929 and see what light it sheds on the desirability of proposed amendments.

2. This is particularly opportune because many commentators, including the New York Times in an editorial on June 2, 1935, refer to the System's experience in those years as proof that the Federal Reserve Board's judgment is not so good as that of the Federal Reserve banks and that the mistakes the System committed during that period were due to the Federal Reserve Board.

3. Briefly stated, the facts in the matter are:

(a) as to 1927, that in that year the System adopted a policy of easing credit initiated by the Federal Reserve Bank of New York and that the reduction by the Federal Reserve Board of the discount rate of the Federal Reserve Bank of Chicago was in pursuance of this policy;

(b) as to 1928, that the Federal Reserve banks, after making attempts to curb speculation in the early part of the year, took no action to check speculation from July 1928 until February 14, 1929;

(c) as to 1929, that in that year the Federal Reserve Board took the lead in actively intervening in the situation for the purpose of checking speculative expansion, and that it was not until after the Board had taken the lead that the Reserve banks proposed advances in discount rates; and

(d) that differences between the Reserve banks and the Federal Reserve Board in 1929 were as to the best method for checking speculation and not as to the desirability of action.

4. It is admitted that the Board shares the responsibility for any action or inaction during the period under consideration, but under the law and the tradition which has grown up in the Federal Reserve System the initiative in credit policy and, therefore, the primary responsibility rests with the Federal Reserve banks, while the Federal Reserve Board merely approves or disapproves of their recommendations and its responsibility, therefore, is secondary.

5. The reason for the easing credit policy adopted in 1927 was that there was a recession in business, and that weakness in the foreign exchanges with the approach of the heavy export season in the autumn might have placed a serious burden on those countries which had recently returned to the gold standard, like Great Britain, and other countries which were preparing to do so.

6. The policy adopted in 1927 was successful when judged by the fact that business activity in this country was revived and that the flow of gold was reversed and the pressure on the exchanges relieved.

7. The 1927 policy was conceived and formulated at the Federal Reserve Bank of New York by its late Governor Benjamin Strong.

8. While the policy was successful in the ways already stated, it had further consequences in that it gave another impetus to speculative activity which by that time had gained an enormous momentum.

9. The policy of ease was reversed late in 1927 and a policy of restraint was carried on through the first half of 1928, first, by permitting gold exports to exert their normal tightening influence on the market, secondly, by the sale by the Federal Reserve System of $400,000,000

of United States Government securities and, thirdly, by advances in discount rates at the Federal Reserve banks from 3 1/2 to 5 percent in eight banks and to 4 1/2 percent in the other four.

10. Speculation, however, had gone so far by that time and the pull for bank and other funds was so great that these measures were not sufficient to check expansion.

11. In the latter half of 1928 nothing further was done to arrest speculation; in fact the situation was eased by the acquisition of a large volume of acceptances by the Federal Reserve banks which enabled member banks to reduce their indebtedness to the Reserve banks. This was due to unwillingness to tighten credit at a time when crops are marketed. The Federal Reserve banks made no proposals to the Federal Reserve Board for further restraint of speculation during that period, and the Federal Reserve Board did not at that time take the lead in the matter.

12. In February 1929 the Board actively intervened by issuing a statement in which it proposed that member banks which were increasing their loans on securities should not be permitted to receive accommodation from the Federal Reserve banks. This was the policy of "direct action."

13. Subsequent to this intervention by the Board, the Federal Reserve banks proposed discount rate advances as their remedy for the situation. The Board refused to approve these advances on the ground that advances sufficient to have an influence on the existing speculative situation would have to be so high as to disrupt the commercial rate structure of the country, and also because it believed that the policy of direct action was more effective in the circumstances and more flexible.

14. The Board's policy was successful in reducing the volume of brokers' loans, in arresting the advance in security prices, and in checking the growth of speculation.

15. At the approach of the end of the fiscal year heavy demands for financing by leading industrial corporations made it clear that the continuation of the Board's policy of direct action might result in immediate catastrophe. For this reason, and because it recognized that the stock market at that time had entered a phase where its collapse of its own weight was merely a matter of time, the Board decided to suspend direct pressure. It felt that it had become the immediate duty of the Federal Reserve System to prepare itself for meeting the imminent shock to business and credit.

Lessons from this experience and my views regarding pending banking legislation as related to this experience may be summarized as follows:

16. Final authority and continuous responsibility for national credit policies should be concentrated in a single, impartial, disinterested, public body having a national viewpoint and owing undivided allegiance to the general public interest.

17. The plan adopted by the House of Representatives, which would concentrate such authority and responsibility in the Federal Reserve Board but would require the Board to consult and advise with an Open Market Committee consisting of five representatives of the Federal Reserve banks, has much to commend it; but it has the following deficiencies:

(a) The representatives of the Reserve banks would have merely an advisory status and, therefore, not the same feeling of responsibility as they would have if they were given more authority.

(b) It provides for only limited representation of the Federal Reserve banks through a membership of only five members.

(c) It offers no safeguard against hasty or ill-advised action by the Federal Reserve Board itself when it acts on its own initiative.

(d) It does nothing to strengthen the position of the Board against the impact of external influence, which has been characterized in current discussions as "political influence" but which may also take the form of special influence by financial interests or groups.

(e) The statement of objectives in the House bill undertakes too much and, in recognition of this fact, provides for too many excuses for failure to achieve the objective.

18. The plan which I have proposed would correct these deficiencies by the following means:

(a) It would give the Open Market Committee authority and responsibility for the initiation of open-market policies subject to review, modification, and determination by the Federal Reserve Board; but at the same time it would impose continuous responsibility upon the Federal Reserve Board by giving it also the authority to initiate policies.

(b) It would preserve the existing arrangement under which every Federal Reserve bank is represented on the Open Market Committee, thus assuring consideration of the views of all parts of the country.

(c) It would require that, when the Federal Reserve Board acts on its own initiative, it should do so only on the affirmative vote of at least one more than a majority of the Board's entire membership, and would require the Board to maintain a contemporaneous record of all actions

taken by it and the reasons therefor and to publish the same in its annual reports.

(d) It would strengthen the independence of the Federal Reserve Board by providing that Board members should be appointed for longer terms, that they should not be removable except by impeachment, that members reaching the age of 70 should be given an allowance on voluntary retirement, that the title of the Federal Reserve Board should be changed to the "Board of Governors of the Federal Reserve System," and that the executive head of the Board should be a chairman elected by the Board instead of a Governor appointed by the President.

(e) It would subordinate open-market operations to the position of "supporting and reenforcing the credit and discount policies of the Federal Reserve System when it is necessary to aid in the establishment and maintenance of sound banking, credit, financial and economic conditions."

19. To adopt any of the suggested compromises which would place authority and responsibility for national credit policies in a newly created, hybrid body consisting of some or all of the members of the Federal Reserve Board and an almost equal number of Reserve bank governors would be to sow the seeds of discord and impotence, to sacrifice an important principle preserved in the original Federal Reserve Act by President Wilson.