THE BANKING ACT OF 1935: ITS SIGNIFICANCE IN AMERICAN MONETARY HISTORY

Address by

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before the

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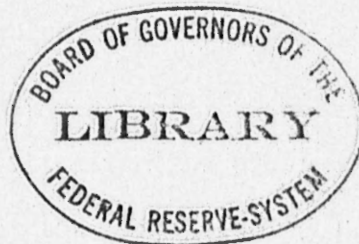

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The spirited, not to say acrimonious, controversy which raged a year ago in connection with certain provisions of Title II of the Banking Act of 1935 is, I think, mainly responsible for preventing a fuller understanding and appreciation of the larger significance of this recent banking legislation in the history of American financial policy.

It is to a consideration of the economic and monetary issues underlying this legislation that I am therefore venturing to invite your attention today. In connection with such an inquiry the Federal Reserve System in the past, in the present, and in the future will necessarily come under review; so also will the remarkable train of circumstances which have brought about the change or shift in the position of the Federal Reserve System from what was expected and intended by its founders. Whence have we come, where are we, and whither may we be tending -- these are questions which naturally will arise in the course of such a review, and in seeking to answer them light will also be thrown upon the present monetary situation and problem confronting our own and other countries today. That that situation presents a bewildering confusion and an unsettling uncertainty needs no emphasis in a gathering of this character. Nor is it necessary to stress the fact that there is little reason for believing that the world will again achieve an assured position of economic and financial stability and prosperity until the monetary problem is eliminated from the apprehensions and anxieties which

are still delaying recovery not only in our own country but throughout the length and breadth of the world.

In a broad sense it may be stated at once that the Banking Act of 1935 and other recent legislation affecting the Federal Reserve System undertook to reorganize the control mechanism of the System in order to insure that the System might be put in a better position to shape its course effectively in the greatly altered conditions now surrounding it, and more particularly to endow the System with new powers made necessary by the anomalous monetary situation which recent years have brought to pass. That economic, financial and monetary conditions have changed profoundly not only in the United States but everywhere since the Federal Reserve System was set up in 1913 is, of course, appreciated by all who are in any way concerned with banking and financial matters, but there has been insufficient appreciation, I think, of how deeply these changes have affected the position and destiny of the Federal Reserve System.

Let us then begin by taking a brief look at conditions as they were at the inception of the Federal Reserve System.

On the economic side it is to be particularly noted that the pre-war world exhibited a high degree of economic integration and balance. This situation was given a rude shock by the World War. The old economic balance was badly deranged, and the economic history of the post-war period is mainly the story of the extreme difficulties which have been experienced by the world and by the separate countries in attempting

to recover anything approximating the degree of economic stability which had been enjoyed by them in pre-war days. These changes may not be overlooked by anyone who would see in adequate perspective the monetary problems confronting every country of the world today.

On the strictly monetary side it is to be noted that the gold standard system was in full force and effect at the time when the Federal Reserve System was established. By that standard most of the countries of the world were tied together into a monetary and economic system which made for a very high degree of continuity and stability in financial and economic conditions and relationships, but it was a standard which for its own efficient operation also required a high degree of economic balance in the world. It may therefore be said, first, that the economic balance which existed in the pre-war world was favorable to the operation of the international gold standard mechanism, and second, that the gold standard in turn was favorable to the maintenance of that balance.

In all of the leading commercial countries of the pre-war world except our own the gold standard as an economic regulator was implemented by central banks. They had been established to assist the functioning of the gold standard as economic and monetary conditions grew more complicated and delicate, and they had come to be regarded as integral factors of the gold standard monetary system.

When, therefore, the Federal Reserve legislation was enacted in 1913 it definitely contemplated a banking system built on the foundation

of the gold standard and set up within the framework of the gold standard system. It was, in brief, established as a gold standard banking system. It was intended to provide a more orderly and smoother operation of the gold standard and thus to secure its full benefits by exercising functions much after the manner of the great European central banks. It was in no sense set up to supplant the authority of the gold standard, but rather to supplement it in certain important details of its operation.

The immediate impulse to the establishment of the Federal Reserve System, it need hardly be recalled, came from the searching and costly experiences of the country in the crisis of 1907. That crisis was occasioned by an acute monetary famine and much hoarding of currency. The System was established for the purpose primarily of preventing a recurrence of currency famine in the future, with all of its destructive effects, by providing a source to which the banks of the country could turn for additional supplies of money to meet the strain of seasonal or other more definitely emergency situations. And, in order that this might be accomplished without in any way impairing the authority or safety of the gold standard, the Federal Reserve Act of 1913 scrupulously and meticulously specified certain safeguards to be observed in the operation of the Federal reserve banks. Among these may particularly be mentioned the provisions affecting the status of the Federal reserve note. Immediate convertibility of bank notes into gold was regarded as an essential in the operation of the classic gold standard. In

order to insure convertibility in all probable circumstances the Reserve Act provided, first, that such notes might be issued only against the deposit of liquid commercial paper, so-called "eligible" paper in the vocabulary of Federal reserve banking; second, that they should be protected by a gold reserve of not less than forty per cent; and third, that no Federal reserve bank should pay out notes issued by another Federal reserve bank, but should return them promptly to the issuing bank for redemption. By restricting the operation of the Federal reserve banks to dealings in liquid paper, and by providing a system of gold redemption, it was felt that there would be little or no danger of either excessive issues of currency or unwarranted extensions of credit. The prevention of such excesses was one of the cardinal objectives of the gold standard.

Such was, briefly, the nature of the Federal Reserve System as conceived in 1913. What then happened? By a curious trick of fate the System never has had an opportunity to function as it was intended and designed to, for hardly had the Federal reserve legislation been enacted -- the Federal reserve banks had indeed not yet been organized and opened for business -- when the World War broke out. The whole economic and monetary scene was suddenly changed. With the war came shattering effects on monetary systems and practices everywhere, and thus was the course of the Federal Reserve System profoundly changed at the very moment of its birth as an operating system.. Under the terrific pressures of the war the gold standard gave way. Unprecedented

dislocations in the distribution of the world's total monetary gold stock occurred early in the war and have never since ceased. The gold standard emerged from the war badly crippled. The political as well as economic unsettlement resulting not only from the war but from a peace which ignored the economic consequences of the extensive territorial changes made by it, and the whole problem of economic readjustment thus presented, intensified as it was by the deeply disturbing post-war crisis of 1921, still further aggravated the situation so far as concerned the prospects of an early or successful restoration of the former international gold standard mechanism. It is not, therefore, surprising that the gold standard, on its restoration in Europe in the middle twenties, encountered great difficulties and finally broke down under the strain of the post-war depression. Its restoration during the years 1925 to 1928 is probably to be regarded, from a strictly monetary point of view, as having been premature though possibly necessary or expedient from the wider point of view of political and social policy in the chaos overhanging central and western Europe in the first critical years which followed the close of the war. At any rate, and whatever may be the ultimate judgment of history, the results of the restored gold standard were not satisfactory. A few years sufficed to show that the gold standard mechanism could not function efficiently as of old in an economic world so far out of balance and joint as that which then existed. Substantial as was the progress toward economic reintegration made in the five years preceding

the crisis of 1929, it had nevertheless not reached a point where it provided a secure foundation on which to rebuild the gold standard system. The world had not yet again become a gold standard world. It was still far from it, as shown by the great difficulties which were almost immediately encountered in the functioning of the newly restored gold standard and the shifts and devices which had to be resorted to in order to save the standard from collapse. The gold standard, such as it was in these years, was predestined to break down. The break came with the suspension of gold payments by Great Britain in September, 1931. That breakdown has had momentous consequences elsewhere and strikingly, of course, on the position and future of the Federal Reserve System.

It is one of the peculiarities -- perhaps they should be called shortcomings -- of the gold standard system that when any of the financially more important countries is obliged in a period of depression to abandon the gold standard, its action exerts deflationary pressures of a serious character elsewhere, partly by reason of the immediate monetary and economic derangements occasioned, but partly and largely because of the mental anxieties occasioned in other countries with regard to the safety of their own monetary position. The abandonment of the gold standard by Great Britain and the large section of the commercial world financially tied to London in 1931 therefore had definite and serious repercussions in the United States and elsewhere. Early in 1933 gold redemption was suspended here and the gold standard

abandoned for a period of several months. The following year the gold standard was restored in a greatly modified form. The gold dollar was revalued by the establishment of a new mint price of $35.00 per fine ounce for gold, as compared with the former price of $20.67. A little later a policy of extensive silver purchases was adopted.

The general effect of this monetary legislation was a still further complication of an already confused monetary situation in the world at large. It had particularly disorganizing effects upon the distribution of the world's gold and silver supplies. A movement of gold to the United States of spectacular dimensions and ominous portent began early in 1934 and has continued without noteworthy interruption ever since, affected in its rate or intensity first by one factor, then by another. The United States has during this period added to its gold monetary stock the entire output of the mines of the world and, in addition, some considerable amounts of gold previously held in private hoards or by central banks.

Such shifts and dislocations in the world's gold supply as have occurred during the past few years are without precedent in monetary history. Not only have they rendered the position of the gold standard in the fragment of the world still tenaciously clinging to the outward form of the gold standard difficult, precarious and probably untenable, but in addition they present a grave monetary situation and problem for the United States, and one that preeminently affects the future position and responsibilities of the Federal Reserve System.

They have furthermore greatly complicated the problem of a return to the international gold standard system in the future. It is one of the strangest ironies of economic history that the United States in reestablishing the gold standard as a matter of law in 1934 should have done it on a basis which made necessary the practice of managed currency as a matter of fact. The huge accessions to our gold supply which have occurred in the past two and a half years as a result of the revaluation of gold have carried the surplus reserves of the banks of the country to a height of three billion dollars, a level never hitherto even remotely approached or contemplated, and one which called for a degree of management far beyond the powers of the Federal Reserve System to deal with before the recent banking legislation.

In review, it may be said that the world has been without the international gold standard in an effective monetary sense since the World War began in 1914. The conditions which the successful functioning of the gold standard system presupposes have simply not existed. In consequence, the Federal Reserve System has never had an opportunity to function or develop as a gold standard system. Almost from the beginning of its organization one anomalous situation after another has arisen to change its course. The large influx of gold into the United States which arose not long after the outbreak of the war, our own entry into the war in 1917 and the necessity under which it placed the Federal Reserve System of assisting Government financing, the peculiar character of the 1920-1921 crisis, confronted the

System quite early in its life with a series of situations for dealing with which there were no established gold standard principles. The guiding principle of central banking administration in the old gold standard world was the state of the reserves and of the foreign exchanges, more specifically the reserve ratio: unfavorable exchanges and a declining reserve ratio were usually taken as indicating the necessity of preventive or protective action, just as favorable exchanges and a rising reserve ratio usually were taken as the occasion for discount rate action downwards; but in the conditions which have surrounded the Federal Reserve System throughout almost its entire life, reserve ratios have had little or no significance as guides to policy or action. The System was therefore obliged to develop substitutes for the reserve ratio. It was in something of the position of a mariner sailing an uncharted sea with broken compass and therefore forced to set his course by the stars. With the reserve ratio no longer a trustworthy reliance, and thrown back upon its own devices, the Federal Reserve System gradually developed a procedure in which it came to look to the state of trade, industry and employment, the movement of prices and much other such data, monetary as well as economic, as more appropriate aids. This was true even during the brief period of time when it was mistakenly thought that the gold standard had been restored in Europe after 1925. Central banks and governments there, like the Federal Reserve System here, found themselves obliged to resort to practices under the pressure of economic or financial

necessity which were not consonant with the traditional nor, as events soon proved, with the useful operation of the gold standard. Currency and the exchanges were managed: they had to be managed. Speaking unsentimentally and in a matter-of-fact way, the world in which the Federal Reserve System began its career became and is today a managed currency world with, it may be added, considerable variety both in the types and in the objectives of management, but all of them having this feature in common, namely, that they are surcharged with highly nationalistic impulses, and thus completely out of step with the requirements of the gold standard, which envisions the currencies of the different countries as also a common or world currency.

When the existing confusion will end no one can say, nor is there as yet any clear indication as to what the future international monetary order will be when one is again restored. With all the undoubted progress that has been made in recent years in the field of monetary analysis and theory, the problem of the place of gold in the monetary systems of the future has not yet been fully clarified. The problem is still approached by too many in a prejudiced if not a partisan attitude of mind. There is altogether too little appreciation on the one hand of what gave to the gold standard system its ascendancy in the pre-war period; on the other hand there is and has been too little appreciation of what has made currency management a necessity in the post-war period and given it its vogue during the depression. There is also too little appreciation by some and too much exaggeration by

others of why, in the present state of economic disorganization, monetary restoration and economic restoration may not usefully be regarded as separate problems. They are rather to be regarded as parts of a common problem calling for coordinated plans and joint efforts if a safe and tenable terrain on which to build a stable monetary and economic order in the future is to be attained.

Looking over the economic history of the past fifteen years, it has not yet been demonstrated that an effective substitute has yet been found for the type of monetary discipline imposed upon the behavior of the modern credit and business system in a time of business expansion by the gold standard in the days of its effective functioning. It has also yet to be demonstrated on the other hand that the delicate credit and investment mechanism can endure and survive the unmitigated rigors of the gold standard regimen in a time of impending or threatened business depression. So much, I think, seems clear in a situation that for the most part has been and still is obscure, confused and baffling, and such was the situation which confronted Congress when it undertook to provide for a freer orientation of the Federal Reserve System and a readaptation of the structure of the System in order to make the American monetary and credit mechanism more competent to deal with conditions which had never been contemplated at the time the Federal Reserve Act was enacted, but which nevertheless had to be recognized. Another fact which had to be recognized was that the Federal reserve banks as originally conceived were not in all

respects well adapted or designed to deal effectively with the larger and more definitely national issues of monetary and credit policy in the United States requiring System action. The shortcomings of the System in this respect became clear when the several Federal Reserve banks early in the twenties began to engage, each for itself, in open market operations. Such separate and independent action in the national money market made each Reserve bank not merely potentially but actually a monetary authority in the United States whenever it might engage in open market operations on any considerable scale. Money and credit in the United States are highly fluid. The dollar of currency issued or the dollar of credit created by any one of the twelve Federal reserve banks is regional only in origin. Such currency and credit are national in their character, circulation and economic effects. The boundaries of the twelve Federal reserve districts are at most economic frontiers, not in any sense monetary frontiers. Our monetary frontiers are national, not regional. When, therefore, the Federal reserve banks in their separate capacities undertake to deal with questions of credit policy (discount rates, open market operations, etc.) they are in effect, though not perhaps consciously, dealing with interests which are of national concern and as such should be made the responsibility of some agency of monetary control representing the Federal Reserve System as a whole and functioning as a control national in its consciousness and sense of responsibility.

What has preceded supplies the background of the legislative

problem which was presented to Congress in undertaking to reshape the Federal reserve organization. The Banking Act of 1935 was its solution. The attitude of mind in which the solution was sought seems clearly to have been to do what was necessary, to do only what was necessary, and to do it in a way which would involve a minimum of dislocation of the existing Federal reserve organization and a minimum of disturbance of the deeply rooted habits of regional life and consciousness which had determined the original structure of the Federal reserve. Unimportant though the regional frontiers might be as monetary frontiers, they were and are far from unimportant as social, economic and cultural frontiers. As such they were respected in the Act of 1935. And thus a problem which was perhaps simple as a mere proposition of theory or monetary logic, in fact called for the exercise of a high degree of legislative judgment. The problem was further complicated by reason of the fact that there were other factors -- political, financial, etc. which had to be considered in the effort to reach a balanced and satisfactory solution of the form of centralized authority most appropriate in the Federal Reserve System, more particularly as regarded the bitterly controverted question of the make-up of the Open Market Committee.

The solution which emerged in the Banking Act of 1935 followed our traditional principle of check and balance in the form given to the set-up of the governing authority in the Federal Reserve System.

Two authorities in fact are recognized and are assigned separate

responsibilities in the determination of the chief questions of Federal reserve policy even though these responsibilities relate to problems which have so much in common that it was contended that the responsibility should be concentrated in a single body.

The former Federal Reserve Board is succeeded by the new Board of Governors of the Federal Reserve System. It is noteworthy that in the title of the new Board the twelve Federal reserve banks are now conceived of as constituting a System and for the first time recognized as an entity requiring its own separate governing authority. The Board of Governors is given either exclusive authority, ultimate responsibility or a preponderant voice in the exercise of the three most important instruments of system or national credit policy. It has exclusive power to change reserve requirements of member banks -- a new and powerful expedient of both banking and credit control. It has ultimate responsibility in the determination of discount rates, and through its majority membership in the all-important Federal Open Market Committee it has potentially at least a controlling position in the Committee.

The Federal Open Market Committee, though it had been established as early as 1923 by the Federal Reserve Board for reasons of administrative expediency, was first given a statutory status in the Banking Act of 1933. Its authority was limited and its membership was limited to the twelve Federal reserve banks, the former Federal Reserve Board occupying a position of secondary influence in the formulation of open

market policies. The adoption or implementation of the policies recommended by this Committee, even when approved by the Federal Reserve Board, was, however, optional with each of the twelve Federal reserve banks, this being in accordance with the original regional design. To improve this situation the Open Market Committee was given by the Act of 1935 an authoritative status and supreme power by being invested with the exclusive authority to make and enforce the open market policy of the System, the separate Reserve banks being obliged to engage in such operations in the purchase or sale of securities as the Committee might decide should be undertaken. Having plenary power in all matters of open market operations, this Committee is to be regarded as the most important single organ of monetary control existing in the Federal Reserve System.

In concentrating in the thus reconstituted authorities of the Federal Reserve System the power to act for the System, it was recognized that there were hazards and that safeguards should, therefore, be established in order to reduce the risk of an injudicious exercise of the great powers given to them. The hazard against which safeguards appear particularly to have been sought was the danger of interference with the free exercise of its best judgment by either the Federal Open Market Committee or the Board of Governors in the matters which constituted their particular responsibilities. The interferences which were feared were attempted banker or financial control on the one hand and so-called political control on the other hand.

The set-up of the Federal Open Market Committee perhaps best exhibits the existence of these fears. It was sought to reduce the hazard of financial control in the decisions of the Committee by giving seven of its twelve seats to the Board of Governors. On the other hand, it was sougnt to avoid the element of political influence in open market policy by refusing to commit the open market authority to the exclusive jurisdiction of the Board of Governors, as some had proposed, and by giving to the Reserve banks representation, even though a minority representation in the Committee, their five representatives being chosen by the Reserve banks organized into regional groups for this purpose.

To remove the Board of Governors from susceptibility to political control, the Banking Act of 1935 terminated the membership of the Secretary of the Treasury and of the Comptroller of the Currency on the Board after February 1, 1936. The Board then became a Board of seven members, the full term of membership was made fourteen years and no member who had served a full term might be reappointed. The head of the Board (now designated as Chairman), instead of holding office at the pleasure of the President, under the new Act is designated for a period of four years. The purpose of these changes appears to have been to give the Board of Governors a more independent status at the very moment when it was also being given a more authoritative status and responsibility in the larger affairs of the Federal Reserve System with respect to the determination of the fundamental matter of credit policy under the conditions of today.

A further and most important safeguard to insure careful exercise of their respective authorities by both the Federal Open Market Committee and the Board of Governors is to be found in the requirement imposed by the new banking act that each of these bodies shall make a complete record of all action taken by it, of the reasons for the action, and of the votes of the members participating. This record is to be published annually in the report of the Board of Governors of the Federal Reserve System.

This requirement marks a long step toward the development of a reasoned and orderly procedure in the conduct of the Federal Reserve System without, however, it should be particularly noted, any attempt on the part of Congress to prescribe what the procedure should be. As such it constitutes not only an innovation in the Federal Reserve System but in central banking generally. Great importance, I think, is to be attached to this feature of the new banking legislation. It may well be expected that in time the new requirement may turn out to be one of the most far-reaching and constructive changes made by the Act, not only as a safeguard but also as an incentive. It does not seem to be extravagant to hope that under the compulsion and impulsion of this provision of the Act there will in time be forged out of the mind and the experience of the Federal Reserve System a deeper and fuller understanding of the relationships existing between the monetary processes and the economic processes, a more competent interpretation of the factors involved in the interplay of the monetary mechanism

and the economic mechanism, a larger conception of the national economic interest, and a truer orientation of Federal reserve attitude and policy to that interest, and eventually result in making the Federal Reserve System one of the most vital organs of our national economic life, such as I believe it is destined to become.

This completes my comments on a few of the principal provisions of the Act and the circumstances which called them forth. An important and controverted piece of legislation like the Banking Act of 1935 may, however, sometimes get a significance from what it omits as well as from what it contains, and to one of the notable omissions of the Banking Act of 1935 I desire to advert in conclusion.

Special interest, I think, attaches to the elimination from the bill as finally enacted of the provision contained in the bill as first passed by the House formulating an objective toward the attainment of which the Federal Reserve System was directed to exert its influence. The Act as finally approved, in preserving for the governing authorities of the System a free hand to develop in their own way and without legislative interference the procedure best suited to the rapid shifts of circumstance and conditions in the present extraordinary period of flux instead of yielding to the oft-repeated proposal earnestly made by the advocates of a managed currency regime that the Act should carry a formula for the guidance of the Federal Reserve System, is to be commended.

A further and perhaps an even larger significance attaches to the

omission just referred to. The inclusion of a formula, when taken along with other fundamental changes made by the Act, would almost certainly have been regarded as the setting up of a permanent monetary authority in the United States as a matter of settled national policy, and thus have carried most serious implications as regards the future of the gold standard.

The future of gold and of the gold standard have not yet been determined, nor will it be determined by the action of any one country. It follows that until the role which gold is to play in monetary systems of the future is settled the role to be played by managed currency cannot be settled on a permanent basis. The management of money within the framework of the gold standard is a very different business from what it is without it. That money management will have a larger part in central banking in the future than it had in the old gold standard world does not admit of doubt, but how much larger that part will be will depend upon the form in which the international gold standard mechanism is eventually restored, and also on how nearly and how soon an economic world suited to that standard is restored. Congress therefore, I think, acted wisely in avoiding including anything in the Act of 1935 which might have foreclosed or embarrassed the unprejudiced and unobstructed reconsideration and determination of the eventual monetary system of the United States when conditions are ripe for the determination. The Act as passed contains no suggestion of an expectation on the part of Congress that the gold standard system

is to be superseded in law or in effect by any new form of permanent monetary control.

The Act of 1935 made only such dispositions as were clearly thought necessary to deal with conditions as they were. Few pieces of important legislation have ever been approached by the American Congress in a more realistic spirit than the banking legislation of 1935. This legislation is not understood unless it is appreciated that it concerned itself with conditions -- not with theories. It kept within the frontiers of the necessary and avoided all unnecessary penetration into the dark. It did not, therefore, undertake to predetermine, even by implication, the future monetary course of the United States farther than circumstances purely indicated to be immediately necessary in order that the Federal Reserve System might be made reasonably competent to function effectively in the rapidly moving world of today. The monetary future of the country in a more permanent sense it left for determination in the future.

What that future will be and what the future of the Federal Reserve System will therefore be are still uncertain and must remain so until the statesmen and the peoples of the world discover that the way back to stable and prosperous conditions for the nations must be by reestablishment of an economically integrated world and the reestablishment of a common or international currency which will command the respect and confidence of mankind. That the international currency of the future, as was that of the past, will be based on gold may not

be doubted. This is becoming clearer and clearer every day. The welter of confusion into which the world has in recent years been projected by the widespread resort to national currencies with their constricting effects upon trade among the nations and therefore upon their industry and prosperity has made it clear beyond peradventure that gold offers the only solid foundation upon which to reconstruct the monetary systems of the future, to release the spirit of enterprise from the captivity of fear, and to restore to western civilization its self respect.