

Statement of George W. Mitchell, Member,
Board of Governors of the Federal Reserve System,
before the
Committee on Banking and Currency, House of Representatives,
March 4, 1964

My statement is divided into three parts. At the outset I have some comments on the proposals incorporated in the bills dealing with changes in the structure of the Federal Reserve System. This is followed by material on bank earnings over the past 10 years, requested by Chairman Patman. Finally, I have a few comments on some of the "money supply" theories advanced before the Committee.

Composition of Board

In my judgment there are no significant benefits or losses to be realized by changing the number of persons on the Board from seven to five, or nine. A Board larger than nine would tend to become progressively more cumbersome and needlessly duplicative of points of view. A Board smaller than five would diminish the potential advantages of differing points of view and delegate more policy-type decisions to staff.

As for the length of term for Board members, it seems to me a four-year term would have the unfortunate selective effect of eliminating many well qualified individuals who could not consider appointment to the Board for that length of time at prevailing salaries. Business, banking and academic employment today are far more attractive than Government posts, especially for men in the prime of their careers with limited independent means. Perhaps an even more important deterrent to recruiting qualified candidates is the fact that a Board member must, and quite properly so, sever business and financial connections on which his future economic prospects and security had theretofore depended. Unless a man has substantial independent personal

or family means or unless he expects to complete his working career within the period for which he is appointed to the Board, the length of the term he can look forward to is a significant consideration in determining his availability. It is my opinion that a term longer than four years is needed to provide the President with a suitable panel of competent men whose independence of judgment is least exposed to considerations of personal or family necessity. On the other hand, I doubt that a 14-year term is needed to achieve whatever contribution job security can make to quality and independence of Board members; my suggestion would be a minimum of six or seven years and a maximum of ten to twelve.

Abolition of Federal Open Market Committee

During the period since I became a member of the Board of Governors, September 1961, it has consistently been plain to me that the members of the Federal Open Market Committee, whether from the Board of Governors or from the Federal Reserve Banks, have made open market policy decisions on the basis of their individual evaluations of the public interest. This statement does not rest on the fact that I admire their independence of judgment because they tend to reach the same conclusions I do--most of them don't--but rather on my observation that on any given public policy the views and reasoning expressed in Committee deliberations reflect the man, whether he lives in Washington or not.

The Committee's policy record supports this judgment. Looking at the voting record on the policy directives from September 1961 through the end of 1963, there were 55 dissenting votes cast on directives relating to current policy. Abstracting the dissenting votes cast by me and one of my colleagues at a time during this period

when we concluded that a policy of greater monetary ease than the one described in the directive would have been desirable, the record shows that 17 dissenting votes were cast by members of the Committee who were members of the Board of Governors, and that 16 dissenting votes were cast by members of the Committee who were from the Federal Reserve Banks. Within the latter group, 8 of the dissenting votes reflected a view that a policy of lesser ease would have been desirable, while an equal number of dissenting votes reflected a view that a policy of greater ease would have been desirable. These dissenting votes were cast by six different presidents who sat on the Committee at one time or another during the period. Dissents by members of the Board were also to the right and left of the majority--for less ease--for greater ease. Looking at individual voting records, President Hayes, Governors Balderston, Shepardson, and Mills have at times over this period voted against the majority in favor of less ease. Presidents Bopp, Clay, Scanlon, Bryan, Deming and Governors Robertson, Mills, King and I at times voted against the majority in favor of more ease. From this record I detect no more bias in one direction or another among the presidents than can be found on the Board.

My reason for favoring a continuation of the Open Market Committee more or less as presently constituted is not primarily negative, however. I think that regional representation from men whose day-to-day business activities keep them in touch with industrial, commercial and banking developments in the major centers of the Nation brings to the Committee qualitative judgments and insights that aggregative statistics will always lack.

Audit

The word audit automatically claims the support and endorsement of everyone who has nothing to hide. But there should be a recognition that from a practical standpoint we cannot afford audit, audit, and reaudit. Verifying the existence and accuracy of the assets and liabilities shown on Federal Reserve balance sheets and determining if expenditures at the Federal Reserve Banks are consonant with legal requirements and guidelines laid down by the Federal Reserve Board is achieved by internal auditing procedures at each Reserve Bank and by the Board of Governors' independent examinations. I believe these are ample guarantees that the Reserve Banks' accounts and spending are fully policed. So far as I am aware, the examination of several thousand vouchers by the Committee staff did not uncover either any falsification of the balance sheet statements or any deviation from statutory requirements or from Board guidelines. This is corroborative evidence that a third verification and audit at the Reserve Banks would waste resources that could be better employed elsewhere. Moreover, I believe it unwise to so constrain management decisions that the business of Government is operated not with a view to getting the job done, but with a view to what a third set of auditors may say about how it was done. Compared with Federal agencies, the Federal Reserve System is not very large but I believe it gains in operating efficiency from the decentralization of management responsibility to administrators on the site.

The term auditing is also used to refer to a review of management policies, procedures and standards. This is a type of audit to be used with special expertise lest there be a tendency to

substitute the auditor's judgment for that of the operating officer who bears the responsibility for performance as well as costs. An illustration can be found in the cost of providing security in Reserve Banks where vast sums of currency, coin, and securities are handled daily. The expenditure for protection must be reasonably related to the exposure to possible loss. An auditor might criticize an expenditure for guards as excessive but his judgment does not assume any responsibility if a loss is actually incurred.

This is not to say that I believe it inappropriate for the GAO, or any officially designated agency, to review the operational standards and techniques in the Federal Reserve System to see if they conform to the best in present-day management practices. On the contrary, I would welcome such an examination. In fact, within the organization of the Board of Governors there is such a unit continuously screening technical operations at the Reserve Banks with a view to achieving the most economical and expeditious manner of processing securities, checks, currency, coin, or just facts.

Some criticism has been made of the presidents of the Reserve Banks for expenditures on employee welfare, community activities, employee education and the entertainment of visitors and guests. If any criticism is made I believe it should be of the Board of Governors for guidelines it has prescribed. However, I believe the guidelines as they stand are satisfactory. It is true they provide for considerable discretion on the part of the presidents and their boards of directors but I see no evidence this discretion has been abused. It should be borne in mind that the Federal Reserve Banks provide many people with their first job and education on the job

is needed to develop the new worker's potential. Average salaries at the Reserve Banks are low--about \$5,000--and welfare-educational programs are especially appropriate.

Federal Reserve Accounting

Over the years some students of central banking have suggested that it would aid public understanding and approval of sound monetary policies if the financial statements and reporting of the Federal Reserve did not follow conventional accounting lines but were made uniquely applicable to central bank operations.

I believe the System has done better to follow conventional business accounting practices on its operating statements and balance sheets. The magic of monetary creation may thereby be blurred but at least the present system has the virtue of requiring the System to show sources of receipts to cover expenses and payments to the Treasury and it also establishes the principle that for every investment expenditure there be an equivalent balance sheet asset. These accounting conventions have more than a fictitious value in setting the rules by which the Central Bank operates and they are safeguards against at least some abuses of monetary power.

In this context it seems to me that the size of the Federal Reserve surplus is not particularly significant, even if it were regarded as a "sinking fund" for the retirement of the public debt. Whether or not member banks should be permitted to own stock in the Reserve Banks should be decided on other grounds, namely on the grounds of encouraging System membership.

The main reason that more banks do not belong to the Federal Reserve System is that it is more profitable to stay out. The nonmembers usually benefit from having lower reserve requirements, or none at all, and some of them benefit by collecting fees for clearing checks. Both of these advantages to the nonmember banks are really disadvantageous to the public interest. Among the member banks there are many that would become nonmembers if the advantages of membership were to become slightly less--one of these marginal advantages is the dividend on Federal Reserve stock. I believe it would be unwise to make membership in the System any more costly from a competitive standpoint than it is now.

Member Bank Earnings, 1954-63

Over the past 10 years, gross revenues of member banks have increased by 130 per cent, from \$4,826 million in 1954 to \$11,134 million in 1963. Member bank operating expenses, however, have risen even faster, from \$2,999 million to \$7,900 million, or more than 160 per cent. Reflecting the more rapid growth in operating expenses than in revenues, net current earnings before income taxes grew by 77 per cent and net income after taxes by 66 per cent. The ratio of net income to capital fluctuated from year to year, but showed no marked change over the period.

The principal developments in member bank earnings and expenses from 1954 through 1963 are summarized in the attached tables. Data are shown separately for reserve city and country banks, a breakdown which also provides a rough indication of the differences in operating experience between large banks and those of smaller size.

Rates of growth in net current earnings over the 10-year period were identical at reserve city and country banks, but country banks experienced a somewhat slower rise than city banks in net income after taxes. The somewhat slower growth in net income after taxes than in net current earnings before taxes at both reserve city and country banks reflects in part the relatively large additions to income in the base year from profits on the sale of securities. Such profits, which are included in net income but not in net current earnings, were particularly large in 1954, a recession year, when interest rates were depressed and market values of fixed-income securities relatively high.

The rate of return on bank capital, as measured by the ratio of net income to total capital accounts, has fluctuated somewhat from year to year, mainly because of the erratic behavior of nonoperating adjustments, particularly profits and losses on the sale of securities. Over the period, reserve city banks earned a slightly higher average return on capital than country banks, 9.0 per cent compared with 8.7 per cent. At each class of banks, this rate exhibited a slight uptrend, averaging about one-half percentage point higher in the last five years than in the first five. This small rise relative to the increase in net income reflects the substantial growth in member bank capital accounts since 1954, mostly from retained earnings. The increase in capital accounts at reserve city banks was 67 per cent, or nearly as much as the growth in net income, while the increase at country banks, 82 per cent, substantially exceeded the rise in net income.

Revenues

An important factor contributing to the growth in member bank revenues over the past decade was the rise in interest return on both loans and investments associated with the general advance in market rates of interest. Of even greater significance, however, was the growth in total earning assets as commercial bank loans and investments were expanded to accommodate growth of the domestic economy. Asset shifts and increases in service charges and trust department fees also made significant contributions to bank revenues over this period.

The average rate of return on loans outstanding at reserve city banks rose between 1954 and 1962 from 4.27 per cent to 5.56 per cent, or less than one-third. At country banks, where the average size of loan is relatively small and loan rates tend to be higher and less responsive to changes in credit conditions than at city banks, the increase was considerably less--from 5.36 per cent to 6.21 per cent, or a little under one-sixth. Although these increases reflect mainly the advance in market rates of interest over the period, they also stem in part from shifts within the loan portfolio toward higher-yielding types, including consumer loans.

Returns on loans have not shown any appreciable advance during the current business upswing such as occurred in the two previous expansions of this 10-year period. In fact, at reserve city banks, earning rates were appreciably lower in 1961 and 1962 than they had been in 1960, when they reflected the relatively high interest-rate structure which had developed late in the previous business upswing. However, country bank rates, which also receded in 1961, rose in 1962 to a level slightly above the 1960 average.

Net interest and dividend return on investments, while fluctuating considerably from year to year mainly in reflection of capital gains and losses on securities transactions, also has moved upward over the period. The increase between 1954 and 1962 was about one-third at reserve city banks and two-fifths at country banks, with the rate at country banks averaging slightly higher over the period than at city banks.

Total earning assets of both reserve city and country banks showed larger relative increases between 1954 and 1963 than the average interest return on assets, and hence were a more important factor in the growth in revenues. During this period, total loans and investments rose 53 per cent at reserve city banks and 72 per cent at country banks.

Additional gains in revenues were realized as a result of the rise in the proportion of these assets held in the form of loans, which yield a much higher interest return than investments. Over the 10-year period, the ratio of loans to total loans and investments rose from 48 to 65 per cent at reserve city banks and from 42 to 56 per cent at country banks. This shift reflected in part the working down of holdings of U. S. Government securities to more normal levels after the unusually large acquisitions during World War II. Finally, banks added slightly to revenues over the period by increasing earning assets at the expense of their holdings of cash assets.

Expenses

Almost half of the \$5 billion increase in member bank operating expenses over the 1954-63 period was accounted for by interest paid on time deposits. This item, which was relatively unimportant in 1954, had increased nearly six-fold by 1963, from \$494 million to \$2,847 million.

The rise was somewhat larger at reserve city than at country banks, and reflected both an upward movement in rates paid on these deposits and rapid growth in total time and savings deposits.

Rates paid on time and savings deposits rose continuously over the period, with particularly large increases in 1957 and 1962 after the Federal Reserve had raised the ceilings on rates that member banks were permitted to pay on these deposits. City banks paid higher rates than country banks and they also raised their rates a little more than country banks between 1954 and 1963. The increase in average rates paid by both groups of banks, however, was between 150 and 160 per cent, considerably more than the rise in average rate of return on earning assets.

Time and savings deposits rose much more rapidly during this period than demand deposits. Consequently, the ratio of time to total deposits increased substantially. Country banks have normally had a higher percentage of time to total deposits than city banks, but this margin narrowed considerably after 1961, when large city banks began to compete for corporate funds by issuing negotiable time certificates of deposit. Thus, the ratio of time to total deposits at reserve city banks increased much more than at country banks between 1954 and 1963. In 1963, time and savings deposits accounted for 35 per cent of all deposits at reserve city banks and 44 per cent at country banks.

Increased wages and salaries accounted for most of the remainder of the \$5 billion operating expense rise at member banks between 1954 and 1963. Mainly, this reflected the rise in wage and salary scales in industry generally. It was also due in part to a rise in number of employees per dollar of assets, as banks accommodated

to the increase in administrative requirements associated with the shift from investments to loans and greater activity in the service areas.

The Money Supply Guideline

I welcome the vigor with which an increasing number of academic economists, including two who have been serving on your staff, are now analyzing the statistical behavior of monetary magnitudes. The laudable aim of these investigations is to establish linkages, and stable relationships between the past behavior of monetary action and productive activity in the economy. I, myself, have recently tried to suggest ways in which the effects of monetary action on spending can be traced. The measurement problems are formidable and I regret to say that, in my judgment, we have not come nearly as close to achieving usable results as some of the academic people believe. Very little work has been done on cyclical changes in the structure of money ownership or on the role of turnover as it affects the demand for money. Another major avenue for tracing the course of monetary action, changes in interest rates and credit conditions, has had even less professional quantitative analysis. Happily, there seems to be a growing interest among professional economists in extending our knowledge along both of these lines.

The money supply school of thought has been strongly influenced by the writing and teaching of Professor Friedman, whose views are familiar to you. A great deal of the empirical investigation has been inspired by his teaching but I would counsel against accepting the recommendations for action advanced by this school of thought.

Specifically, I don't believe that the way in which changes in money supply generate changes in economic activity has been sufficiently thoughtthrough and empirically tested to warrant the adoption of a fixed monetary policy rule based on the past behavior of the money supply. In fact, it has not even been established, in times like these, whether changes in money supply precede changes in economic activity, or vice versa, or whether money supply and economic activity move coincidentally. However helpful historical money supply patterns are to our understanding of past economic developments, converting this understanding into a rigid operating rule without the benefit of modifications that human judgment can provide to take account of the changing environment would be a hazardous step.

For example, had we at the beginning of 1961 adopted the Friedman proposal for a constant 4 per cent rate of expansion in money supply, defined to include coin, currency, and privately-held time and demand deposits in commercial banks, we would have added some \$14 billion less to credit supplies than actually was provided by the monetary policies followed by the Federal Reserve in these years. In contrast, the Federal Reserve could formulate monetary policy during the last three years by looking not only at the Friedman definition of the money supply, but also at the more logically defined money supply, at interest rate and credit conditions, and at the unfolding balance-of-payments situation.

I would like to return for a moment to some testimony that you have heard that changes in the money supply systematically precede fluctuations in general economic activity. A causal connection is imputed to this association; namely, that changes in the money supply

cause the level of activity to change. From this imputation a policy prescription is derived which provides for continuous increases in the money supply at some optimal but invariant rate. I invite your attention to the attached chart which is presented to give you an opportunity to test Professor Brunner's technique for determining what causes what. In particular, you might want to guess which one of these series is the best predictor and, therefore, causal in Professor Brunner's analysis, of the others.^{1/}

There is nothing in this type of statistical exercise that proves that money supply changes are truly leading economic activity and, of course, there is nothing in such a bare statistical exercise that proves or even argues persuasively that changes in the money supply cause fluctuations in economic activity.^{2/} I don't mean to deny that such a causal relationship exists. If it didn't there would be no argument for the existence of any type of monetary authority. I do argue, however, that the nature of the causal process is important, and that it has not been delineated and that I have seen nothing to demonstrate that the causal relationship is constant in degree and timing over economic cycles or over long periods when basic structural relationships in the economy have changed.

It appears to me that the arguments for abandoning discretionary money management in favor of a rigid formula is a surrender of the intellect and abandonment of the objectives of scientific inquiry. We are asked to cease grappling with the complexities of the modern economic world because the all too human minds of investigators seem inadequate to cope with the problems of such a

world. Without in any way denigrating the importance of the credit and monetary-creation powers vested by the Congress in our present monetary authorities, I must disassociate myself from those who feel these powers can be employed without thought, judgment, discretion, and concern for the world as it is.

Selected Earnings Data for Member Banks, by Class of Bank^{1/}
 1954-1963, inclusive
 (Dollar amounts in millions; ratios expressed as percentages)

	Gross revenue		Net current earnings before income taxes	
	Reserve City	Country	Reserve City	Country
1954	2,857	1,969	1,153	674
1955	3,170	2,173	1,313	764
1956	3,659	2,419	1,558	840
1957	4,074	2,697	1,679	870
1958	4,271	2,856	1,670	840
1959	4,819	3,256	1,922	1,013
1960	5,298	3,630	2,162	1,111
1961	5,429	3,788	2,058	1,085
1962	5,952	4,202	1,984	1,128
1963 ^{2/}	6,504	4,630	2,040	1,192

	Net income after taxes		Total capital accounts		Net income as a percentage of total capital accounts	
	Reserve City	Country	Reserve City	Country	Reserve City	Country
1954	669	427	7,362	4,362	9.1	9.8
1955	629	357	7,838	4,661	8.0	7.7
1956	662	364	8,325	4,946	8.0	7.4
1957	750	419	8,851	5,256	8.5	8.0
1958	933	524	9,503	5,583	9.8	9.4
1959	805	452	9,993	5,905	8.1	7.7
1960	1,061	628	10,455	6,366	10.2	9.9
1961	1,083	629	11,071	6,846	9.8	9.2
1962	1,035	660	11,694	7,372	8.9	8.9
1963 ^{2/}	1,142	677	12,325	7,941	9.3	8.5

	Net interest return on loans as a percentage of total loans <u>3/</u>		Net interest and dividend return on securities as a percentage of total securities <u>3/</u>	
	Reserve City	Country	Reserve City	Country
1954	4.27	5.36	2.50	2.40
1955	4.30	5.47	1.76	1.90
1956	4.57	5.54	1.65	1.93
1957	4.96	5.80	2.09	2.27
1958	5.00	5.83	3.48	3.04
1959	5.35	6.06	1.18	2.05
1960	5.93	6.13	3.13	3.21
1961	5.44	6.10	3.67	3.36
1962	5.56	6.21	3.35	3.34
1963	n.a.	n.a.	n.a.	n.a.

	Interest paid on time deposits as a percentage of total time deposits		Time deposits as a percentage of total deposits	
	Reserve City	Country	Reserve City	Country
1954	1.34	1.25	21.4	32.6
1955	1.39	1.33	21.8	32.5
1956	1.62	1.53	22.0	32.7
1957	2.18	1.97	23.5	34.4
1958	2.26	2.14	25.9	36.5
1959	2.44	2.28	26.4	37.3
1960	2.63	2.53	26.2	38.7
1961	2.80	2.65	28.7	40.0
1962	3.39	3.04	31.7	41.6
1963 <u>2/</u>	3.45	3.18	35.3	43.5

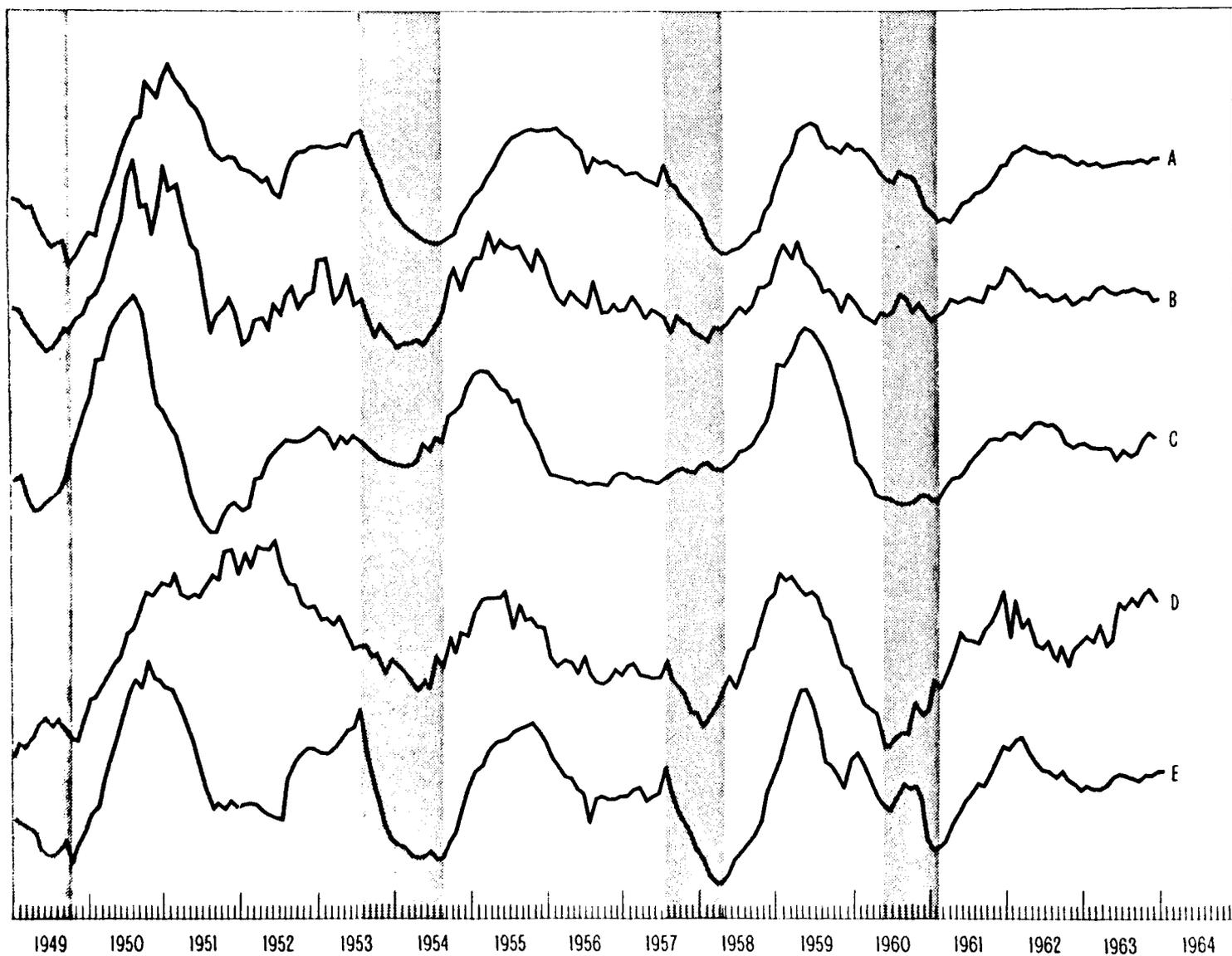
1/ Reserve city category includes all reserve city banks and prior to 1962, New York and Chicago central reserve city banks.

2/ Data for 1963 partly estimated.

3/ After non-operating losses and charge-offs, recoveries, and profits, but not including transfers to and from valuation reserves.

n.a. Not available.

Percent Change over Corresponding Month
of Preceding Year - 1949-63
5 Economic Time Series



1/

5 Economic Time Series

On chart

The chart of year-over-year percent changes contains the following series, although not in this sequence:

- | | |
|---|---|
| 1. Demand deposits adjusted and currency | D |
| 2. Industrial production | E |
| 3. Nonagricultural employment | A |
| 4. Private nonfarm residential construction | C |
| 5. New orders for durable goods | B |

Shaded areas are recession periods as dated by National Bureau of Economic Research.

2/ There is one other more or less technical qualification that should be observed in the presentation of cyclical lead and lag analysis. It is possible to create by simple arithmetic manipulations, leads and lags where none exist, except in terms of arithmetic relations having nothing to do with economic substance. One must always be very wary, therefore, in drawing conclusions produced by these manipulations where there is no satisfactory explanation given of the economic and institutional mechanics by which the leading series is supposed to influence the lagging series and no satisfactory explanation of the economic rationale of using the particular arithmetic manipulations.

To be more explicit. In any series that has a roughly cyclical movement, the movement of the rate of change of that series (that is to say the percentage change from one month or one quarter to the next) will also be cyclical--but with different timing--so that movements of the rate of change will lead the series itself. The exact amount of the lead and whether it is a constant lead or varies in different parts of the cycle--i.e., as between the upswing and the downswing--will depend on the particular pattern of movement of the original series, but the lead will average about one quarter the length of the cyclical movement. This means that if we have two series that have, say, the identical cyclical movement, then we can always show that either one of them leads the other by plotting the rate of change of the one it is desired to show leading against the original series of the other. Not only can either of two coincident series be converted to lead but by the same operation a slight lag can be converted to a lead. Therefore, unless very specific economic and institutional rationale are to be given for the particular arithmetic operations, they remain essentially primitive arithmetic exercises rather than economic analyses.

Just as the arithmetic operations of taking rates of change can shift the cyclical timing and change the impression of leads and lags, the arithmetic operation that Professor Brunner uses, of recording each month of a series in terms of its percentage change from the corresponding month of the previous year, can also change timing. The arithmetic relations in this case are somewhat more complicated than in the case of the rate-of-change calculations--depending on the length of the cycle, the existence of a trend, etc. But in series with rising trends, which is the case in the charts presented by Professor Brunner, the arithmetic operation itself can produce the appearance of leads. This, too, is a case where the ability to manipulate series arithmetically in such a way as to arrive at leads cannot by itself be used to establish even a presumption of the nature of the economic relationship involved.

I might say parenthetically that Professor Brunner nowhere indicates the economic rationale for working in terms of year-over-year changes, the movements and magnitudes of which depend not only on what is happening currently but also on what happened a year ago. It is, therefore, a quite awkward technique to use in evaluation of current happenings.

2/ Cont'd

Professor Brunner, I am sure, would not take exception to this raising of the question of the logic and relevance of certain aspects of his procedures, he himself applies the most rigorous standards of logic and relevance to his evaluation of other economists' work. I have recently heard him express himself as astonished at some of his academic colleagues for presenting arithmetic relationships without demonstrating their relevance to economic and policy issues through an analysis of the economic and institutional mechanisms involved. But he has also observed how difficult it is to apply the same high standards of logic and relevance to one's own work that one does to the work of others and that each worker in the field must rely on others to perform this critical appraisal for him.