[SUBCOMMITTEE PRINT]

THE FEDERAL RESERVE SYSTEM AFTER FIFTY YEARS

PROPOSALS FOR IMPROVEMENT OF THE FEDERAL RESERVE AND STAFF REPORT ON HEARINGS BEFORE THE SUBCOMMITTEE ON DOMESTIC FINANCE OF THE COMMITTEE ON BANKING AND CURRENCY

SUBCOMMITTEE ON DOMESTIC FINANCE

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LETTER OF TRANSMITTAL

AUGUST 20, 1964.

To Members of the Subcommittee on Domestic Finance:

Transmitted herewith for the use of the Subcommittee on Domestic Finance of the Banking and Currency Committee, and other members of the committee and the Congress, is a staff report on the testimony presented at the subcommittee hearings on "The Federal Reserve System After Fifty Years."

This document also contains the subcommittee's recommendations dated June 28.

The hearings which were held during the first 4 months of 1964 represent one of the most comprehensive inquiries into the Nation's banking and monetary system ever conducted. The testimony, comprising three volumes, should provide a fertile source of information and analysis for legislators and scholars for many years to come. Even more important, this inquiry furnishes an indisputable basis in fact for reform of the Federal Reserve System as it exists today.

In transmitting this report to the subcommittee, it is my hope that it will be carefully read and considered not only by the members of the Banking and Currency Committee but also by the entire Congress and the general public as well.

The report was prepared by staff of the Banking and Currency Committee under the supervision of Dr. Robert E. Weintraub, senior economist.

Sincerely yours,

WRIGHT PATMAN,
Chairman, Banking and Currency Committee.

PROPOSALS FOR IMPROVEMENT OF THE FEDERAL RESERVE SUBMITTED FOR DISCUSSION BY THE SUBCOMMITTEE ON DOMESTIC FINANCE*

We have heard considerable testimony on the Federal Reserve System. The testimony strongly suggests that some revision of the System is indicated to improve future monetary policy and thereby our economy's performance, in accord with the Employment Act of 1946. A set of corrective proposals which emerges from the testimony given before the subcommittee is presented herewith for further consideration.

We are not suggesting, of course, that these proposals cannot be improved upon. While the subcommittee has not settled on any specific proposal, it intends to consider the entire set in public hearings after the next Congress convenes in January 1965. The proposals, though preliminary and tentative, are circulated at this time to allow for full study and discussion by the Congress, the executive branch, the Federal Reserve, and the public:

A. To emphasize the public character of the Federal Reserve

1. Provide for the retirement of the Federal Reserve stock.
2. Vest all power to conduct open market operations in the Federal Reserve Board.

B. To increase the effectiveness of monetary policy by assuring the recruitment of an outstanding Federal Reserve Board and an adequate response to advances in economic knowledge

1. Remove the present requirement that the President, in selecting Governors of the Federal Reserve Board "* * * shall have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests and geographical divisions of the country." Instead require only that the Governors be men of integrity devoted to the public interest.
2. Reduce to five the number of Governors of the Federal Reserve Board.
3. Reduce to 5 years the terms of office of the Governors and allow for reappointment.
4. Make the term of the Chairman of the Board of Governors coterminous with that of the President.
5. Raise the salaries of the Governors.

C. To insure public control over the expenditures of public moneys

1. Provide for a public audit by the Comptroller General of all expenditures by the Federal Reserve Board and the Reserve banks.
2. Provide for paying into the Treasury as miscellaneous receipts all capital gains and interest received by the Federal Reserve from U.S. Government securities.
3. Authorize appropriations by the Congress of the expenses of the Federal Reserve banks and the Federal Reserve Board.

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*Released by all the Democratic members of the subcommittee: Wright Patman, chairman (Tex.), Henry S. Reuss (Wis.), Charles A. Vanik (Ohio), Claude Pepper (Fla.), Joseph G. Minish (N.J.), Charles L. Weltner (Ga.), Richard T. Hanna (Calif.), and Charles H. Wilson (Calif.).

D. To provide statutory guidelines for monetary policy and assure coordination of all of the Government's economic policies in achieving the goals of the Employment Act of 1946

1. Require that the President set forth in his periodic economic reports, in conjunction with his recommendations on fiscal and debt management policy, guidelines concerning monetary policy, domestic and foreign—including the growth of the money supply, as defined by him—necessary to attain the goals of maximum employment, production, and purchasing power of the Employment Act of 1946.

2. Express the sense of Congress that the Federal Reserve operate in the open market so as to facilitate the achievement of the President's monetary policy; and require that the Federal Reserve, if its monetary views and actions diverge from those recommended by the President, file with the President and the Congress a statement of reasons for its divergence, in form like the President's Economic Report.

E. To allow for greater specialization in performing the monetary control function

1. Permit the Federal Reserve Board to concentrate on monetary policy by transferring its present bank supervisory functions to the Comptroller of the Currency, the FDIC, or alternatively, to a newly created Federal banking authority.

* * * * * * *

In addition to the foregoing proposals, the subcommittee recommends that the following questions pertaining to Federal Reserve operations be studied:

(*a*) The extension of control over reserve requirements so as to cover all commercial banks.

(*b*) The opening of the discount window to all commercial banks.

INDEX

PART III. MONETARY POLICY

PART IV. THE NEED FOR CHANGE

PART V. AUDIT BY GAO AND OTHER SPECIFIC PROPOSALS

PART I.—SCOPE AND BACKGROUND OF THE HEARINGS

A. INTRODUCTION

On January 21, 1964, the Subcommittee on Domestic Finance of the Committee on Banking and Currency started consideration of six legislative proposals introduced by Chairman Patman (Texas) for the purpose of making revisions in the structure of the Federal Reserve System. Extensive hearings on "The Federal Reserve System After 50 Years" were held during the ensuing 3 months. This report undertakes to analyze the testimony presented.

Testimony was given by 50 witnesses. Included among these witnesses were the 19 ranking executive officers of the Federal Reserve System, a group consisting of the 7 Governors of the Federal Reserve Board and the presidents of the 12 Federal Reserve banks. The Secretary of the Treasury and two officials of the General Accounting Office also testified. In addition, the subcommittee heard 2 representatives of the American Bankers Association and 2 from the Independent Bankers Association; the Director of Research of the AFL-CIO; and 23 experts in the fields of economics, public administration, and law. In assembling this group of witnesses, the subcommittee was guided by two criteria: (1) professional standing, and (2) the desirability of hearing from witnesses representing diverse schools of thought.

In order to achieve a cross section of opinion, experts were invited who, in addition to their scholarly achievements, have served, respectively, as advisers to Presidents Kennedy and Truman, and Senator Goldwater;[1] made special studies for this committee and the Joint Economic Committee;[2] worked as full-time employees or served Federal Reserve banks in administrative or consulting capacities;[3] and participated in the preparation of the reports of the Commission on Money and Credit and the Canadian Royal Commission on Banking and Finance.[4] Despite the wide range of viewpoints represented, there was substantial agreement among the 23 experts in economics, public administration, and law, concerning the Federal Reserve System's structure and policies.

B. THE STRUCTURE OF THE FEDERAL RESERVE SYSTEM

In the past 50 years we have become increasingly aware of the economic significance of Congress' constitutional monetary power. Al-

[1] Professor Samuelson (MIT), Mr. Keyserling, and Professor Friedman (Chicago).
[2] Professors Meltzer (Carnegie Tech), Brunner (UCLA), and Dr. Warburton (FDIC), and Professor Gurley (Stanford).
[3] Professor Robertson (Indiana), Bach (Carnegie Tech), and Barger (Columbia).
[4] Professors Shapiro (Harvard), Reagan (Syracuse), H. Johnson (Chicago), and Gordon (Carleton University, Ottawa).

though America's post-Civil War monetary history had long been marked by financial panics due in large part to a perversely elastic money supply, it was not until the Federal Reserve Act of 1913 that Congress saw fit to delegate its tremendously pervasive power to regulate the Nation's money supply, interest rates, and credit.

The 1913 act created the Federal Reserve System as Congress' delegate to control the Nation's money system. The System consists of three basic elements: 12 district or Reserve banks, the Board of Governors, and the member commercial banks. The System's initial capital was raised by a capital stock subscription to which member banks were required to subscribe. Though the stock cannot be transferred or hypothecated, it officially links the public elements of the Federal Reserve, and thereby the U.S. Government itself, to the private banking community.

For the past 50 years the Federal Reserve System has existed, grown, and changed—neither entirely in the Government nor out of it, not a part of the commercial banking system but deeply rooted in it. It is a far different System today than it was in 1913. A brief review of its legal and extra-legal evolution follows.

1. The 1913 act

(*a*) *Specific powers delegated.*—The Federal Reserve Act of 1913 grew out of the panic of 1907, which was caused by an acute scarcity of currency and marked by many bank failures. The Federal Reserve was created to prevent such panics by "furnish[ing] an elastic currency." To this end, 12 regional Reserve banks were chartered for 20 years.[5] Each regional bank was given three specific powers by the 1913 act. These were:

> (1) To buy and sell * * * bonds and notes of the United States and bills, notes, revenue bonds * * * issued * * * by any State, county * * *
>
> (2) To purchase from member banks and to sell * * * bills of exchange arising out of commercial transactions * * *
>
> (3) To establish from time to time, subject to review and determination of the Federal Review [Reserve] Board, rates of discount to be charged by the Federal Reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business.

The power to discount was regarded by everyone at the time as the principal power of the Federal Reserve System. By exercising this power the Reserve banks were to encourage member banks to convert short-term self-liquidating paper, which then constituted the bulk of their assets, into Federal Reserve notes when needed. By furnishing these notes (currency) the Federal Reserve would counteract the drying up of bank liquidity that had caused the panics of 1893, 1904, and 1907.

The Board of Governors was given the responsibility of supervising member banks. The Board also selected three of the nine directors of each Reserve bank. Finally, the Board exercised limited power in the area of monetary policy. The Board had power to review rates of dis-

[5] The McFadden Act of 1927 gave them perpetual charters.

count set by the Reserve banks and also to establish a rediscount rate. This latter power could be used to induce changes in rates of discount themselves. Thus the 1913 act created 12 regional monetary authorities, for the Reserve banks each had the same power to set a rate of discount and operated independently of one another. But limited authority also was vested in the Board of Governors for it had both review and indirect policy initiating powers.

This brief summary of the economic powers delegated by the 1913 act indicates, as Dr. Raskind (professor of law and economics, Vanderbilt) told the subcommittee that—

> * * * the Federal Reserve System emerged as a response to the unfortunate experience of narrowly regional banking systems and to the needs for a system that could provide services for commercial banks and act as fiscal agent for the Federal Government. * * * The principal structural features of the 1913 act further support the characterization of the system as one concerned less with monetary control than with narrower, technical service functions. The principal features of this act were the creation of decentralized Federal Reserve banks as depositories of member bank reserves, provisions for expanding credit (and currency) on the basis of commercial obligations, and arrangements for rediscounting by member banks with the Federal Reserve (1671–1672).

(*b*) *Representation.*—Under the 1913 act, the Board's seven-man membership was entirely appointed by the President of the United States. The Secretary of the Treasury and Comptroller of the Currency were ex-officio members of the Board of Governors and the Secretary served as its Chairman. The other five members were appointed for 10 years, one term expiring every 2 years. The Board was thus a genuine public instrument.

The Reserve banks, however, were not. The affairs of each of the 12 district banks were administered by a nine-man board of directors. Each consisted of three class A, three class B, and three class C directors. The class A and class B directors were elected by member banks, one director of each class being elected by small banks, one of each class by banks of medium size, and one of each class by large banks. The class C directors were designated by the Board of Governors. (These arrangements concerning the administration of the Reserve banks are still in force.)

By law the three class A directors may be bankers. The three class B directors must be actively engaged in the district in commerce, agriculture, or some other industrial pursuit, and must not be officers, directors, or employees (but may be shareholders) of any bank. The three class C directors may not be officers, directors, employees, or stockholders of any bank. But one of the class C directors must be a person of "tested banking experience," and this person is designated as chairman of the bank's board of directors.

The directors each take an oath to "diligently and honestly administer the affairs of said bank fairly and impartially and without discrimination in favor of or against any member bank or banks." They do not take the constitutional oath as Government officials representing the public interest. The boards of directors appoint the presidents of the Reserve banks, subject to the approval of the Board of Governors of the System. The Reserve bank presidents take no oath at all on appointment to their office. (Today, those that serve on the Open Market Committee as principals or alternates do swear "to support and defend the Constitution of the United States against all enemies, foreign and domestic.") The Reserve banks thus, as set up in 1913, were quasi-public institutions.

2. Birth of the Open Market Committee

The Reserve banks achieved effective control of monetary policy after World War I. During World War I, the Government debt increased from less than $1 billion to over $25 billion.[6] This provided the basis for the growth of open-market purchases and sales of Government securities by Reserve banks. Reserve bank domination of monetary policy was a corollary of this development, for open-market operations are both the most useful and the most flexible instrument available to the monetary authorities. When the Reserve banks whether acting alone or as a group buy Government securities the money supply tends to increase. Conversely, when they sell Government securities the effect is to tighten money. Details of the open-market operation are the subject of a later discussion.

From October 1921 to May 1922, the Federal Reserve banks individually purchased almost $400 million worth of Government securities to obtain earnings. These purchases disturbed the Government securities market. In turn, the disturbances created by these uncoordinated purchases led to the formation in 1922 of an ad hoc committee of the presidents of five eastern Reserve banks to coordinate open market operations. The Committee was not explicitly sanctioned by law. In 1923, this system was recognized by the Federal Reserve Board, which named the five presidents the Open Market Investment Committee. The individual district banks could still initiate open-market purchases, which the Committee would execute, but these independent operations were generally very limited.[7] In 1930, the membership of the Committee was expanded to include representatives from all 12 Reserve banks.

3. The 1933 and 1935 acts

In 1933, under the pressure of widespread bank failure and the general economic depression, Congress created the FDIC and, almost as an afterthought, made into law the arrangements which had grown up for coordinating the open-market operations of the 12 district banks. But authority for the conduct of the open-market operations was hopelessly diffused, since each Reserve bank could refuse to participate in operations recommended by the Committee.

The 1935 act vested power to initiate and enforce open-market operations in the Federal Open Market Committee, consisting of the 7 Governors and 5 of the 12 Reserve bank presidents. This put open-market operations partly under Government control by removing seven of the district bank presidents from the Open Market Committee, and replacing them with the seven presidentially appointed Governors of the Federal Reserve Board. The Board also was given power to

[6] U.S. Department of Commerce, Bureau of the Census, "Historical Statistics of the United States, Colonial Times to 1957," GPO, 1960, p. 711.
[7] The details of the formation of the Open Market Committee are discussed more fully in app. A of vol. III.

fix (within clearly defined limits) the reserves member banks carry behind their deposit liabilities.

But the 1935 law, while giving more power to the public element of the Federal Reserve, the Board of Governors, also loosened its ties with the Chief Executive by removing the Secretary of the Treasury and the Comptroller from the Board and lengthening a Governor's tenure to 14 years.

4. Evolutionary Changes

Since 1935 our country has undergone profound economic change and development. We have experienced two wartime inflations and five peacetime recessions. In spite of these vast changes, however, Congress has failed to update the act in terms of modern-day, national economic goals. It has ignored the development of the tremendous power exercised by the Federal Reserve in controlling the amount and cost of money principally through open-market operations. This power was scarcely recognized in 1913 when the act was passed. In fact, it was not thoroughly understood or developed until after 1935.

Because Congress has not acted, the Federal Reserve has adapted itself to the new conditions without benefit of law or legislative standard. It has found ways to finance itself, independent of fees collected and Government appropriations, and still today, 50 years after it was established, it has not been audited by the General Accounting Office. Since 1935 the Federal Reserve also has evolved highly but perhaps unnecessarily complex techniques for controlling the money supply. It has played a central role in war finance. Most importantly of all, since 1946 it has assigned itself duties largely on its own terms deriving from the Employment Act of 1946, although that act does not specifically mention the Federal Reserve System.

Unfortunately, as the Federal Reserve's power developed and we began to better understand our monetary system, policy guidelines to canalize this power failed to appear. The responsibilities of the Federal Reserve System as spelled out in the act itself testify to the almost wholly technical and service functions envisioned for the System upon its creation. As Dr. Warburton (FDIC) pointed out (1322), there are four passages relating, respectively, to open-market operations, discounts and advances, rates of discount, and changes in reserve requirements—the first three of which refer to the "accommodation" of commerce and of business or industry and agriculture, with an additional clause (in two cases) referring to "maintenance of sound credit conditions" or "the general credit situation of the country," and the fourth referring to prevention of "injurious credit expansion or contraction." These passages Dr. Warburton described as having always been ambiguous, and for many years archaic, as criteria for monetary policy.

5. Structure today

Today the member banks still own the capital stock and elect six of the nine directors of their respective district Reserve banks. The district banks continue to set discount rates. The Board of Governors continues to review discount rates, and also to apply regulations to member banks, including now the setting of reserve requirements within the limits prescribed by law. The Open Market Committee, operating through the System's Account Manager and the New York

Federal Reserve Bank, continues to carry out the most important economic function of the Federal Reserve and still consists of the seven Governors, serving 14-year terms that are staggered so one is appointed every 2 years, the president of the New York Reserve bank, and four other district bank presidents. Thus, there has been no significant change in the structure of the Federal Reserve since 1935.

Concerning the statute as it now stands, Professor Miller (School of Law, George Washington University) concluded—

> * * * that Congress can, and apparently has, turned over complete control of monetary matters to nonlegislative organs. Congress, it seems to me has lost whatever control it may once have had, and theoretically still retains. Thus, under title 12, United States Code, section 263, which provides for the creation of a Federal Open Market Committee, the "intelligible principle" supposedly required for delegations to administrative agencies seems to have vanished * * * this delegation does cede complete power to the Open Market Committee * * *. Congress, in short, has abdicated—in this, as well as many other matters of great public importance * * *. It is not extravagant to say that Congress is slowly bleeding to death—from self-inflicted wounds (1680–1681).

C. THE CENTRAL BANKING POWERS EXERCISED BY THE FEDERAL RESERVE SYSTEM

1. Functions and tools

(*a*) *Functions.*—The Federal Reserve System is our country's central bank. Congress has bestowed upon the Federal Reserve System the power to control the Nation's money supply. The fact that it was a tacit, unintended grant in no way diminishes either its scope or totality. In addition, certain Federal Reserve regulations apply to all commercial banks operating under national charters and State banks which have chosen to join the System.[8] Though the two functions overlap somewhat,[9] it is the monetary control function that has the most profound effect upon the health of the Nation's economy. Professor Lerner (Michigan State) called attention to this when he observed—

> * * * the business of the Federal Reserve System is not the business of banking but the management of the money supply of the country * * * (1398).

(*b*) *Tools.*—The Federal Reserve System has three basic tools for exercising monetary control. Each has an effect, direct or indirect, upon commercial bank reserve positions. First, the Federal Reserve System has the power to set rates of discount. Increases in the rate discourage commercial banks from borrowing from Federal Reserve banks and thus reduce reserve positions below what they otherwise would be. Decreases in the discount rate tend to result in an in-

[8] As a corollary of its regulatory and supervisory function, the Federal Reserve performs certain technical functions. It collects and clears checks, transfers funds, and also serves as the Treasury's fiscal agent.

[9] For example, the Federal Reserve's power to require member banks to hold (within specified limits) a certain fraction of reserves behind their deposit liabilities is both a regulatory power and a monetary control power.

crease in reserve positions. Second, the Federal Reserve Board has the power to increase or decrease, within certain limits, the proportion of reserves that member banks are required to keep behind their deposit liabilities. When the required reserve ratio is lowered member banks can expand the money supply. Conversely, the money supply can be reduced through increases in reserve requirements. Third, the Open Market Committee of the Federal Reserve has the power to buy and sell Government securities. The open-market tool is the Federal Reserve's most flexible and useful policymaking instrument. Purchases increase commercial bank reserves while sales reduce them.

When the Federal Reserve System buys Government securities from a nonbank dealer in Governments, it issues officer's checks which are deposited in a member bank. The latter in turn deposits the checks in a Federal Reserve bank. In this way member bank reserves increase. If the Federal Reserve buys from a bank that also is a dealer in Government securities, the bank's reserve account is credited directly. Conversely, when the Federal Reserve System sells securities to a nonbank dealer, it receives payment in the form of checks drawn on a member bank. These checks are then collected by the Federal Reserve System through debits to the member bank's reserve account. If the sale is made to a bank that also is a dealer, that bank's reserve account is debited directly. In both instances, the reserve base of the money supply is reduced.

2. Impacts

(*a*) *On money supply.*—The effect of changes in bank reserves was very clearly described by Governor Mitchell. Referring to the effect of open-market purchases of securities, he informed the subcommittee:

> Now the question is, What will a bank do with unused reserves? The small country banks typically carry unused reserves because it is uneconomical for them to put them to work. But a large bank, typically a Reserve city bank, has a man who runs what is called the money position. His job is to keep excess reserves in the bank at a minimum. In other words, his job is to put every dollar's worth of reserves to work.
>
> Now this is the point. To the extent that he and his counterparts succeed in doing this, you will have additions to the money supply * * * (1210).

(*b*) *A possible bottleneck.*—Governor Mitchell did not state that open-market purchases by the central bank would increase the money supply. Rather he claimed only that they could increase the money supply, and implied that they actually would only if borrowers can be found by the men who run commercial banks' "money positions." In the same vein of reasoning, Federal Reserve attempts to add to the money supply by increasing bank reserve positions were characterized as permissive as opposed to causative by Governor Daane (1210).

The proposition that the monetary authorities might be frustrated in attempting to expand the money supply was first put forth by John Maynard Keynes in the middle 1930's. And, under circumstances such as then prevailed, it may be correct that attempts by the Federal Reserve to increase the money supply would fail. The history of the

34-884—64——2

1930's, however, does not allow us to determine whether monetary policy would stimulate business in a full-fledged depression. For, as Professor Brunner (UCLA) pointed out:

> Monetary policy was not powerless, it was simply not used. The tremendous expansion of the money supply, initiated in 1933, was perhaps the single most important factor contributing to the recovery. It is noteworthy, however, that this expansion was not due to policy actions but resulted from the inflow of gold (1090).

This is not the place to debate whether monetary policy would work in a full-fledged depression. Our view is that an adequate money supply is necessary but not sufficient to assure both the achievement and maintenance of business prosperity. Monetary policy cannot, of course, revive a depressed economy nor can it maintain full employment without inflation in an economy characterized by growing labor and capital resources if fiscal and other policies are perverse. On the other hand, fiscal and other Government policies, no matter how enlightened, cannot achieve these goals without an adequate monetary policy and money supply. What this means is that although there are limits to what monetary policy can accomplish by itself, it must be used. The Federal Reserve cannot—under any circumstances whatsoever—be excused for not using its powers. Unless our monetary tools are used, the power of fiscal and other policies to affect the economy will be greatly, and perhaps altogether, diminished. A sensible monetary policy will not by itself bring economic growth and stability, but it is a prerequisite for the achievement of these goals.

(*c*) *On interest and thereby on national income, employment, and prices.*—The mechanism which allows the men who run the "money positions" of commercial banks to find borrowers is a fall in the rate of interest. It is thus immediately through bank reserve positions and then, in turn, through a fall in interest rates that attempts by the Federal Reserve to increase the money supply are made effective. This was brought out by Professor Strotz (Northwestern) when he observed:

> The mechanism through which it would be effective is that the central bank, by increasing the available reserves as a basis for loans of the commercial banks would induce the commercial banks to lower interest rates. A consequence of the reduction of interest rates would be an increase in the amount of borrowing * * * (1465).

Borrowers borrow money and resulting increases in the money supply serve to increase spending by both consumers and investors. By definition this involves an increase in national income; for consumption plus investment spending and national income are two sides of the same coin. The increased spending also will tend to raise interest rates back toward and even above initial levels. Thus increases in money supply growth serve to generate maximum employment and business prosperity or, alternatively, to cause price inflation—the result depending on whether the additional monetary growth is injected into the economy when it is underemployed and depressed or when it is fully employed and therefore susceptible to inflation given a large increase in the growth of the money supply.

Conversely, decreases in the growth of the money supply can be brought about by Federal Reserve action to reduce bank reserve positions, such as is contemplated by open-market sales or raising reserve requirements, for example. The Federal Reserve can reduce the rate of growth of the volume of money to zero. In fact, it has the power to actually decrease the volume of money, and has done so in the past. Such action immediately raises interest rates and reduces borrowing. Investment and other spending decline. This decline can, in turn, generate a further decline if the Federal Reserve then fails actively to pursue an expansionary monetary policy. It is not enough that the monetary authority switch to a neutral or passive policy once the economic decline it has initiated is underway; for there is a feedback from a decline in spending to the money supply which, if permitted, will generate further declines in spending and money supply, etc.

If executed delicately, monetary restriction can curb an inflation—assuming an inflation actually exists. But when the growth of the money supply is chopped away until it approaches zero, and especially when the stock of money falls, depression and unemployment follow. Later the situation is aggravated by anything less than an actively expansionary monetary policy. Probably the most important reason that this result comes to pass is, as Congressman Reuss (Wisconsin) concluded, that the Federal Reserve has the power to "chill off investment quite markedly by starving the money supply" (1467).

Of course, the above description oversimplifies the mechanism that links a change in monetary policy to our economy's performance. It ignores such questions as which groups are the first to be affected, and the timing of the impacts. We do not have complete knowledge about these matters. Fortunately, however, we do not need detailed knowledge of the transmission process. As Prof. Dudley Johnson (Washington) pointed out:

> One can be an empiricist here and say that one observes in the real world that when there is an increase in the stock of money there follows, with some lag, an increase in (national) income (1466).

Further knowledge of the mechanism that links changes in the money supply to changes in the level of business activity should be pursued vigorously. But we cannot afford to act now as if we had no knowledge of the matter. Empirically, the money supply and economic activity are traveling companions, and this fact must be a principal basis of monetary policy. It is enough, to cite a familiar analogous case, to know that aspirin deadens pain, diminishes fever, and acts as an anti-inflammatory agent. Realistically, few would advise against taking aspirin even though doctors know less about the processes involved here than economists know about the monetary process. Decisions to act always are based on incomplete and imprecise knowledge of the link between the action and the result. Indeed, policy decisions normally are made with far less complete and precise knowledge of the transmission mechanism than we now have in the case of the link between the money supply and economic activity.

3. The role of the Federal Reserve: An official view

Some persons prefer to think of the Federal Reserve as exercising control of the flow of funds, or alternatively, credit or bank credit rather than money. This was true of most of the Federal Reserve officials who testified. But though they spoke in terms of the Federal Reserve's actions as affecting bank credit rather than money in the immediate stage of the monetary control process, they informed the subcommittee that ultimately the actions affected economic activity. A colloquy between Congressman Pepper (Florida) and President Hayes (New York) brought this out clearly. Referring to the Open Market Committee, Congressman Pepper asked,

> Now, then, what I was intending to say therefore, was that this body of 12 has the power to determine the amount of credit available to the people of this country, does it not?

The ensuing colloquy is instructive:

> Mr. HAYES. It has a large influence on it.
>
> Mr. PEPPER. Well, I think it has a major influence in that determination, does it not?
>
> Mr. HAYES. That is correct.
>
> Mr. PEPPER. The amount of credit available in this country has——
>
> Mr. HAYES. I would like to insert "bank credit."
>
> Mr. PEPPER. All right. What influence upon the economy of this country does the amount of bank credit available in this country have?
>
> Mr. HAYES. Well, it has a very powerful influence.
>
> Mr. PEPPER. Well, how does it affect the economy?
>
> Mr. HAYES. The theory of it is that——
>
> Mr. PEPPER. I am not talking about the theory. How does it affect the economy, please, sir?
>
> Mr. HAYES. It affects the economy by placing purchasing power in the hands of individuals, corporations, and institutions who presumably will use that purchasing power to spend and to activate or to add to the activation of the economic machine. That is the essential——
>
> Mr. PEPPER. Does it affect the value of the dollar?
>
> Mr. HAYES. Certainly.
>
> Mr. PEPPER. Does it affect the interest rates?
>
> Mr. HAYES. Yes, sir, certainly.
>
> Mr. PEPPER. Does it affect the amount of funds that are available for investment in the country, in capital——
>
> Mr. HAYES. Yes (655).

The point is that, whether the Federal Reserve believes and tries to influence the supply of credit or money when it manipulates bank reserve positions, it ultimately affects the economic environment in its entirety and its particulars as well. In a statement of purposes and functions, cited by Mr. Goldfinger (AFL–CIO), the Federal Reserve's Board of Governors itself put the matter plainly enough for all to understand:

> How is the Federal Reserve System related to production, employment, and to the standard of living? The answer is that the Federal Reserve, through its influence on credit and money, affects indirectly every phase of American enterprises

and every person in the United States. (Board of Governors of the Federal Reserve System, "The Federal Reserve System, Purposes and Functions," p. 2.)

D. PURPOSE AND THEME OF THE HEARINGS

1. Purpose

At the outset of the hearings, the subcommittee indicated that the last revisions of the System, concerned mostly with the open-market function, were born in a depression atmosphere; and that since then much has been learned about economic development, interest rates, the money supply, and full employment. The vast Federal Reserve System, the most powerful monetary network on earth, must serve the needs of the people and their Government, and it was to this objective that the hearings and inquiry were addressed. In his opening statement, Chairman Patman, of Texas, stated:

> We want to make sure that the public interest is the paramount consideration of the Federal Reserve. We want to make sure the Nation's money system is not governed by or for the private interests of any one group.

The Chairman went on to say, in outlining the purposes of the investigation, that—

> In line with this we are vigorously opposed to anything that smacks of unsound money. We want neither inflation or deflation. We seek prosperity and high employment under the terms of the Full Employment Act and we want to be sure that the Federal Reserve System, holding as it does the great monetary power of the United States, serves that end (8).

Thus, the subcommittee undertook a basic examination of the Federal Reserve in its historical development and present functioning.

2. Theme

The question of the Federal Reserve's independence served as the theme of the hearings. Though this question may seem to some persons to be an abstract academic issue, it raises many concrete problems. One is whether economic objectives of the administration and the Congress can be fulfilled in the face of the Federal Reserve's independence. The recent tax cut serves to dramatize the basic difficulty.

(*a*) *Independence and the tax cut.*—On February 26, 1964, President Johnson signed into law H.R. 8363, a bill reducing personal and corporate taxes and aimed at stimulating labor employment and business production. Writing in the summer of 1964, it can be said that whether or not the economic expansion and concomitant growth of employment which the administration and the Congress hoped to achieve by the tax cut will be achieved depends on the future policy of the Open Market Committee of the Federal Reserve System. This committee has the power to nullify the anticipated beneficial effects of the tax cut. If the committee reverses the policy of monetary ease which it has followed since the fall of 1962 and puts into effect a tight money policy, the expansion will not be realized.

The Open Market Committee may fear that the tax cut is going to generate future inflation and an increased balance-of-payments deficit unless it is offset by monetary stringency. The committee may judge that preventing prices and the payments deficit from rising is its No. One priority job, more important than the job of achieving maximum employment. Given this set of judgments, the committee may act to tighten money, even before inflation and an increased payments deficit become realities. Such action would, in effect, nullify the anticipated beneficial effects of the tax cut. As President Johnson said in his economic message to Congress, "It would be self-defeating to cancel the stimulus of tax reduction by tightening money."

(*b*) *The domination of monetary policy over fiscal policy as a practical matter.*—The Open Market Committee may, as a matter of fact, decide to negate the stimulus of the tax cut because its voting members believe—as an ethical principle—that it is evil to live above income; that is, to run a deficit. This possibility is not as farfetched as it might seem at first glance. Chairman Martin told the subcommittee that even though 5½ percent of our labor force now is unemployed—

> * * * as long as we are running a deficit in this country, we have to finance that deficit. And I insist that the major portion of any Federal deficit should be financed out of bona fide savings, and not out of created money (87).

Unfortunately financing the deficit out of "savings" rather than creating money would tend to nullify the effects of the tax cut. Though many find it difficult to understand, the volume of money must grow as population and the economy grow. Additions to the money supply are not necessarily inflationary. In fact, some annual increase is necessary to accommodate growth and avoid deflation and recession. Professor Dudley Johnson (University of Washington) recognized this when he told the subcommittee:

> To the extent that the money authorities * * * force the Government to finance its deficit from the real savings of the community * * * the efficacy of alterations in Government expenditures and/or tax receipts in expanding aggregate demand is reduced, if not completely offset (1443).

Whatever the Open Market Committee decides, it will decide in secret session, and, under present laws, whatever it decides will not be subject to review and possible reversal by any authority or authorities in the country, including the President and the Congress. On the one hand, then, the Federal Reserve can review and reverse the fiscal policy of the administration and the Congress. It can do so in one afternoon at a single meeting of the Open Market Committee. But the administration and the Congress cannot, under present law, review and reverse the Federal Reserve's monetary policy. The administration and the Congress can undo what the Federal Reserve does only by changing the law. Enacting legislation takes much longer than one afternoon—witness the fact that the tax cut, signed into law by President Johnson on February 26, 1964, was proposed initially by President Kennedy on January 24, 1963. The mere fact that this situation exists demonstrates that the continued "independence" of the Federal Reserve raises serious questions of profound political and economic importance.

3. Congressman Patman's bills

Six bills, which have as their collective aim the remaking of the Federal Reserve into a genuine public instrument, were introduced by Chairman Patman just prior to the opening of the hearings. These bills served as the fulcrum of discussion. The bills provided a practical framework within which witnesses could discuss the theme of "independence." Each bill relates to a specific aspect of the overriding question of the Federal Reserve's so-called independence.

Briefly, H.R. 3783 "provides for the retirement of Federal Reserve bank stock." It thereby would eliminate some of what Secretary of the Treasury Dillon called "Vestigal elements of an earlier conception of private participation in central banking policies * * * still visible" (1233).

H.R. 9685 "provides that interest received by Federal Reserve banks on U.S. Government securities shall be covered into the Treasury," and as a corollary, requires the Federal Reserve to obtain such sums as may be necessary to pay its expenses from Congress. The bill clearly would terminate the Federal Reserve's ability to undertake new spending programs and even to continue many old ones without obtaining congressional approval. But it is by no means clear that subjecting the Federal Reserve to the standard appropriation procedures to which most other Government bodies are subjected could affect monetary policy.

H.R. 9631 provides for the abolition of the Federal Open Market Committee, and in its place authorizes the Federal Reserve Board to conduct open-market operations by instructing the Federal Reserve banks. The Board would be required to govern its open-market operation, not only with a view to "accommodating commerce" and with regard to the "general credit situation," but "in coordination with the policy and responsibility of the Federal Government as set forth in section 2 of the Employment Act of 1946." H.R. 9631 also sets forth particulars concerning the size, tenure, and selection of the Board of Governors. The set of particulars provided here is just one of many possible sets that would, if adopted, reduce the Federal Reserve's power to veto the policies of the Congress and administration. In addition, H.R. 9631 provides for an audit of the expenditures of the Federal Reserve Board and the Reserve banks by the General Accounting Office.

H.R. 9749 instructs the Federal Reserve to support Government securities "when market yields equal or exceed 4¼ percent." This bill limits the Federal Reserve's freedom of action with respect to monetary policy itself. Currently the Federal Reserve is not limited by any instruction. Indeed no guideline or set of guidelines is now given by the administration or Congress on monetary policy. But Congress has the power to instruct the Federal Reserve to do certain things under certain circumstances. Alternatively, Congress can set forth guidelines for monetary policy or require administration formulation of such guidelines. H.R. 9749 is just one of many possible ways in which Congress might give instruction or guidance to the monetary authorities. Others also were discussed during the hearings.

H.R. 9686 and H.R. 9687 are only indirectly related to the Federal Reserve System. The former provides for the payment of interest on the Government's tax and loan balances in commercial banks and for reimbursement of banks for services performed for the Treasury as well. The link between H.R. 9686 and the Federal Reserve is that the current way of handling tax and loan balances prevents the Treasury's operations from causing disequilibrating flows of money into and out of the banking system, and the present way of handling these balances allegedly could not be continued if the banks had to pay interest on them. Thus passage of H.R. 9686 supposedly would cause disequilibrating flows of funds into and out of the banking system and thereby complicate the Federal Reserve's job. H.R. 9687 also would complicate this task. For this bill would allow banks to pay interest on demand deposits and it is argued that if this were permitted, interbank flows of funds would rise sharply.

The scope of the hearings was not limited to these six bills. The theme of the hearings was the System's "independence." The bills express this important problem in concrete terms and thereby served as the fulcrum for discussion. But witnesses were not confined to this problem alone. The subject of the hearings was the Federal Reserve System. Representative Charles H. Wilson (California) stressed this point in a question he put to President Hayes (New York). He asked:

> Mr. Hayes, * * * by your own words here you were invited to participate in a series of hearings on the subject of the "Federal Reserve System After 50 Years." Now, that's a pretty broad subject. It does not seem you are being limited. You were not instructed that you cannot speak about different phases of the System, or you could not make recommendations to us, or that you were being held back in any way on what you could bring to our attention in any way, were you?

Mr. Hayes answered "No" (640).

PART II.—INDEPENDENCE

A. THE FEDERAL RESERVE'S INDEPENDENCE AS A MATTER OF LANGUAGE

1. Part of Government or allied to Government

There is some confusion about the meaning of "independence" as it applies to the relation of the Federal Reserve to the Government. To some Federal Reserve officials it was a question, as President Bopp (Philadelphia) put it, of "the degree of independence within Government" (740). Others discussed the potential loss of independence in terms of nationalization. President Ellis (Boston) did this when, in referring to Mr. Patman's bills, he commented:

> Taken as a group, these proposals amount to a nationalization of the country's central bank (269).[1]

Still other officials of the System distinguished between the Board of Governors and the Reserve banks and asserted that the 12 Federal Reserve banks are, as President Hayes (New York) put it, "allied to Government but not part of Government" (536).[2] But it must be noted that Chairman Martin disagreed with this. He told Congressman Reuss (Wisconsin):

> Let me say, Mr. Reuss, that I don't concede that the presidents of the 12 Federal Reserve banks are private individuals (38).

2. Independence defined as the authority to act independently and the argument for the continuation of this authority

Though Federal Reserve officials differed on whether the Federal Reserve banks constitute a part of the Government or merely are allied to it, there was complete agreement among them, and the other witnesses as well, on the legal right and authority of the Federal Reserve Board and the Open Market Committee, the two policy-making bodies of the System, to make policy independently of the administration and the Congress. And this is precisely what independence means as it applies to the relation of the Federal Reserve to

[1] Some indication that important segments of the commercial banking community carry this argument to its logical conclusion and think of the Federal Reserve as a private organization, which the Congress has hired on an eternal contract basis to help the Government achieve desired economic goals, is provided by a March 1964 pamphlet issued by the Manufacturers Hanover Trust Co., which contains remarks of the bank's consulting economist, Prof. Marcus Nadler (New York University) on the independence of the Federal Reserve. The pamphlet, of course, states: "The opinions expressed are Dr. Nadler's * * *." On the particular question at hand, Dr. Nadler remarked, "The Patman recommendations, if enacted, would undermine the independence of the Federal Reserve System and for all practical purposes would make the Reserve Board a branch of the Government * * *. As a creature of Congress, the Reserve authorities must consider the broad economic policies of the administration and assist it to achieve the desired economic objectives * * *. The nationalization of the Reserve banks and the conversion of the Federal Reserve System into a branch of the Government would constitute a serious blow to the economic system of the country."

[2] In fact, the words are Allan Sproul's. Quoting them, Hayes said, "I agree fully * * *" (536).

the Government. The argument for continuation of independent authority was made by Chairman Martin when he stated:

> Because money so vitally affects all people in all walks of life as well as the financing of the Government, the task of credit and monetary management has unique characteristics. Policy decisions of an agency performing this task are often the subject of controversy and frequently of a restrictive nature; consequently, they are often unpopular, at least temporarily, with some groups. The general public in a democracy, however, is more apt to accept or tolerate restrictive monetary and credit policies if they are decided by public officials who, like the members of the judiciary, are removed from immediate pressures.
>
> There is a long-established tradition both in this country and in other democracies that the proper exercise of reserve banking functions requires that it be insulated against private or public pressures * * * (23).

Scholars would caution that in most other democracies central banks currently are, literally not merely figuratively, arms of the political authorities. This point need not be pursued here. A summary of the relations between central banks and governments in other democracies today was submitted for the record (889–892) by President Irons (Dallas) in response to a request by Congressman Widnall (New Jersey). Regardless, what is important here is that most would agree with Chairman Martin that, as a matter of language, independence means insulation from public pressures, especially as these pressures are expressed by the President. As Professor Strotz (Northwestern) stated:

> By an independent central bank we mean, of course, one whose authority is substantially independent of the executive wing of the Federal Government (1451).

Mr. Kelly, the president of the American Bankers Association, put it this way:

> * * * the Federal Reserve is independent in the sense that its policies and operations are not subject to direct management *or determination* by the President (1905). [Emphasis supplied.]

The fact that monetary policy is not subject to direct management or determination by the President is a measure of the degree of the Federal Reserve's independence. Ordinarily, so-called independent administrative bodies are not subject to the direct management by the executive branch of Government but their policies are, in the final analysis, determined by the executive or, alternatively, by clear-cut legislative guidelines.

3. Finality of the Federal Reserve's decisions

Unlike other independent decisionmaking bodies such as the FTC and ICC, the decisions of the Federal Reserve are not subject to outside review and so cannot be reversed. This awesome fact was brought out in colloquies between Congressman Pepper (Florida) and President Deming (Minneapolis) and President Hayes (New York). The relevant questions and answers follow:

(*a*) *Colloquy between Representative Pepper and President Deming.*—

Mr. PEPPER. Suppose the President would write a letter to the Federal Reserve Board and say, "Dear Mr. Chairman, I enclose a copy of my message recently delivered to the Congress, and I think it would be in the national interest if the Federal Reserve System, through all the functions that you exercise, would implement the declaration of the policy that I have made, and I shall appreciate and look forward to your cooperation." What would be the effect of that?

Mr. DEMING. Well, I think in this case the Open Market Committee, if it were to get such a letter, would reply that this is always the policy of the Open Market Committee, to attempt to have as strongly a growing economy as we can have, and * * *.

Mr. PEPPER. Would not you consider it sort of an inappropriate thing, like trying to talk to a judge in the backroom?

Mr. DEMING. I do not think the President would write such a letter, myself. I do not have any case—I do not know of any case in history where he has, but the——

Mr. PEPPER. But it accentuates the fact that under the present system the Government does not have any direct way of influencing the decisions of this committee that has so much to do with the economy of the country.

Mr. DEMING. Well, the committee is fully cognizant of the position against poverty.

Mr. PEPPER. Thank you, very much.

Mr. DEMING. And it is completely sympathetic to it (726).

(*b*) *Colloquy between Representative Pepper and President Hayes.*—

Mr. PEPPER. Under the law, is there any right of review of the decisions made by the Open Market Committee?

Mr. HAYES. I am not sure I understand, Mr. Pepper.

Mr. PEPPER. I mean you make decisions relative to the functions of the Open Market Committee. Is there any other body which has the right of review of your decisions?

Mr. HAYES. I think not.

Mr. PEPPER. So, then, you are an independent body, consisting of 12 citizens of the country, chosen as provided by law, and you exercise your discretion, not subject to review by any other authority or authorities, in making the decisions that you say are perhaps the most vital decisions made affecting the economy of the country. Is that true?

Mr. HAYES. Well, I spoke a little hastily. Obviously, the Congress which set us up has the authority and should review our actions at any time they want to, and in any way they want to. And we welcome for that reason any hearing like this, or any other investigation that the Congress may wish to make of us.

But we are a creature of Congress. So I certainly would not want to——

Mr. PEPPER. But while Congress, you might say, appropriates the money to provide for the U.S. Supreme Court, we don't have any right to review their decisions——

Mr. HAYES. I think there is a constitutional difference. I am not a lawyer but obviously there are three departments of Government. We are specifically under Congress (633).

The colloquy between Mr. Pepper and Mr. Hayes resumed a few minutes later and this part of their dialog demonstrates the almost total finality of the Federal Reserve's independent policymaking authority.

Mr. PEPPER. So to get back to the inquiry I made a few minutes ago, this Open Market Committee, consisting of 7 members appointed by the President and confirmed by the Senate, and 5 members elected by the Federal Reserve System of the country, a body of 12, that Board which, as you said a while ago, is not subject to any review by any authority or authorities in this country——

Mr. HAYES. Other than Congress, Mr. Pepper.

Mr. PEPPER. Well, excuse me. You can be abolished or new laws can be made by the Congress but this is the Banking and Currency Committee of the Congress, and we do not have any right to review your committee unless we change the law.

We, for example, can abolish inferior Federal courts under the Constitution but we have no right to review their decisions.

Now, are we not in the same relationship with the Open Market Committee? Congress can abolish it but we have no right to review the individual decisions which that committee makes.

Mr. HAYES. Well, by legislation you can do anything you want.

Mr. PEPPER. I mean under the present law.

Mr. HAYES. Under the present law that is correct (654).

(c) *The difficulty of enacting new law.*—An appropriate postscript to the above dialogs was added by Chairman Patman (Texas) when he observed that enacting legislation is a difficult and time-consuming process. He put the matter this way:

You know, in a democracy such as our own there are a lot of people who have bottleneck positions, any one of whom can say "No" and make it stick, but there is not one person in the United States who can say "Yes" and be absolutely sure. They just cannot do it.

Now, when you go to making legislative changes you first introduce a bill that is referred to a subcommittee. The subcommittee chairman can stop it if he wants to.

Then it passes out and it goes to the whole committee, and the whole committee chairman can have a lot of influence on it, and it can stop there.

Then it has to go through the leadership of the House and then the Rules Committee and those four bottlenecks—that is not all—just those four we see every day.

And then in the Senate it is the same way. So the chances of getting something really meaningful but opposed by an entrenched interest in this country, that is profiting so much by occupying a position that gives them special privileges, are rather remote because it takes only a few to stop things while a majority cannot always actually accomplish things.

So we have those deterrents to changes. So we should not speak of them glibly in that we can just go to Congress and get something done right quick. We just cannot do that (1113–1114).

B. RELATIONSHIP OF THE FEDERAL RESERVE'S INDEPENDENCE TO THE PRESIDENT'S RESPONSIBILITIES UNDER THE EMPLOYMENT ACT OF 1946

The fact that the Federal Reserve's relation to the President and Congress has not changed since 1935 is itself extremely significant. Totally new concepts concerning the economic functions of the President and his responsibility for the results of monetary policy were given legislative substance in 1946 when Congress passed the Full Employment Act and charged the President with achieving "maximum employment, production and purchasing power." This act, in the words of Professor Miller (George Washington):

> * * * is of such basic importance that it takes on the character of a constitutional amendment, is the basic charter under which government affirmatively seeks to improve the American economy and also the economic well-being of the American people (1681).

1. The Federal Reserve's assumption of the Employment Act's goals

Congress did not redefine the relations of the Federal Reserve to the President when in 1946 it enacted the full employment law and thereby profoundly changed the economic duties and responsibilities of the President. Furthermore, it also is significant that for about a year after passage of the Employment Act, no reference to it, not even the fact that it had been passed, was made in the monthly publication of the Board of Governors or in the System's annual report.

Since 1946 our understanding of the importance for achieving the goals of the Employment Act, of Federal Reserve policy in general, and that of the Open Market Committee in particular, has increased significantly. The relationship of monetary policy to the 1946 law now is well understood by most Federal Reserve officials, as well as by professional economists. Chairman Martin put it this way:

> I would subscribe fully to the view that the Open Market Committee is concerned with maximum production, maximum employment, and maximum purchasing power—that those are its objectives and purposes (35).

Every Reserve official agreed with the sense of this.[3] Moreover, some expressed concern that Members of Congress, as President Scanlon (Chicago) stated—

> * * * appreciate that Federal Reserve credit policy is, in fact, carried out with a view to achieving the objectives of the Employment Act of 1946 (527).

[3] Some, however, tended to obscure Chairman Martin's clear-cut statement of purposes by inserting the noncognitive term "sustainable" between "maximum" and "employment."

2. How independent action by the Federal Reserve makes it impossible for the President to carry out his mandate under the 1946 Employment Act

Federal Reserve policy is, as affirmed by official statements, determined with the goals of the Employment Act as policy targets. But the fact that Federal Reserve policy is made independently of the views (as well as the management) of the President makes this law meaningless. Professor Reagan (Syracuse) recognized this when he said:

> The President is required by the Employment Act to submit an economic program, such a program must include recommendations on monetary policy to be meaningful. Thus the President must be, as H. Christian Sonne has said, "the coordinating agent for the whole national program." If the Congress wishes to hold the President responsible for economic policy, and if the electorate thinks of him as responsible (as is clearly the case) then he must be given authority commensurate with his responsibilities (1577).

This means authority to decide monetary policy or at least to nominate those who do decide it.

Professor Miller (George Washington) put it this way:

> I should think that if the objectives of the Employment Act are to be attained, as I believe they should, it is of the highest importance that the policies of all organs of government be consistent with each other; that, in other words, there be a high degree of congruity in economic policy. It is my understanding that at present such congruity, if it is reached, is attained through a policy of consultation and coordination; but that, however, there is no legal requirement for the Federal Reserve Board to coordinate its policies with the Treasury Department. This to me violates at least two principles:
>
> (*a*) In the first place, it makes congruity of policy a matter of accident of personality and of whether or not given government officials get along well enough together to cooperate rather than fight (1681).

On this matter, an answer to a question put to him by Congressman Widnall, of New Jersey, by Professor Gordon (Carleton University, Ottawa) is especially relevant. Referring to the clash of personalities which precipitated the Canadian economic crisis of 1956–61, Professor Gordon remarked:

> Well, I believe, myself, sir, that a structure should always be designed to provide for the existence in positions of authority of inappropriate personalities (959).

The second principle Professor Miller thought to be violated by the lack of formal coordination is this:

> (*b*) Secondly, the Federal Reserve Board, in all of its operations, seems to be an independent organization, not responsible or accountable to any official, including the President * * *. To the extent that the Board operates autonomously, it would seem to run contrary to another principle in our constitutional order—that of the accountability of power (1681).

The heart of the matter is that the Federal Reserve's structural independence and so insulation from the President and, under today's law, from the Congress as well, means that the Employment Act of 1946 is simply not enforceable. The President cannot, as he is required to do by the Employment Act, submit a program that is likely to be effective in achieving the goals of the law unless the Federal Reserve is willing to cooperate. There is no assurance that the required cooperation will be forthcoming. Moreover, the President's program will not have even the proverbial "ghost of a chance" if the Federal Reserve decides upon a perverse monetary policy. Thus the President's program is really not a working program but a vision, the fulfillment of which depends on the policy of the independent Federal Reserve.

3. Showdown not a realistic alternative to Presidential authority

Leon H. Keyserling pointed out that Federal Reserve executives "take policy steps clearly in conflict with the policies of the administration when they so desire" (1843). There is no assurance that the President could compel the Federal Reserve to do what he thought was in the public interest if the Chairman and a majority of the other 11 members of the Open Market Committee, or simply a majority without the chairman, did not want to do so. Moreover, it could be politically inexpedient for a President to force a public showdown with the Federal Reserve's Chairman over anything, except a "life and death" issue. An article appearing in the Wall Street Journal, which was put into the record by Congressman Brock (Tennessee), indicates that a showdown between President Johnson and the Chairman would be politically very risky:

> If he [Martin] were forced out of his post—or just irritated into indignant resignation—the impact upon this administration could be profound * * *. Republicans would be handed on a platter their first convincing evidence that this Democrat [Johnson] has no sense of economic responsibility (1427).

Past experience teaches that even strong disagreements tend to evaporate rather than to be resolved. On this, Secretary Dillon's answer to a question by Congressman Brock (Tennessee) is enlightening. Mr. Brock asked:

> Is it really possible for you to have a violent disagreement? I mean, these are not black and white decisions in most cases. Are they not mostly a gray area? You have a number of experts that disagree within the Treasury, as they do within the Fed?

Secretary Dillon answered:

> I think that is correct. I think it would be unusual to have—certainly in the spirit in which we have been working in the 3 years that I have been here I have not seen any—real black and white basic differences of opinion.
>
> However, if you had strong-minded individuals on either side, even if it were gray area issue, they might strongly differ with each other. We have not had that sort of a situation in the last 3 years.

> I think there have been some differences of opinion in the past. I think there were some differences of opinion on a number of occasions—probably on one or two occasions during the preceding administration—that were quite strong, but after a time they evaporated (1264).

The hard truth is that unless the administration is willing to force a showdown it cannot change Federal Reserve policy. Its spokesmen may nag privately and for a time even disagree publicly, as Secretary Humphrey and Mr. Burgess did in 1956 and 1957. But it is not likely to make a major issue over monetary policy if it is a question of reducing unemployment 1, or even 2, or possibly 3 percentage points. Monetary economics is a complex subject and it would be difficult to explain to the general public how a slightly more expansive policy could achieve a 1, 2, or even 3 percent fall in the rate of unemployment.

In essence, then, structural independence of the Federal Reserve from the President and the President's responsibilities under the Full Employment Act are both logically and practically inconsistent. Congress must decide which of the two it wants. We can't have both. What we have now is independence of the Federal Reserve and lip-service to the proposition that the President is responsible for coordinating "all plans, functions, and resources" to achieve "*maximum* employment, production, and purchasing power." [Emphasis added.] He is simply not responsible for what the Federal Reserve does with the monetary powers of the Nation.

4. The absurdity of the situation

Since what the Federal Reserve does is perhaps the most important determinant of levels of employment, production, and purchasing power, the President cannot in any meaningful sense be held responsible for achieving the objectives of the Employment Act as long as the Federal Reserve's independence of his views is preserved. The absurdity of the situation was pointed out by many witnesses. Prof. Dudley Johnson (Washington) put it this way:

> To argue that the control over the money supply should be independent of the values of certain representatives of the citizenry in a democracy strikes me as ludicrous. It is as if Congress were to create a Department of War and Peace and the President of the United States would appoint a Board composed of seven members for terms of 14 years, with the terms arranged so that one expires every other year. Now this Board would have the exclusive jurisdiction to decide whether or not the United States would or would not go to war (1444).

In a similar vein, Professor Raskind (Law and Economics, Vanderbilt), commented as follows:

> When the President, who is authorized in the limit, to make decisions involving nuclear war, is barred by statute from responsibility from the monetary component of economic stabilization policy, the need for change is apparent (1669).

Mr. Keyserling put the matter in terms of both our current economic policy and traditional political philosophy. He observed:

> The President and the Congress, in the Nation's interest as they see it, have recently undertaken a contrived Federal deficit of unparalleled size. This tax action, for all practical purposes, is irreversible for many years to come. It will confront the Government with many thorny problems for many years to come. Can it be argued with any rationality, under the circumstances, that the Government has no direct and proximate interest in the extent to which the management of the people's money—which in fact is created by the Government—advances or impedes the objective of this momentous step in tax and fiscal policy? Can a deflationary monetary policy be permitted to cancel out, in whole or in part, an expansionary fiscal intent?
>
> I submit, in conclusion, that we have moved far beyond the point when any one impregnable citadel of policy formulation, affecting profoundly the totality of our objectives as an economy, a nation, and a people, can remain "independent" of that ultimate responsibility to the people through their Government which is the very hallmark of our democracy and our free institutions (1761).

C. CENTRAL BANK INDEPENDENCE AS A MATTER OF GENERAL THEORY AND HISTORY

1. Central bank independence and monetary stability and instability

The case for making a nation's central bank independent of the political representatives of its people is that insulation is necessary to prevent abuse of the money-creating powers of government and resulting monetary and economic instability. But this hypothesis was not supported by decisive empirical evidence or logical deduction by Chairman Martin or any other witness who asserted its validity.

As it was set forth by Chairman Martin and its other proponents as well, the proposition appears one-sided. Simply stated the contention is that if the System were to lose its independence from public pressures there would be excessive creation of money and resulting inflation. It is not contended that insufficient money creation and persistent unemployment would result, though this is logically an equally likely result.

Case histories of hyperinflation were cited by Federal Reserve officials, Mr. Kelly (ABA), and Secretary Dillon by way of attempting to demonstrate that the money-creating powers of Government can be abused. No one would deny the possibility of such abuse. The question, however, is which sort of institutional arrangements are apt to lead to abusing the money-creating powers of Government. More often than not, severe or hyperinflation have occurred in countries run by dictators, not in democracies. Thus a central bank which is insulated from the public would appear more apt to generate hyperinflation than a truly public monetary authority. Certainly the 1950 inflation in Paraguay, which both Governor Daane and Secretary Dillon referred to, illustrates the danger of insulating Government in general and the money-creating powers of Government in particular, from the pressures of the people; for, as Chairman Patman pointed out, Paraguay is governed by a dictator and is not a democracy. Paraguay has been governed by one political party with the army's support since 1943. Elections have been formalities wherein the people can only vote "yes," affirming the party's (and the army's) candidate. The 1945–55 Argentine inflation cited by Secretary Dillon is another example of the danger of insulating the money-creating powers of Government from the people; for these were the years of Peron.

Cases in which an insulated, and so independent, monetary authority abused its powers by following the deflationary policies to excess also have occurred. Canada in the 1956–61 period provides an example. During this period the independent Bank of Canada was pursuing a tight money policy; even though 10 percent of the labor force was unemployed. Referring to that occasion, Professor Gordon (Carleton University, Ottawa) stated:

> The Minister of Finance was questioned in the House concerning the policy and he denied that he had anything to do with the policy or was responsible for it (959).

Other examples could be cited. Indeed, Professor Friedman (Chicago) stated that in the case of the independent Federal Reserve—

> The chief defect in Federal Reserve policy has been a tendency to go too far in one direction or the other, and then to be slow to recognize its mistake and correct it. Contrary to widely held views, the major mistakes of this kind in peacetime have all been in a deflationary direction * * * (1135).

Thus, as Prof. Harry Johnson (Chicago) pointed out, the assumption that an independent central bank will govern monetary policy flexibly and efficiently and in the best interests of the country—

> is not consistent with the historical evidence of the behavior of monetary authorities; the evidence is rather that central banks have done little if anything to restrain inflation in wartime * * * while in peacetime they have displayed a pronounced tendency to follow deflationary policies on the average (970).

Insulated central banks, in short, do not protect against but in fact have caused both inflations and depressions. Professor Friedman put it this way:

> Experience shows that independent monetary authorities have introduced major elements of monetary instability, and analysis suggests that they can be expected to continue to do so (1134).

2. Responsibility and independence

(*a*) *Independence and the impossibility of assigning responsibility.*—As indicated, Professor Friedman also argued that logic, or as he puts it, analysis, suggests that an independent monetary authority can be expected to produce economic instability. In an article submitted for the record he wrote:

> One defect of an independent central bank * * * is that it almost inevitably involves dispersal of responsibility * * *. In the past few years, I have read through the annual reports of the Federal Reserve System from 1913 to date, seriatim. One of the few amusing dividends from that ordeal was seeing the cyclical pattern that shows up in the potency that the authorities attribute to monetary policy. In years when things are going well, the reports emphasize that monetary policy is an exceedingly potent weapon and that the favorable course of events is largely a result of the skillful handling of this delicate instrument by the monetary authority. In years of depression, on the other hand, the reports emphasize that monetary policy is but one of many tools of economic policy, that its power is highly limited, and that it was only the skillful handling of such limited powers as were available that averted disaster. This is an example of the effect of the dispersal of responsibility * * * no one assumes or is assigned the final responsibility (1170–1171).

Professor Lerner (Michigan State) put the argument this way when he observed:

> Independence of the monetary authority from the Executive in matters of policy, even if both do the best they can in the public interest, leads to fiscal and monetary policies working at cross purposes, defeating each other's objectives. It enables both the Executive and the monetary authority to blame each other for whatever happens to the economy (1400).

(*b*) *Independence and the possibility of evading responsibility.*—An independent central bank can, of course, benefit an inept political administration. Such an administration can shirk its responsibility because, as Prof. Harry Johnson observed:

> The monetary authority can easily be cast as a scapegoat * * * (972).

This is certainly a disadvantageous byproduct of central bank independence. But the primary defect of insulating the central bank from the political processes and assuring that its officers do not have to pay for failing to perform well is that the central bank itself can shirk its responsibilities. Thus, independence raises the specter of major mistakes being committed, such as those that were committed in the early 1930's by the then completely independent Open Market Committee. The danger of such a catastrophe occurring in the future was brought into common view by Representative Vanik (Ohio) and Secretary Dillon. Mr. Vanik asked:

> But can you conceive of a situation where the Fed may take some very, very tremendous action and the barn would burn down, and we would be pretty powerless to do anything about it except to try to correct it on the next go around?

Mr. Dillon answered:

> It is theoretically possible, yes. (1250).

History, of course, warns us that the theory in question is, unhappily, valid.

(*c*) *The meaning of responsibility.*—Because insulated central bankers can shirk their responsibility it is important, as Chairman Patman recognized, to link the central bank to the political administration. If something goes wrong the people then are assured of "being able to blame somebody they had something to do with putting into office." Professor Gordon (Carleton University, Ottawa) in commenting on Chairman Patman's remarks also indicated the necessity of achieving a political tie. He stated:

> We mistake the question of responsibility very often. We think of the responsibility of a public official in terms of his personal integrity. However, responsibility really means being responsible to some other body and eventually to the people at large (960).

The powers of a central bank may be exercised by men of the highest integrity, but the bank cannot be said to be responsible unless its officers, or alternatively, their nominators, are subject to the election process. "Power under a constitutional order," Professor Miller (School of Law, George Washington University) pointed out, "means accountable, i.e., responsible power." (1684.)

3. Bad effects of not being able to assign blame

(*a*) *Learning made unnecessary and policy inflexible.*—The problems created by institutional arrangements which fail to assign responsibility for error are familiar to all students of comparative economic systems. One of the great weaknesses of Socialist political economies is that they have no way of assigning accountability where it belongs. Thus, for example, a few years ago Soviet Premier Khrushchev complained about the production of cars without tires. But he did not know whether to blame automobile factory managers for exceeding their quotas, tire plant managers for not meeting theirs, or any of the several suppliers of materials to tire plants. In our profit system a mistake like this would occur, but whoever was responsible for it would be detected quickly by impersonal market forces and punished by these same forces. He certainly would lose money and perhaps he would even be compelled to seek new employment for himself and his capital. But this is the very strength of the profit system. For by fixing responsibility it insures that adherents of once fashionable dogma and also incompetents will either learn their business and jobs or give way to those who can and will learn. And thus our profit system succeeds by what is essentially a learning process.

An independent central bank is heir to weaknesses similar to those of a socialistic economy. For by virtue of the central bank's independence, central bankers do not have to bear final responsibility. It is not enough to say, as Chairman Martin did:

> Now we do bear the slings and arrows of the public. You are in the position of being able to blame us if it goes wrong (96).

Recent history proves otherwise, however. Insulated central bankers can terminate all inquiry simply by saying, as Chairman Martin so often does when someone tries to clarify the role of the Federal Reserve in particular historical episodes, "You and I don't read economic history the same way."

Because they do not have to worry very much about being blamed and paying for their mistakes, insulated central bankers are not apt to learn from them. In practice this means that independent central bankers are not likely to acquire knowledge of the processes on which they are acting; and so, they are not likely to develop sound operating methods. It also means that central bank policy will be *inflexible*, and, in turn, that bad policies are likely to be perpetuated. These structural flaws were recognized by Prof. Harry Johnson (Chicago) when, referring to the economic instability misguided monetary policies have generated, he observed:

> These defects are in my judgment inherent in the conception * * * of an independent monetary authority, and are unlikely to be modified greatly * * * on the basis of accumulated experience and research (970–971).

Failure to do substantive research in monetary economics is still another flaw of the Federal Reserve which derives from its independence. Many witnesses complained about this failure. To quote Professor Bach (Carnegie Tech)—

> The Fed deserves criticism for its failure to push more actively on the fundamental research that must be done to continue to improve further our monetary policy (1390).

(*b*) *Reliance on strong personalities.*—This tendency for deleterious policies and misguided methods to persist is reinforced by the tendency for central bank independence to produce a "cult of personality." Professor Friedman brought this out when he observed:

> Another defect of the conduct of monetary policy through an independent central bank that has a good deal of leeway and power is the extent to which policy is thereby made highly dependent on personalities. In studying the history of American monetary policy I have been struck by the extraordinary importance of accidents of personality * * *. A similar situation prevails today. The actions of the Reserve System depend on whether there are a few persons in the System who exert intellectual leadership (1171–1172).

The dependency of an independent central bank's policies on personalities together with the fact that insulation means that responsibility won't be affixed in the event of error tends to perpetuate inappropriate policies and operating methods. For there are no compelling reasons for insulated authorities to admit error, and it always is difficult for men, especially strong personalities, to admit that a specific institutional decision they made was wrong. Of course, in a democracy it doesn't matter whether those in error will admit being wrong. As Chairman Patman put it, in a democratic Republic like the United States—

> The politicians have responsibility. If they don't carry out the will and wishes of the people, they are defeated (62).

But an independent, politically insulated central bank, by definition, is not a democratic institution. Its officers are insulated from, and so need not be responsive to, the public will. Its intellectual leaders need not learn from mistakes. Thus inappropriate policies and actions tend to be perpetuated. There is nothing in the structure of independent central banks that compels or impels correction.

(*c*) *The sensitivity (not accountability) of independent central bankers to public opinion and the temptation to propagandize.*—The fact that independent monetary authorities need not be responsive to public opinion does not mean that central bankers are insensitive to public opinion. They are sensitive. But as Prof. Harry Johnson (Chicago) put it, an independent central bank's—

> position as the one agency of economic policy formation outside the normal political structure both exposes it to subtle and sustained political pressures and forces it to become a political animal on its own behalf, devoting considerable effort, either to justifying its policies * * * or to denying responsibilities * * * (971).

In other words, independence permits central bankers to substitute linguistic acrobatics for actual flexibility. A truly flexible policy, one that responds quickly to changes in economic conditions, requires that decisions be made by men who must pay some sort of penalty for monetary and economic instability. Unless this condition is met, and it is not likely when the central bank is independent, policy and operating methods will tend to be inflexible and errors to be perpetuated.

D. INDEPENDENCE AND THE PROBLEM OF COORDINATION

1. The necessity of achieving coordination

Another weakness inherent in an independent central bank is that monetary and fiscal policies are not coordinated. Every economist who testified saw the necessity for coordination. Said Professor Barger (Columbia)—

> Coordination of monetary policy with the general economic policy of the President obviously is necessary * * * (1354).

Of course no Federal Reserve official denied this. In fact, all claimed the desired coordination was currently being achieved at informal luncheons and the like. But for many this sort of arrangement is not enough. Prof. John Gurley (Stanford) put it this way—

> "Independence" is a good word, and so many people think that the independence of the Federal Reserve is a good thing. But it is not a good thing. It is like having two managers for the same baseball team, each manager independent of the other. The managers could get together for lunches once a week; that might help. Or one of them could try to offset the actions of the other—that might work a bit. Nothing of this sort, really, would correct the basic situation, the intolerable arrangement of having two managers (1309).

Thus limited informal advisory efforts to coordinate policy aren't enough to assure coordination. The Chairman of the Federal Reserve may meet with administration officials. They may even agree—though they need not and often have not. But most important, the Chairman of the Federal Reserve cannot commit the system to a course of action. He has only one vote on the 12-man Open Market Committee. This crippling limitation on the "lunch meeting" method of coordinating monetary and fiscal policies was brought into common view by a colloquy between Representative Minish (New Jersey) and Secretary Dillon. The dialog is as follows:

> Mr. MINISH. * * * Mr. Secretary, on page 3 of your testimony it says that Presidents Kennedy and Johnson have continued the practice of meeting from time to time with the top financial officials of the administration.
>
> Chairman Martin, it says, has participated fully in these discussions. How fully can he participate if he has to go back to the Board and the Open Market Committee for directions?
>
> Secretary DILLON. Well, he can participate fully from the point of view of explaining the considerations that are topmost in the minds of both the Board and the Open Market Committee, because he meets with the Board and Open Market Committee every 3 weeks. And, therefore, it is not at all difficult for him in this sort of a meeting to either explain very clearly what he thinks their views would be or to take back to them the views of the President. * * *
>
> So, I think it has been a very useful two-way thing, so that the President and the other financial officers of the Government understand what is motivating the Open Market Committee and the Board and what they are thinking about, and they, in turn, get absolutely straight first hand from the President himself his own desires in the field of economic and monetary policy.
>
> Mr. MINISH. So that he can only get the views of the people that he is dealing with until he gets further directions from the Open Market Committee?
>
> Secretary DILLON. Well, yes, as I pointed out in my prepared statement, he cannot commit the Open Market Committee or the Board to any specific action.
>
> He can commit himself to trying to obtain action, if he wishes to, and at times I think that has been the case. But he cannot commit the Board (1255–1256).

Professor Gurley proceeded to point out one of the many unreasonable situations that result from the separate formulation of monetary and fiscal policy. He stated:

> That we have a separate manager for monetary policy gives rise to unreasonable situations, such as the President of the United States trying to use moral suasion on the Federal Reserve, hoping that it will not nullify the good effects of the tax reduction. * * * (1309)

It was precisely this problem of assuring a coordinated economic policy that led Professor Villard (CUNY) to assert,

> I am prepared to compromise the independence of the Federal Reserve in order to achieve overall coordination of economic policy (1022).

Dr. Warburton (FDIC) put it this way—

> Proper administration of monetary policy is so vital to national welfare and the success of other Government policies that it should be a responsibility of a top-ranking official and appropriately coordinated with the executive branch of the Government (1319).

Professor Strotz (Northwestern) used an especially colorful imagery to project the need for coordinating monetary, fiscal, debt, and other national economic policies when he stated:

> Thus, from every limb of the puppet go many strings held by different authorities, all of whom may have different intentions as to how the puppet is actually to perform—and in the midst of a windstorm. In such a situation, who can dispute the need for coordination of the many different puppeteers? The notion of an independent monetary authority set up to achieve a particular goal, such as price level stability, is, in any practical context, very unrealistic (1453).

2. A byproduct of not integrating monetary and fiscal policies

Failure to coordinate monetary and fiscal policy, then, can lead to negation of one set of fiscal policies, and thereby the substitution of a less desirable set of fiscal policies; for no administration can allow its overall economic policies to fail and long endure. Prof. Eli Shapiro (Graduate School of Business, Harvard) called attention to this possible byproduct of not coordinating monetary and fiscal policy. The point is that an independent monetary authority can create an insufficient money supply and thereby impel, if not compel, the adoption of fiscal deficits. Professor Shapiro put it this way:

> Since policy decisions are made by different agencies and since these decisions require trade-offs to be made among the various goals, our stabilization strategy requires coordination among the agencies to insure the pursuit of a common end. For if one agency takes price stability to be the critical goal and pursues policies appropriate to the attainment of that goal, while other agencies deem full employment or economic growth to be the more important objective of policy, we will observe conflicting policies which may indeed prevent the attainment of any of these goals.
>
> For example, if the central bank, in its interest in price stability, maintains a monetary policy which dampens demand, the fiscal policy of the Government in attempting to offset this policy will be forced to run larger deficits (1099–1100).

The point which Professor Shapiro made also was stressed by several Congressmen. Representative Hanna (California), in a dialog with Professor Samuelson (MIT) pointed out:

> * * * is it not basic here that one of the reasons that we cannot have members of the Board (and OMC) too independent is that their actions are in no sense independent of politics? * * * I was not speaking of politics in a petty sense * * * but * * * in the fact that no matter for what reason they did it, what they did would have an effect upon the political situation (1120).

Implicit in Mr. Hanna's remarks is the fact that, whether they like it or not, legislators and the President are held accountable by the people for the economy's performance. Thus, if the Federal Reserve causes or contributes to severe price inflation, Congress may be impelled to enact price controls. Alternatively, if the Federal Reserve causes or contributes to rising unemployment and business recession, Congress may try to generate economic expansion through a variety of deficit spending and welfare programs. Certainly past economic stagnation and recessions provided impetus for the growth of Government in general and Government welfare spending in particular. "Those who oppose the trend toward more Government spending should ask why we have had so much monetary restriction. With greater monetary ease, private investment activity would not be stifled. Hence, the need for easy fiscal policy would be eliminated."

E. CENTRAL BANK INDEPENDENCE AND DEMOCRACY

An independent central bank is essentially undemocratic. It is the very antithesis of democracy to give so much power to men who are insulated from the elective process. In a democratic republic, the central bank must be a truly public body. Thus, "the central bank," said Professor Samuelson (MIT)—

> like the House of Lords, it should be able to delay innovations to smooth down the volatile changes of public opinion and of thin majorities. But the central bank should never be thought of as an island of isolated power, as a St. George defending the economy against the "dragon" of inflation and frenzied finance * * *. "The age of chivalry is dead—that of responsible, democratic government has succeeded" (1110).

Traditionally, Americans have been against ideas and institutions which smack of government by philsopher kings. As Mr. Goldfinger pointed out:

> The persistent inference that representative government means runaway inflation, unless some superboard made up almost excusively of technicians or bankers filters out all such possibilities, is offensive in a democratic society * * * (1474).

The point was brought out also in a dialog between Representative Brock (Tennessee) and Professor Villard (CUNY). Representative Brock asked:

> Is it not true that you would create more political pressures for changes in monetary policy overall, economic policy, with the change in the administration, with the advent of some new pressure on the President?
>
> Are you not subjecting yourself to some rather drastic shift according to the winds if you take this position?

Professor Villard answered as follows:

> Well, I do not believe so, because it seems to me that—perhaps I should answer it the other way around and say that obviously the President will be subject to political pressures,

> but what I am concerned with is that he should be the one who makes the basic economic decisions.
>
> Now, in making these decisions he will undoubtedly be subjected to pressures, pressures on the one hand, for example, to reduce the level of unemployment, pressures on the other hand, to prevent an increase in prices.
>
> I think both of these alternatives generate political pressures. I sometimes worry about the fact that the pressure on the President to prevent an increase in prices may be more powerful politically because everybody is subjected to price increases but there are only a relatively small percentage of the population who are unemployed, so that it may well be that he will give too much weight from my point of view to preventing price increases.
>
> But I do not see, in a democracy, any alternative except to give the power to make decisions on basic economic policy to the Executive. This does not guarantee that he will make the right decisions all the time, but I do not think there is any possibility of setting up a group of experts who should have this power.
>
> In fact, I agree with Professor Johnson's point that you would really have to have a fourth arm of the Government composed of experts if you do not want to give the power to the President.
>
> In short, it seems to me that, to the extent that power can be appropriately delegated by the Congress, must be given to the President (1043).

Thus, our democratic tradition alone will be enough to make many thoughtful people demand a politically accountable central bank. But if this were the only argument, many might still prefer an independent central bank, basing their preference on the oft-heard assertion that independence has economic advantages. In the hearings, however, those who supported independence on this ground failed to develop substantial logical or empirical evidence for this position. On the contrary, testimony presented at the hearings brought into common view some important economic weaknesses and disadvantages of an insulated independent central bank, and, as demonstrated in the foregoing, those who cited these developed powerful analytical and historical reasons for them. The case against central bank independence is strong, whether viewed from the standpoint of achieving economic responsibility, flexibility, and coordination, or from the standpoint of making our institutions truly representative of the people.

PART III.—MONETARY POLICY

A. BASES OF OPPOSITION TO REFORM

1. The present system said to operate well

Federal Reserve officials, the witnesses representing the American Bankers Association and Independent Bankers Association, and Professor Bach (Carnegie Tech) did not favor changing the System's organization at this time. But many of these witnesses admitted the existing structure is, to use Chairman Martin's term, "cumbersome." Professor Bach, the only university economist who was against change at this time, put it this way:

> The organization of the Federal Reserve System today still reflects the outdated regionalism and fears of 50 years ago when the System was established.

Bach also stated:

> * * * there has been clear evidence of some conflict and inefficiency arising out of the present complex Federal Reserve structure * * * (1388).

Still, Professor Bach was against major reorganization such as contemplated by Representative Patman's bills at this time. He was against reorganization now because "* * * the present system operates, on the whole, well" (1388). Therefore, Professor Bach did not think there was much to be gained from major reorganization.

This was basically the view of Chairman Martin. He put it this way:

> And I think it has been fairly well done. I don't say that it could not be done in different ways. But I want to emphasize the fact that by and large the Federal Reserve Board as such has the control—we have had a decentralized central bank. It has been the wonder of a good many of our foreign friends, and to their amazement it has worked surprisingly well despite its *cumbersome* nature (40). [Emphasis supplied.]

Other Federal Reserve officials also felt there was no need to change because things were going well. President Clay (Kansas City) put the matter as follows:

> Well, now, you have a system I believe that works pretty well as it is right now. Maybe there are some modifications that might be advisable but I think they should be taken in small steps rather than great big chunks so that we know where we are going on this. I think this is a matter of safety to the whole economy (785).

President Hayes made essentially the same point when he observed:

> While change may be inevitable, Mr. Chairman, it should come about as the result of the play of natural forces; it should not be forced simply because it may seem to be logical. Samuel Johnson once said: "He is no wise man who will quit a certainty for an uncertainty." To be sure, one might quit a badly operating "certainty" for an untried "uncertainty" that offered the promise of betterment. But when, as here, the system sought to be replaced is operating well, Dr. Johnson's counsel seems to me to be pertinent (532).

2. Bad policy said not related to faulty structure

Pragmatism then was the System's first defense. "It works. Why, therefore, change it?" If the premise is accepted the conclusion follows. But the premise is not, as will be demonstrated in this part of the report, acceptable. The second line of defense was that changing the System's structure along lines contemplated by Mr. Patman's bills would do little, if any, good for it would not bring a better monetary policy. Professor Bach put it this way:

> The major policy failures of the Federal Reserve—and there have been some, notably in the 1930's—have not been attributable to the organizational structure of the System (1388).

Referring to Mr. Patman's bills, President Deming (Minneapolis) stated the argument as follows:

> What is being considered here is whether a differently organized or structured Federal Reserve System would have turned out, or will turn out, a better monetary policy. It is this that I very much doubt. If monetary policy has at times been inappropriate, it is not, I submit, because of faulty organization or structure (688).

Witnesses from outside the Federal Reserve were not so willing to accept the present structure. A substantial portion of their testimony indicated, first, that the Federal Reserve System is not operating well, and second, that its bad policies stem inevitably from its structure. It follows that the System must be restructured if we are to avoid future monetary mistakes and resulting economic instability. This topic is pursued in part IV.

B. MONETARY POLICY: PERFORMANCE

1. Chairman Patman's review

The Federal Reserve is our monetary authority. All of the 19 ranking personnel of the System who testified before the subcommittee agreed that, in meaningful terms, the goals of monetary policy are "maximum employment, maximum production, and maximum purchasing power"—the goals of the 1946 Employment Act. It is a fair question to ask whether the Federal Reserve's policies have contributed to our achieving these objectives or, alternatively, whether these policies have caused labor to be unemployed, factories and equipment to be idle and the dollar to be unstable.

On February 11, Chairman Patman charged in his opening statement that the Federal Reserve's monetary policy was in fact an important root of our recent economic instability. He stated:

> Almost everyone will agree the Federal Reserve's record in the 1929–33 depression was bad. This is not a partisan opinion. President Hoover wrote in his memoirs (p. 212) that the Federal Reserve "was indeed a weak reed for a nation to lean on in time of trouble."
>
> Since Hoover's time we haven't had a great depression. But we have had five recessions and two inflations in the 30 years since 1933, and this is not a record anybody ought to brag about.
>
> Of course, the Federal Reserve's officials will tell you these episodes weren't its fault, but reflect the failure of other policies. This is at best a half-truth. Recognizing that other policies, especially fiscal policy, influenced past economic trends and turns in no way whatever absolves the Federal Reserve from responsibility for these trends and turns.
>
> Let's look at the five recessions and two inflations we've had since 1933. Between the summer of 1936 and the spring of 1937 the Federal Reserve doubled bank reserve requirements. The price we paid for this was the sharp 1937–38 business and employment decline.
>
> Inflation was unavoidable during the Second World War and immediately thereafter. But the Federal Reserve was not completely blameless in this episode. In 1942 reserve requirements at central city banks were reduced from 26 to 20 percent. It was 1948 before this inflationary action was reversed and reserve requirements at central city banks increased back to 26 percent.
>
> During the 1948–49 recession the Federal Reserve reduced its holdings of Government securities by $5 billion. These sales decreased bank lending and investing power, and thereby aggravated the 1948–49 recession.
>
> During the sharp inflation that followed the invasion of South Korea, the Federal Reserve did nothing until January–February 1951 when reserve requirements on demand deposits were raised by 2 percent and on time deposits by 1 percent. The Korean war inflation slowed down almost to zero immediately.
>
> From the spring of 1951 until now our great and essentially healthy and venturesome free enterprise economy has three times been throttled by the Open Market Committee of the Federal Reserve System. The Open Market Committee's decisions affect the money supply and interest rates. I will let the facts speak for themselves. The recession of 1953–54 began in July 1953. The growth of the money supply fell steadily beginning in January 1953, and by July was at an annual rate of less than 1 percent.
>
> The next recession began in July 1957 and lasted until April 1958. Interest rates started to rise in the middle of 1956. The growth of the money supply fell below 2 percent during 1956 and by the spring of 1957 the money stock was

actually decreasing. It continued to decrease until the beginning of 1958, long after the recession began.

The most recent recession began in May 1960 and lasted until February 1961. Once again we find interest rates rising and the growth of the money supply falling just before the downturn. The money supply fell from $142.8 billion at the end of September 1959 to $139.4 billion in June 1960 (925–926).

2. Federal Reserve officials' views on the recessions of 1953–54, 1957–58, and 1960–61

(*a*) *1953–54.*—Neither Chairman Martin or other ranking Federal Reserve personnel volunteered opinions on the causes of the 1953–54 recession and they were not questioned about this episode. Hence, there is no way of knowing whether they are willing to bear any of the onus for the economic downturn of July 1953 to August 1954. But whether they would be or not, the staff is concerned that Federal Reserve policies brought on that recession. The Federal Reserve Board's December 1954 "Bulletin" indicates that in the July to December 1952 and January to April 1953 periods, just before the downturn began in July 1953, open-market policies were intentionally restrictive. The relevant materials from the "Bulletin" are reproduced below.

Use of Federal Reserve instruments, July 1952 to October 1954 [1]

Date	Action	Intent with respect to effect on credit and money	Explanation
July–December 1952	Limited net purchases of U.S. Government securities in open market to $1,800,000,000.	Restrictive	To meet seasonal and other reserve drains only in part, requiring banks to borrow some of the reserves needed so as to restrain bank credit and deposit expansion at a time when credit demand was very large and the economy was fully employed. Purchases in August and September were made primarily at time of Treasury refunding operations and were offset in part by subsequent sales.
January–April 1953	Sold in open market or redeemed $800,000,000 net of U.S. Government securities.	do	To offset seasonal changes in factors affecting reserves and thus to maintain pressure on member bank reserve positions.

[1] Board of Governors of the Federal Reserve System, Federal Reserve Bulletin (Washington), December 1954, p. 6.

(*b*) *Chairman Martin on the 1957–58 episode.*—The hearings show unshakable reluctance on the part of today's officials to admit that the Federal Reserve's monetary policy played a causal role in 1957–58. Congressman Reuss, of Wisconsin, asked Chairman Martin:

> Isn't it true in retrospect that the Federal Reserve System put on the brakes and tightened money at a premature time, at least once or more in the last 5 or 6 years? (84)

Chairman Martin asserted, with respect to the 1957–58 recession:

> * * * I am not willing to concede that the Federal Reserve, by its policy in 1957, brought on that downturn; I think that the causes were much more fundamental than that (84).

Chairman Martin gave no supporting argument for his denial of Federal Reserve responsibility for the 1957–58 recession, nor did he discuss the 1960–61 recession.

It is a matter of historical record that Chairman Martin and the Federal Reserve did in fact show an unwarranted preoccupation with inflation at that time. Chairman Martin's own testimony on August 13, 1957, which was after the downturn had begun, reflects this preoccupation. As reported in the New York Herald-Tribune for August 14, 1957, Martin told the Senate Finance Committee, "Inflation is the most critical problem facing the country." It is noteworthy that this opinion was not shared by administration officials. This, too, was noted by the Tribune:

> Where Mr. Humphrey and Mr. Burgess in their appearances before the committee had held out the hope that inflation may be coming to an end, Mr. Martin gave no indication that he would agree with their appraisal.

Chairman Martin's testimony in 1957 will be enough for most people to conclude the Federal Reserve erred at the time. It adds support to the powerful evidence that the Federal Reserve's "inflation neurosis" caused the 1957–58 recession, which is provided by the data on the stock of money preceding and just after the downturn in July 1957. As was noted earlier, Chairman Patman called attention to the relevant facts when he stated:

> * * * by the spring of 1957 the money stock was actually decreasing. It continued to decrease until the beginning of 1958 * * * (926).

Mr. Patman also pointed out that the same pattern, wherein the downturn in economic activity is both preceded and surrounded by a fall in the stock of money, held for the start of the 1960–61 recession.

(c) *Governors Mitchell and Daane on the 1957–58 and 1960–61 recessions.*—Congressman Reuss explored the question of the Federal Reserve's role in the 1957–58 and 1960–61 recessions with Governors Mitchell and Daane. The dialog follows:

> Mr. Reuss. I want to pursue with you gentlemen the theme that we were discussing * * * whether the money supply was an important factor in economic growth. I think it is.
>
> Mr. Mitchell says, quoting from page 13: "It has not even been established in times like these whether changes in money supply precede change in economic activity or vice versa."
>
> I gather Mr. Daane agrees with that, and I emphatically disagree.
>
> Let me ask Mr. Mitchell this. In the year from February 1957 to February 1958 the Federal Reserve actually decreased the narrowly defined money supply. It decreased from $137 billion to $136 billion. In the middle of this 1-year period, in July 1957, there was the start of a serious recession and enhanced unemployment.
>
> * * * In saying as I do that the Federal Reserve's decrease in the money supply had something, and an unfortunate something, to do with the unemployment and recession that followed, am I guilty of McCarthyism, of guilt by association, or

> is there not a causal connection between this strangulation of the money supply and the unemployment and recession which followed?
>
> Mr. MITCHELL. I think you put it beautifully. This is guilt by association; yes.
>
> Mr. REUSS. I am guilty of monetary McCarthyism?
>
> Mr. MITCHELL. Yes; that is right, because we don't know which comes first. If you have a decline in business activity, it will of itself result in a decline in velocity and/or a decline in the money supply. Free reserves rise * * * (1214).

Governor Daane also argued that Federal Reserve policy had not strangled the money supply, but rather that the volume of money fell because business activity declined. He stated, "You [do] have a substantial increase in excess reserves * * *" (1215).

The answers of Governors Mitchell and Daane raise a theoretical possibility, not a factual point. Conceivably, velocity could fall and free and excess reserves rise as a result of a decline in business activity. But this possible bottleneck to effective monetary control was *not* a problem in the 1957–58 recession. It is a fact that in addition to the money stock, both excess and free reserves actually fell between December 1956 and December 1957, the year in which the business recession started. Using the 6 months immediately preceding the downturn in July 1957, excess reserves were constant and free reserves fell. Indeed, at no time in the past 10 years was the theoretical bottleneck to which Governors Mitchell and Daane alluded an operational problem. The Governors recognized this when, in a supplementary answer to a question put by Congressman Reuss, they observed:

> Over the past 10 years member banks have on the average *continuously* made almost full utilization of the supply of reserve funds made available to them by the Federal Reserve (1933). [Emphasis supplied.]

Moreover, it is important to recognize that even if excess and/or free reserves were to rise and velocity to fall, the adverse effect of such changes on total spending could be offset by a proportionately greater rise in the volume of money. Thus, from a theoretical, as well as an empirical, standpoint, the argument raised by Governors Mitchell and Daane is invalid. Factually, the bottleneck alluded to was not an operational problem. Theoretically, the argument fails to take into account that monetary policy can be used to offset changes in velocity in the event that velocity behaves perversely.

Governors Mitchell and Daane also argued that, since the rate of growth of the broadly defined money supply (including time deposits) did not fall off significantly until after the economy turned down in the summer, it would be difficult to attribute the downturn in the economy to monetary developments in 1957 (1516). The question of whether the money supply should include time deposits is beyond the scope of this report. However, it can be stressed here that the Federal Reserve acts directly on currency and demand deposits, and only indirectly on time deposits. Thus, the staff is not convinced that a broad definition of the money supply is justifiable when considering the impact of Federal Reserve policies. Moreover, the official position of the Federal Reserve on the matter is that the money supply does not include time deposits. Money is defined in the monthly Bulletin of the Board of

Governors to include only currency plus demand deposits. Also, as witness the following colloquy, Governor Mitchell agrees that this is the appropriate definition.

> Mr. REUSS. But let me see if we can't find one area of agreement here. In that same paragraph on page 13, when you were talking about Professor Friedman you talk about the Federal Reserve formulating monetary policy with "a more logically defined money supply."

The dialog continues as follows:

> Mr. MITCHELL. Narrowly defined.
>
> Mr. REUSS. Good for you. You think that currency outside banks and demand deposits is a more sensible view of the money supply.
>
> Mr. MITCHELL. That is right.
>
> Mr. REUSS. So do I (1216).

The relevant data then are the statistics on the narrowly defined volume of money. These data show that the Federal Reserve either acted to deliberately decrease the stock of money or passively allowed it to fall prior to and just after the start of both the 1957–58 and the 1960–61 recessions. We do not know which is true. But judging by Chairman Martin's remark that "inflation was the crucial problem" as late as mid-August 1957 it would appear that the Federal Reserve's errors were errors of commission. It is interesting that Governor Mitchell despite his earlier attempt to deny the role played by monetary development in bringing on the 1957 recession was critical of the failure of the Federal Reserve to reverse its policy after the recession had started. On this he stated:

> * * * my feeling was that the Federal Reserve did not switch policy early enough in 1957, and I think the facts warranted an earlier switch, and if I had been a member of the Board, I would have voted for an earlier switch than the one which occurred (1217).

Governor Mitchell's argument is to the effect that monetary policy did not introduce the disturbance but affected its length and depth. Chairman Martin appears to agree; he was not willing to admit monetary policy brought on the 1957 recession; he thought "the causes were much more fundamental than that." On the other hand, he was at times willing to concede the Federal Reserve's policy has been less than perfect, in reversing trends brought on by these unspecified "fundamental" causes. Regardless, the facts definitely suggest that monetary policy not only prolonged and aggravated the 1957–58 recession, but also brought it on.

Concerning the 1960–61 recession, Governors Mitchell and Daane did not disagree with the contention that a restrictive monetary policy brought on that episode. Clearly, the volume of money fell prior to as well as immediately after the downturn began. In a supplementary reply to a question put by Congressman Reuss, Governors Mitchell and Daane recognized this when they observed:

> From mid-1959 to mid-1960, demand deposits and currency contracted by $3.2 billion, or 2 percent. Whatever significance is attached to the money supply measure, this

34–884—64——4

performance reflects a highly restrictive monetary policy, which many observers have charged with partial responsibility for the economic downturn that began in the spring of 1960 (1948).

C. MONETARY POLICY: POTENTIALITY AND FAILURE

1. The relation of monetary policy and money supply to our economy's performance

(*a*) *Testimony that monetary developments have a powerful impact on our economy.*—No witness claimed that our knowledge of the mechanism that links monetary policy and monetary developments to our economic performance is complete. At the same time it was the overwhelming consensus of the witnesses that money definitely matters and that monetary policy is causally related to national income, prices, international payments, employment, production, etc. Federal Reserve officials agreed that a causal relationship exists from the Nation's monetary developments to its economic performance. As Governor Mitchell pointed out:

> If it didn't there would be no argument for the existence of any type of monetary authority (1188).

The historical evidence for the theory that money matters is what most impresses economists. Professor Meltzer (Carnegie Tech) told the subcommittee:

> Evidence from a large number of countries and many different time periods suggests that money and national income are closely associated (928).

He testified further that:

> Monetary policy is not a matter of "pushing on strings" as the Board and others have so often suggested. It is a powerful force in our economy * * * (928).

Professor Brunner (UCLA) noted first that:

> * * * substantial increases in the money supply are typically associated with every major inflation ever observed.

A moment later he looked at the other side of the coin and observed:

> * * * that receding activity levels typically occurred after the growth rate of the money stock fell below a barrier of 3 percent per annum (1051).

Professor Brownlee, too, noted that our "principal" economic difficulties "have been with the variability of the rate of change in the supply of money" (1063).

Dr. Warburton (FDIC) who has studied the question for nearly half a century analyzed the data for the 1919–63 period and concluded that there was—

> * * * a typical though not invariable, time sequence in the occurrence of the crucial turning points, or cyclical peaks and troughs. Money supply leads, followed by final product expenditures, and then by rate of use of money. This sequence gives stanch support to the principal theory of the origin of

> severe business fluctuations * * * they originate in maladjustments in money supply (1315).

In addition, Dr. Warburton told the subcommittee that he had done some exploratory work for the period 1781 to 1919, and that—

> The results of this exploratory work tend to support the hypothesis that serious business fluctuations are led by serious irregularities in money supply (1316).

The evidence is clear. The supply of money plays a strong causal role in the economy. It is not all that matters but it clearly is an important determinant of our economy's long-term growth and short-term stability and freedom from recessions and inflations. This report is about the Federal Reserve—our Nation's monetary authority—and we may appear to be saying that money supply is all-important. Obviously, it is not. But clearly, monetary policy is important, far more important than many believe.

(b) *Testimony that the Federal Reserve controls the Nation's money supply.*—Since irregular growth of the money supply is a strategic and perhaps the dominant factor underlying business fluctuations, it is important to know how the growth of the Nation's money supply is controlled. The tools the Federal Reserve has to control the volume of money were described in part I–C of this report. It will be recalled that the Federal Reserve has power to change the proportion of the reserves banks are required to keep behind their deposit liabilities, to vary the rate at which banks can discount eligible paper, and most important, to buy and sell Government securities on the open market. By means of these three policy instruments it can manipulate bank reserve positions and thereby control the Nation's money supply and ultimately national economic performance.

There is, of course, full agreement that the Federal Reserve has the technical power and knowledge to control the money supply if it chooses to do so (although there is considerable evidence, too, that its techniques for so doing are inadequate). When Representative Reuss asked whether the Federal Reserve can change the money supply, Governor Mitchell responded that "it is at times difficult" but it could be done—"ignoring all other consequences" (1198–1199). If we can judge by official publications et al., the "other consequences" pertain to such bank phenomena as the quality of credit, free reserves, who is borrowing, and most importantly, the availability of bank credit. Judging by the erratic behavior of the money stock, these other consequences have not been ignored. Indeed they seem to have received an unwarranted amount of attention and at the expense of adequate—in the sense of sound and prudent—*monetary* control.

Furthermore, though their day-to-day policies belie this, Federal Reserve officials agree that what they do is aimed first at affecting bank reserves and ultimately the economy's performance.

Vice Chairman Balderston, in a speech at Georgia State College on February 13, 1964, which was referred to several times during the hearings, put it this way: "The role of general monetary policy is to regulate the reserves available to commercial banks so as to promote economic growth, high levels of employment, reasonable stability in prices, and to aid in achieving equilibrium in our balance of payments.

It is this responsibility so vital to the protection of integrity of the dollar that has been delegated by Congress to the Federal Reserve System." The evidence summarized and assembled in this report demonstrates that the Federal Reserve has not met this responsibility adequately.

(*c*) *Testimony on the Federal Reserve's role in prewar economic fluctuations.*—There was little specific testimony on economic turns and trends before World War II. The testimony of Professor Friedman (Chicago), who is the coauthor of a comprehensive study of our monetary history ("A Monetary History of the United States 1867–1960"), contained a brief, specific reference to the interwar period. He stated that the Federal Reserve had three times made major mistakes during this period, and that all three errors were "in a deflationary direction." Professor Friedman told the subcommittee—

> "These major mistakes include the sharp deflation enforced on the country in 1920–21; the contraction in the quantity of money by one-third from 1929 to 1933; the doubling of reserve requirements in 1936–37 and the subsequent shift from a rapidly rising to a declining quantity of money * * * (1135).

Dr. Warburton (FDIC) in a memorandum submitted for the record gave a somewhat more detailed description of monetary policy before the war. He wrote:

> When the Federal Reserve banks were opened, their operations were directed to issuance of currency in the form of Federal Reserve notes. During World War I, and for a year after the armistice in 1918, their policies were focused primarily on financing the Government debt. The consequent monetary expansion produced a rapid rise in prices, and led the Federal Reserve Board and banks, toward the end of 1919 and during 1920, to their first attempt at control of the circulating medium through substantial increases in discount rates. The impact of this restrictive policy on business activity and employment, in the depression of 1920–21, was greater than had been anticipated.
>
> Throughout most of the 1920's Federal Reserve officials spent much time and effort in attempting to develop guidelines for their future policies. Under the leadership of the Federal Reserve Bank of New York, attempts were made to reverse the direction of policy with sufficient frequency to maintain a substantial degree of economic stability. However, no attention appears to have been given to the need for growth in the money supply, although the policies pursued did not prevent such growth during most of the 1920's.
>
> In 1929 and the early 1930's Federal Reserve policy shifted from an emphasis on the state of business and employment to concentration on reduction of bank loans used in speculative markets or based on securities. The measures taken drastically reduced member bank reserves, relative to the growth needed for economic stability, with disastrous results on the supply of money. The great depression was the consequence.
>
> In the middle and late 1930's, after the change in the price

> of gold and its impact upon gold holdings of the Federal Reserve banks, Federal Reserve authorities were primarily concerned with preventing such holdings from resulting in an undue expansion of the money supply (1322).

The 1929–33 episode was the worst monetary and economic catastrophe in our history. But even today, many people believe the "Great Depression" was born suddenly and fed by nonmonetary forces. It is useful, therefore, to review briefly the Federal Reserve's role in the period. Early in 1928, before the "crash" of the stock market, the Federal Reserve adopted a policy of monetary stringency which weakened many of our financial, mercantile, and industrial enterprises and thereby made the economy extremely vulnerable to depression. On May 18, 1928, Gustav Cassel, a Swedish economist, testified before the House Banking and Currency Committee and warned that the Federal Reserve's policy of monetary restrictions "may have an effect on the general level of prices that will result in a depression. * * *"[1] Cassel's warning went unheeded.

As noted by Professor Friedman, between 1929 and 1933 the volume of money fell by one-third. Thus, the Federal Reserve, which controls the supply of money compounded its error of 1928 and turned what might have been a short though deep recession into a catastrophe.

Many persons, as the hearings brought out, blame the Hoover administration for the disastrous monetary policy of 1929–33. They base this on the fact that the Secretary of the Treasury then was Chairman of the Federal Reserve Board. However, neither the Secretary nor any other public representative was on the Open Market Committee, and it was this Committee's policies that were the major factor underlying the one-third contraction of the money supply between 1929 and 1933. Moreover, as Professor Friedman testified, the Congress and administration officials (especially Mr. Ogden Mills, Under Secretary of the Treasury) urged the Open Market Committee to reverse course and follow expansionary policies. In early 1932, the Committee heeded this advice and the economy actually perked up somewhat. But as soon as Congress adjourned, the restrictive policy was resumed and followed until the collapse of the banking system in 1933. Small wonder, therefore, that President Hoover wrote in his "Memoirs" (212) that the Federal Reserve "was indeed a weak reed for a Nation to lean on in a time of trouble."

Errors committed more than 30 years ago would not cause us serious concern today if we could be sure that those in authority today had learned something from the errors of those in charge in 1929–33. But as already noted, there is cause for concern that there is no feedback mechanism in the structure of the Federal Reserve to assure that past errors are analyzed and insight and knowledge of the monetary process thereby achieved. A study by Professor Meltzer (Carnegie Tech) and Professor Brunner (UCLA) bears this out. On this Professor Meltzer testified:

> Our detailed study of the Federal Reserve's procedures reveals that their knowledge of the monetary process is woefully inadequate, unverified, and incapable of bearing the heavy burden that is placed upon it. After 50 years, the Fed-

[1] Cited in Gustav Cassel, "The Crisis in the World's Monetary System," p. 73.

eral Reserve has little verified knowledge to form the basis for its policy actions. Equally important, the dominant views expressed by Federal Reserve officials [today] are founded on notions that were responsible for major errors in 1929–33, 1936–37, and at other crucial points (927).

It was precisely because of the danger of future major mistakes that Professor Friedman (Chicago) expressed a preference for congressional control of monetary policy. Answering a question by Congressman Harvey (Michigan) Professor Friedman observed:

> So far as the minor short-term movements are concerned, you may well be right that Congress would have been worse. I do not know, it might have been better or worse.
>
> My preference for Congress derives from a different consideration. As I see it, the major problem of monetary policy is to have a system which is not subject to major mistakes. What I am convinced of, on the basis of the record, is that Congress is less likely to make a major mistake than a Reserve Board is, although it may make more minor mistakes.
>
> You may be right that in terms of the minor fluctuations Congress would have been worse. What I am impressed with is that Congress would never have permitted the decade of the thirties to develop as it did and would not do so again in the future (1152).

(*d*) *Testimony on the role of monetary policy from 1939 to 1952.*—World War II was financed in several ways: by taxes; the sale of Government securities in exchange for money that was in circulation before the war; and the sale of Government securities in exchange for newly created money. To facilitate the creation of new money, reserve requirements at central city banks were reduced from 26 to 20 percent in 1942 and not raised back again until 1948. In addition, in 1943 the Federal Reserve Act was amended so that for the duration plus 6 months member banks did not have to keep reserves behind deposits "payable to the United States by any member bank [and] arising solely as the result of subscriptions made * * * for United States Government securities * * *" (82). Thus member banks did not sacrifice any alternative in subscribing to Government securities, and hence it is clear that the interest on the debt which banks accumulated during the war (they cannot be said to have bought this debt) has and continues to represent an outright subsidy to banks and a burden on the general taxpayer.

Mr. Jerry Voorhis, a former Congressman from California, and currently executive director of the Cooperative League of the United States, testified on the cost of linking the creation of money to the creation of debt. Mr. Voorhis (and Chairman Patman concurred in this both during the war and the current hearings) would have had the Federal Reserve print the money that *had* to be created during the war in order to finance *that part* of the Government's budget not paid for by taxes and funds raised by the sale of Government securities in exchange for money previously in circulation. Mr. Voorhis' plan would not have generated any more inflation than was actually generated by wartime bond sales in exchange for newly created bank money. The magnitude of inflation under Mr. Voorhis' plan would not have differed from what occurred because the increase in the money supply would have been the same. The advantage of Mr. Voorhis' plan is that it would not have involved the creation of interest-bearing debt and thus it would not have saddled us with interest payments on this debt which continue to this day. Probably $50 billion of Government interest-bearing debt which was issued during the war need not have been created. Unfortunately, the practice of linking money creation to debt creation continues. Still today, as Mr. Voorhis testified:

> [A major] way in which we now bring about increases in our money supply is by increases in our debt, either public or private (1592).

During the period 1939–45, Mr. Leon H. Keyserling, told the subcommittee that—

> * * * with all of our productive resources strained, total national production grew at an average annual rate of 9.1 percent in real terms, and industrial production grew at an average annual rate of 11.8 percent. To generate this phenomenal expansion of output, the nonfederally held money supply grew at an average annual rate of 15.7 percent, Federal budget expenditures measured in uniform dollars grew at an average annual rate of 49.4 percent, and the Federal deficit measured in 1957 dollars averaged about $60 billion annually. Under these circumstances, there was a substantial amount of price inflation, * * * (1755).

The wartime inflation ended in 1947. In fact, it really ended earlier since the rapid rise in reported prices immediately after price controls were lifted in June 1946 was merely legal recognition of the earlier rise in black market prices. From 1947 until the outbreak of the Korean war in June 1950, there was no advance in consumer prices and very little in wholesale prices.

Contrary to popular belief, the Federal Reserve followed a deflationary policy after the war, especially after 1947. It was a net seller of Government securities from V–J Day to the invasion of South Korea. Its deflationary policy was in fact instrumental in producing the 1948–49 recession. Prior to and just after the downturn in November 1948, the Federal Reserve sold $5 billion of Government securities.

Some witnesses apparently forgot what happened during this period. In their zeal to condemn H.R. 9749, which provides for Federal Reserve support of Government bonds when yields equal or exceed 4¼ percent, they overlooked the fact that the postwar deflationary policy took place at a time when the Federal Reserve supposedly was dominated by the Treasury. For example, President Hickman (Cleveland), referring to the period when the peg was in force on the bond market, stated:

> And during that period, of course, after the war, we had a very great inflation. From the end of the war, 1947 to 1951, bonds were sold to the Federal Reserve System in very large volume. And this became part of the monetary reserves of the banking system. And the banks loaned the money out, inflated the money supply, and this caused prices to rise. Actually, wholesale prices in that period went up about 70 percent, or something like that (185).

The fact that the policy of supporting the bond market in the postwar period did not bring inflation does not mean it has no inflationary potential. It may not be able to cause inflation but can feed one, as the Korean war experience proved. The outbreak of war in Korea led many to try to hoard goods. They sold Government securities to obtain the funds they needed to build up inventories. By supporting the price of Government securities the Federal Reserve made it comparatively easy to hoard. In the second half of 1950 the Federal Reserve bought $2.4 billion of Government securities, and the money supply rose more than 3 percent by March 1951. This greatly added to the inflationary pressure from wartime hoarding. Wholesale prices rose about 14 percent by March 1951. Of course, the Federal Reserve could have at least partly offset the inflationary pressure by raising bank reserve requirements. It finally did this in the January–February period of 1951. The price rise was halted, but by this time the horse was out of the barn.

(*e*) *Testimony on monetary policy from 1952 until now.*—The testimony of non-Government witnesses on monetary developments after 1952 was, on the whole, highly critical of Federal Reserve policies. The criticisms concentrated on (1) the Open Market Committee's deflationary bias, or "inflation neurosis" as Prof. Dudley Johnson (Washington) put it, which was the root of our low rate of economic growth in the 1953–62 period, and (2) continuation of the Committee's history of over-reacting to changes in the economy and thereby aggravating the problem of unemployment and that of periodic inflation as well.

It is as easy to magnify the Federal Reserve's recent errors as it is to understate them. In the staff's opinion, the testimony neither exaggerated nor understated the facts. The criticisms were based on two problems. One problem arose because our monetary growth was not large enough to permit our economy's production and employment to accommodate the improvement of our technology and the growth of our savings and labor force. The growth of the money supply was especially low from January 1956 to August 1962. During this nearly 7-year period, the volume of money increased from $135.2 billion to only $144.8 billion; this is only 1.1 percent per year.[2]

The second problem arose because there were three business cycles in the period since 1952. We have had the same problems in earlier decades, and they have been more critical in the past. But this does not justify their existence in the most recent decade of our history, and, more important, unless changes are made, their future existence.

Dr. Warburton (FDIC) put the problems of the post-1952 period in their proper historical perspective. He stated:

> During the past decade Federal Reserve policy, as described by officials, has been focused on three objectives: provision of a money supply adequate for growth; countercyclical variations superimposed upon the rate of growth; and particular situations, notably the balance of international payments. Federal Reserve actions in pursuit of these objectives have resulted in a more stable money supply, with some growth, than in any other period in the Nation's history for which

[2] All figures on the money supply used in this report are those available from Federal Reserve sources through May 1964.

adequate data are available, except for several years of the 1920's. Business fluctuations have also been less severe than in any other period of equal length. However, serious questions continue about the adequacy of Federal Reserve policy, particularly with respect to the rate of growth of the money supply and with respect to business fluctuations resulting from the emphasis on countercyclical policy (1323).

Listed below are excerpts from the testimony of the experts on our Nation's money system on the two problems which continue to plague us.

First, on the inadequacy of growth of the money supply and the Federal Reserve's "inflation neurosis"

Chairman Martin:

But one thing I am certain of is that inflation creeps up on you (83).

But let me point out that people are always asking: "Where is the inflation?" And then all of sudden you have it. And our job is to try and prevent this, try to keep it in its incipient stages from getting out of control. And to go back to the 1957–58 period we are talking about, we then had an inflation *psychology*. And I think it was essential that we stop it (87). [Emphasis supplied.]

Prof. Dudley Johnson (Washington):

Now, if one examines the behavior of the Consumer Price Index, especially since 1953, or after the first 6 months of the Korean war, I think you will see a general upward drift in this index.

Now, my statistician friends tell me that a significant part, if not all, of this rise in the CPI can be explained by the upward bias which is structured in this price index. As I mentioned earlier, this results from certain technical characteristics in the construction of price indexes—the constant repricing of a frozen basket of goods as well as the inability to measure the quality improvements in the goods and services which make up the index, what this means is that the past inflationary problem in the United States has been greatly overexaggerated. In fact, I don't think we have had that much, if any inflation, since 1953. This leads me to conclude that we have been paying a very dear price in terms of foregone production and unemployment to fight a nonexistent inflation (1460–1461).

Prof. Harry Johnson (Chicago):

* * * while in peacetime they have displayed a pronounced tendency to allow deflationary policies on the average. Moreover—I refer here particularly to the behavior of the United States and Canadian central banks in the past decade * * * (970).

Professor Gurley (Stanford):

Since 1950, the ratio of the money supply to GNP has fallen from 40 to 25 percent. This has raised interest rates across the board which in turn has been a factor in the slowdown of our output growth rate. Monetary policy has been a tightwad, doling out money in driblets when more was called for (1311).

Professor Lerner (Michigan State):

I would agree that during most of the period a lower rate of interest would have been desirable * * *. I think so, because of the effect on the economy in increasing the level of economic activity and giving us more employment and prosperity (1404).

Professor Strotz (Northwestern):

We can think of ourselves as regulating the quantity of money. Then the interest rate will be determined by the technical terms under which we can exchange present goods for future goods, and the desires of the community to consume now or to consume later. These forces, I think, ought to be allowed to find their equilibrium position.

So I think the interest rate will achieve a proper level if we determine that the quantity of money shall be maintained at a proper level (1461–1462).

Professor Bach (Carnegie Tech):

The Fed's action on the investment boom in 1957 was, I think, a debatable one in the strength of the action it took. I think reasonable men can differ on this. My own taste is that it was somewhat too restrictive at that point and my own taste has been that it has been on the whole slightly too restrictive over the past 5 or 6 years (1402).

Professor Robertson (Indiana):

The greatest restraints were placed on the economy by the monetary policy in effect from 1955 to 1960. Taking the period since the accord we find that the rate of growth of the money supply from 1951 to 1963 was approximately 2.2 percent per annum. That the recession of 1957–58 was not necessarily induced but was brought on more sharply by an unnecessary tightening of interest rates in the late summer and early fall of 1957.

Representative Vanik (Ohio) then asked: "You assign error to the Federal Reserve's policy?"

Mr. Robertson replied:

Yes; I would, especially in 1959 and 1960. In these years, although we were beginning to feel some international constraints, the international gold flow problem was not yet a major problem. I feel that the Fed was bringing about high rates in that period for purely domestic reasons, and I don't think that we can let the Fed off the hook by saying they were required at that time to put a stopper on the gold flow (1370).

Professor Brownlee (Minnesota):

Since the "accord" between the Treasury and the Federal Reserve (1951), the average annual rate of growth in the money supply has been about 2 percent * * *. If increases in the money supply were the only demand expanding device, an annual average rate of increase of 2 percent is too small to keep the price level constant with real output growing at 3 percent or more per year (or to keep output growing at 3 percent per year at a price level which cannot be reduced). Federal cash payments to the public exceeded receipts, thereby increasing the Federal debt and adding to aggregate demand. State and local borrowing also increased substantially. The result is a level of interest rates higher than would have prevailed had there been smaller increases in debt and larger increases in the money supply.

I believe that the money supply could have been expanded faster than it was, given the fiscal situations of the various governmental units, without significant price increases. Many persons believe that the real gross national product has been from 3 to 5 percent below that which could be produced without inflation for nearly 7 years (1065).

Professor Villard (CUNY):

Once again to put a quite complicated matter in the baldest possible terms, as I see it, in order to reduce the rate of increase in prices by hardly more than 1 percent a year we have recently been wasting perhaps 5 percent of our productive potential. When I take into account that continuing unemployment has caused labor leaders to question seriously the value of automation and is turning many of the unemployed into unemployables, I find what I estimate to be the recent "trade off" between unemployment and inflation a very poor bargain indeed (1021).

Mr. Keyserling:

* * * let us take a quick look at the unsatisfactory trends in our economic performance since the beginning of 1953. The most characteristic feature of this poor performance has been the chronic rise of unemployment and idle plant * * *. While total national production expanded at an average annual rate of only 2.9 percent during this period, the nonfederally held money supply expanded at an average annual rate of only about 1.8 percent (1746 and 1747).

Prof. Eli Shapiro (Harvard):

With respect to the tradeoffs, the question that you posed earlier, I think my response to your comments would be, as fairly as I can do it—I would think that the Federal Reserve authorities are preoccupied with stability of the price level in such a way that when compelled to make a choice they tend to err in the direction of price stability, whereas I would personally regard getting to the utilization of our full capacity as a primary goal in our society * * *.

So that, moreover, I think that we have enjoyed a remarkable period of price stability under the circumstances with widespread unutilized capacity (1122).

Prof. Dudley Johnson (Washington):

> One did not hear the term "structural unemployment" during World War II, since there was a sufficient flow of aggregate spending to employ the then existing labor force. Nor did one hear much talk about "structural unemployment," or "technological unemployment" in 1952, or in 1953, periods in which there occurred a rapid increase in the rate of technological change. Aggregate monetary demand was sufficiently high in these two periods so that unemployment was only 3.1 percent in 1952, and 2.9 percent in 1953, even in the face of rapid technological change (1436).

Mr. Goldfinger (AFL-CIO):

> For a decade, unemployment has been in a rising trend. Even last year, when the real volume of national output rose nearly 4 percent, unemployment increased. This key domestic problem of unemployment and underemployment is poisoning race relations and creating difficulties in labor-management relationships, as well as wasting manpower resources. Moreover, for the unemployed, underemployed, and their families the lack of gainful job opportunities causes obvious distress.
>
> The Nation's monetary policy during the past decade has contributed to this condition. During much of the past decade, monetary policy has been relatively tight and interest rates have been relatively high—discouraging the needed expansion of demand for goods, services, and manpower. Moreover, monetary policy decisions were factors in setting off the three recessions since 1953 (1472).
>
> And there is a history of the Federal Reserve tilting with the windmills of overall demand inflation in the 1950's with the resultant trend of rising unemployment.
>
> The Federal Reserve's continuing fear of inflation is notorious. Prof. Dudley Johnson has called this inflation fear a Federal Reserve "neurosis." On the other hand, there is a constant displeasure with, but no real fear of persistent high unemployment, which has continued in this country for over 6 years (1477).

Professor Samuelson (MIT), in a column published in the Washington Post, November 25, 1963, which he submitted for the record, had this to say on the deflationary bias of the Federal Reserve:

> An index number of scholar's confidence in the Fed, using 1928 as a base of 100, showed a steady postwar rise from 3 in 1945 to 73 in late 1952. The incompetent handling of matters in early 1953 sent this index confidence plunging down toward 50; there followed what technical chartists call a head-and-shoulders topping out, until the disastrously biased tight-money capers of 1956–60 created a crash in the index. Since then the index of confidence in the probity of the Federal Reserve has been painfully climbing back toward the level of 50.

How to improve the image? Sending Board members' speeches to the complete mailing list of the American Economic Association is perhaps not the most constructive move possible at this time. Institutional advertisements in the leading economic journals is probably too crude. You can't buy love; you have to earn it. The therapy must be fundamental and drastic.

Professor Samuelson then urges the monetary authorities to:

Stop being jockeyed into the underdog position of last defender of stability of the price index. The universe was not created with a basic division of powers; the Government being under obligation to use its fiscal policies to produce high and growing real output; the Federal Reserve being under obligation to use its monetary policy to insure stability of the price level.

Such logic leads—indeed it did lead, even in the days before gold was a problem—to credit policies that are too tight and fiscal policies that have thereby to be so much the looser. The result, even at full employment, will be a bias against capital formation and a bias toward present consumption.

The founders of the Federal Reserve really didn't know what they were doing. But surely none of them thought they were designing an engine that would be a bulwark against growth (1125–1126).

Second, on the recessions of 1953–54, 1957–58, 1960–61 and the Federal Reserve's tendency to overreact

Mr. Keyserling:

The thesis that the movements in the money supply were merely responsive to the business cycle, and not causal factors in themselves, cannot be supported upon analysis of the year-by-year trends * * * extraordinarily drastic restraints upon the nonfederally held money supply * * * gave much force to the economic downturns of 1957–58 and late 1960-early 1961 (1747).

Professor Friedman (Chicago):

Taken altogether, the period from 1957 to mid-1962 was characterized by unduly wide swings in the rate of growth of the money stock and also by a somewhat lower average rate of rise in the money stock than in earlier postwar years. The swings in the money stock contributed to the too-frequent ups and downs in the economy. The low rate of rise in the money stock contributed to the generally high level of unemployment but also, on the favorable side, to relative stability in wages and prices.

September 1962 saw another change of course. The change was in a desirable direction, but too great in magnitude. Since then, the quantity of money, defined narrowly, has risen at a rate of nearly 4½ percent a year; and defined more broadly at over 8 percent a year. These are rates of rise that cannot be long maintained without producing a substantial increase in prices (1138).

Professor Friedman, it should be noted, urges that the monetary authorities be instructed to increase the narrowly defined money supply (currency plus demand deposits) at a rate of 2 to 4 percent per annum. This, he contends, would minimize both unemployment and inflation.

Professor Brunner (UCLA):

> During the recession of 1948–49, the Board lowered the legal reserve ratios in successive steps. This action was effectively designed to raise the extended [monetary] base by a substantial amount, and was thus properly planned to increase the money supply and counteract the prevailing deflation. Unfortunately, the Federal Reserve authorities also engaged in large-scale open-market sales which lowered the extended [monetary] base. These sales dominated the effect of the changes in the legal reserve ratios, a fact clearly revealed by the growth rate of the extended [monetary] base. Contrary to the Federal Reserve's assertions, the open-market sales did not modify a prevailing "policy of ease"; neither did the Federal Reserve actually exert a "countercyclically stimulative" policy. Policy was deflationary at the time, because the positive effect of lower requirement ratios was overwhelmed by the negative effect of open-market sales.
>
> A somewhat different constellation was observed in the recession of 1953–54. Once more, the release in required reserves, accomplished by the reductions in legal reserve ratios, contributed to raise the extended [monetary] base. But, this effect was again offset by a contraction of Federal Reserve credit. This contraction was reflected simultaneously in the Federal Reserve's portfolio of discounts and advances, and its portfolio of Government securities. Thus, both discount policy and open-market policy explains the deflationary direction in the movement of the extended [monetary] base during the recession of 1953–54. Inspection of pertinent data for 1957–58 and 1960–61 would again reveal that both open-market and discount policy shaped the deflationary trend * * * (1074–1075).
>
> During 1961, policy became decisively expansionary, hesitated seriously for some months in 1962, and moved further to generate a growth rate of the base in the late fall of 1963 not achieved since 1952. This prolonged and decisively expansionary policy is quite likely one of the single most important reasons explaining the length and vitality of the current upswing in economic activity (1073).

Dr. Walker (executive vice president, ABA) also agreed that recent policy was far from tight. He pointed out that for the past 3 years, "Credit policy, in short, has been and continues to be essentially easy" (1882).

Whether considered in terms of money supply or credit availability, policy has been expansionary in recent years, viewed as a whole. Many, like Professor Brunner, are persuaded these monetary developments are an important cause of the recent business upswing. But many also are apprehensive that recent developments won't continue, and, in fact, many believe that the recent growth of the money supply was the result of a "happy accident," as Professor Bach (Carnegie Tech) put it.

Our recent business upswing began in the spring of 1961, following moderate monetary expansion beginning in the fall of 1960. The upswing, as Professor Brunner (UCLA) noted in testimony cited above, hesitated in 1962 following a sharp decrease in the growth of the money supply. Since August 1962, the money supply has increased at the rate of 4.1 percent per year. The economy has bloomed with this expansion. And given the rosy monetary developments, the takeoff of the economy was not unexpected.

The current economic expansion, however, will last only if the Federal Reserve acts in the appropriate way. Testimony before the subcommittee gives cause for concern that because of its "inflation neurosis" the Fed may brake the growth of the money supply too hard whenever it "senses" that inflation is creeping up, like some unseen tiger stalking an innocent prey. In fact, the Federal Reserve—as this is written in early June 1964—may again be turning about to tilt with real or imagined "incipient" inflation, for since late last year the growth of the money supply has decreased steadily. Hopefully, this trend will be reversed.*

There was some testimony that the Open Market Committee believes that it has been following an anti-inflationary or a progressively less easy policy for over a year, which means that the current upswing of employment and business activity has been a "happy accident." Certainly this is the impression obtained from reading the instructions of the Committee as reported in the Federal Reserve's Annual Report for 1963 and 1962 as well. At the end of 1961 the account manager was instructed to provide reserves "but with a somewhat slower rate of increase in total reserves than in recent months." In early 1962 the instruction called for "maintaining a supply of reserves adequate for further credit expansion" and also "maintaining a steady money market." In March the instruction continued to call for supplying reserves "adequate for further credit expansion" but now the account manager was warned to avoid "undue downward pressure on short-term interest rates." In June 1962 the instruction called for "providing a somewhat smaller rate of reserve expansion." In December 1962 the instruction called for "maintaining a firmer tone in money

*On July 10, when this report was in galleys, the Federal Reserve released money supply estimates for June showing a rise of $1.3 billion for the month. If continued for a year the June developments would generate an 8.5 percent rise in the volume of money by July 1965. Thus the June developments definitely buck the downtrend that began in January, and in fact almost fully corrects for its deficiencies. But 1 month's developments do not constitute a trend. June might mark the resumption of monetary expansion on the order of what we had since August 1962. On the other hand the monetary expansion in June may denote only an attempt by the Federal Reserve to maintain an orderly Government securities market—traditionally the Federal Reserve increases the money supply before large Treasury refundings, and in July the Treasury refunded nearly $42 billion of Government securities. In future months we will learn which of these two hypotheses is correct.

markets while continuing to provide moderate reserve expansion." Not once during 1962 did the instruction call for stepping up the pace of reserve expansion or for achieving lower interest rates or an easier money market tone. On the contrary, as noted, the last instruction in 1961 called for slowing down the expansion of reserves. In mid-1962 the account manager was told to further brake the rate of increase in reserves. In December, he was told to achieve a firmer money market.

There was no real change in the instruction after December 1962 until May 1963 when the account manager was told to achieve "slightly greater firmness * * * while accommodating moderate reserve expansion." In July the instruction called for achieving still "a slightly greater degree of firmness" and at the same time continuing to accommodate "moderate expansion in aggregate reserves." This instruction remained in force through the end of the year.

Clearly, anyone who assumes that the instructions of the Open Market Committee are followed by the System's account manager at the New York Reserve Bank must be hard put to explain the monetary expansion we had from August 1962 to mid-January 1964.

Attention now is called to the tendency of the Federal Reserve to overreact, especially to the threat of inflation. On this problem and its implications for monetary developments now and in the near future, witnesses made these comments:

Prof. Harry Johnson (Chicago):

> * * * in the short-run conduct of policy they have tended to overreact to changes in the economy and to reverse their policy with a substantial delay, thereby contributing to the economic instability that their policies are intended to combat (970).

Professor Meltzer (Carnegie Tech):

> What we find is that the Federal Reserve permits a larger rate of growth in the money supply during the periods when they should be controlling inflation, and a smaller rate of growth in the money supply during periods when they should be preventing unemployment (941).

Professor Friedman (Chicago):

> If the Reserve System waits until the inflationary effects of its present policies become clearly manifest and only then curtails the rate of monetary expansion, it will be months thereafter or perhaps a year or more before the inflation is stemmed. In the interim, it will understandably be tempted to step on the brake too hard (1139).

Prof. Dudley Johnson (Washington):

> * * * whether such monetary ease will continue is problematical, given the recent statements by the monetary authorities on the possible inflationary effects and payments effects of the recent tax cut (1448).

Professor Strotz (Northwestern):

As for present Federal Reserve policy, I would voice the following complaints. I am disturbed to find the Board of Governors already so concerned about the possible inflationary effects of the recent tax cut as to consider moving in a direction that nullifies the intended expansionary effects on employment motivating the cut in the first place (1454).

Mr. Goldfinger (AFL–CIO):

During the past 3 years, the Federal Reserve—the Nation's monetary manager—has fortunately been more positive in its role. But interest rates—the price of money—which were pushed upward during the 1950's are at high levels and unemployment remains about 5½ percent of the labor force. Yet it is not monetary ease that is now the primary concern of the Chairman of the Federal Reserve.

In 1964, America once again faces a potential threat from the Federal Reserve—monetary policy may be used to negate the demand-generating and job-creating impact of the tax cut. Once again, the Nation's monetary policy may be tilting with the windmills of overall demand inflation or ineffectively responding to a balance-of-payments deficit, leaving persistent, high levels of unemployment in its wake (1472).

It is not unreasonable, then, for those of us who criticize the Federal Reserve for its recession-preceding, money tightening actions of 1957 and 1959 to wonder how much additional damage can result from mistaken inflation fears in the 1960's (1477).

Just as Chairman Martin is certain that "inflation creeps upon you," with a memory of the past, I fear that he will see "inflation" where it is not, and quite honorably attempt to destroy it. The result will be disastrous at a time of already tight money and high unemployment. We cannot afford such loss again—with a 5½-percent jobless rate and unemployment rates two to three times that level for Negroes and young people (1478).

Professor Bach (Carnegie Tech):

On the issue of current monetary policy, I shall be brief. In my judgment, the results of monetary policy have turned out to be about right for 1963—in part, I suspect, because of a happy accident. The stock of money has grown at an annual rate of about 4 percent during 1963, and at an annual rate of 5 percent during the last half of the year. This compares with more like 2 percent over a period of several years before 1963, in spite of the fact that the Federal Reserve announced a movement to a policy of "less active ease" at mid-1963, raised the discount rate from 3 to 3½ percent, and apparently reduced its target level of free reserves (1391).

Professor Meltzer (Carnegie Tech):

1963 is a very good year to discuss, 1962–63. I mentioned in my statement, in my earlier remarks, that it was precisely at the time that the Federal Reserve indicated that they

34–884—64——5

> had moved to a policy of slightly less ease that the money supply began to grow at a much more rapid rate. Their indication of a change in policy toward less ease was published in the Federal Reserve Bulletin by the manager of the account, Mr. Stone. Slightly less ease should mean that the money supply is going to be compressed, that growth in the money supply is going to slow down. But it is just at that time that the money supply began to grow faster.
>
> Judged by free reserves that Mr. Hayes at these hearings and that Mr. Martin and others have used over and over again as the indicator of their policy—their policy has been tight. But judged by appropriate indicators, that adequately summarize Fed policy operations on the money supply, their policy has been easier since late 1962. So they misjudged the meaning or content of their policy, and I think there is a strong case to suggest that they do not understand, in any reasonable detail, the operations that they are conducting or their effect (951).

In summary, the staff is convinced that recent monetary policy has been excessively concerned with inflation and has tended to overreact to the threat of inflation. Thus it produced and nursed three recessions. The annual rate of growth of the money supply fell to less than 1 percent before the 1953–54 episode, and before the 1957–58 and 1960–61 recessions the volume of money actually fell.

Monetary developments have been expansionary since the fall of 1961, and the rate of increase in the money supply has been just about right to achieve growing employment without inflation. The economy, in consequence, now is experiencing an upswing in business activity and declining unemployment, and without rising prices. But so great is the Federal Reserve's fear of inflation that the growth of the money supply at rates sufficiently close to what has obtained since 1961 are not likely to continue. Moreover, there is evidence that the Federal Reserve never meant for as much ease to obtain as we have had, and that therefore the period of expansion we have been experiencing has been an accident.

(*f*) *Testimony on the interaction, if any, between monetary developments and the balance of payments.*—Nearly every witness testified that since 1956 the Federal Reserve's policies have been formulated, at least in part, in response to our balance-of-payments difficulties. Most witnesses, however, were disturbed by this. They felt we had sacrificed domestic employment and growth in trying to achieve balance-of-payments equilibrium. Moreover, they were doubtful that the policy of monetary stringency which had increased our domestic problems was the appropriate one for solving our international difficulties. Mr. Goldfinger (AFL–CIO) put it this way:

> Resultant high unemployment and yearly losses of billions of dollars of potential output from economic slack are ineffective "solutions" to the balance-of-payments problem. The administration and the Congress and, indeed, the Federal Reserve Board, have already used more direct and more effective means of treating the payments problem.

> Money tightening efforts have not resulted in much lowering of the deficit, but they have slowed domestic economic progress (1478).

Professor Lerner agreed. He observed:

> As to the level of interest rates and the money supply, it is my feeling that lower interest rates and a greater money supply would have done much more good than harm, and possibly no harm at all. The higher income level would have increased demand for imports and the lower interest rate would have induced more idle money to be held abroad, but the higher level of employment would have made investment in the United States more attractive compared with investment abroad and thus might very well have offset or more than offset the first two influences on the balance of payments.
>
> This cannot be known with any certainty, but in any case the loss from national income from higher interest and lower money supply is almost certainly much greater than any real cost that would have been involved in a larger gold drain (1400–1401).

Precisely because we know that tight money policies create domestic economic problems and do not know whether they decrease or increase our international payment problems we can find fault with the Federal Reserve for attempting to solve our payments difficulties with tight money policies. The fact is that following 7 years of monetary stringency (January 1956 to August 1962) our payments deficit continued to run at an annual rate of more than $3 billion. Only since the money supply has been growing at a rate large enough to generate an upswing has our payments position improved. Until the Federal Reserve can demonstrate the power of monetary stringency to equilibrate a payments deficit without causing substantial domestic unemployment they should not follow a restrictive policy for the purpose of trying to eliminate our payments deficit. Rather, they should take the chance that a policy of adding to the money supply in proportion to the growth of our productive resources will underwrite "maximum employment, production, and purchasing power" at home without increasing our payments problems. As Professor Bach put it:

> I have the feeling that we could afford to take a bit more risk, if you want to put it that way, with our gold stock * * * (1405).

In the above connection, a letter from Chairman Martin to Senator Douglas, of Illinois, which was inserted into the record on pages 1381–1383, reveals that our gold reserves could fall to $8 billion (or by $7 billion from the present level) and all that would occur, under the law, is that the Federal Reserve System would have to pay a tax of $300 million a year because of the resulting deficiency in gold reserves. But this tax would be meaningless, for as the letter points out, "Payments on these taxes would diminish net earnings on the Federal Reserve banks and reduce by an equal amount their payments to the Treasury as interest on Federal Reserve notes, which amounted to $800 million in 1962. It should be understood that the total payment to the Treasury would not change; it would simply be divided into two parts adding to the same total, one part labeled 'tax on reserve deficiencies' and the other labeled 'interest on Federal Reserve notes.' In the example, the total payment would still be $800 million, but $300 million would be in the form of a tax and $500 million would represent interest on notes" (1383).

Professor Barger (Columbia), alone among university economists who testified, felt that the Federal Reserve had steered a middle course between gold and jobs successfully. He testified:

> It seems certain that our employment rate would be lower today, and our gross national product larger, had monetary policy been somewhat easier during the past 2 or 3 years. But I also believe that the Federal Reserve has shown extraordinary skill in keeping money just tight enough to bring gold losses to a practical halt, without doing any more damage to domestic employment and the growth of the gross national product than proved absolutely necessary (1356).

Professor Barger also testified that—

> The position of the administration is that the gold flow and balance of payments should take priority * * * (1370).

Congressman Vanik (Ohio), asked where it had been indicated by the administration that the Federal Reserve should give priority to stemming the gold outflow over curbing unemployment. In a tripartite colloquy, among Representative Vanik and Professors Barger (Columbia) and Robertson (Indiana) it developed that the Federal Reserve did not have legal authority or administration approval to do this. More important, the dialog also indicates, as others testified, that monetary stringency is simply not an effective way of equilibrating balance-of-payments problems. The dialog follows:

> Mr. VANIK. I have not seen that written down anywhere. I have not seen it anywhere where the administration said when it comes to deciding between full employment or curbing unemployment and limiting the gold flow that we are going to favor limiting the gold flow. If you had seen it I would like to have you spell it out for me.
>
> Mr. BARGER. I would quote the statement of the late President Kennedy if you like, at the time that Telstar was first launched, when he said that the one thing, whatever else the United States did, the one thing that it would never do, would be to devalue the dollar. If that is not a categorical statement of priority, I don't know what is, sir.
>
> Mr. ROBERTSON. * * * I think both Professor Barger and I agree with the overwhelming majority of the economics professors in our views that domestic matters should take precedence over foreign in any handling of the money markets and in any engineering of interest rates, and I certainly would want to be on record as saying this. * * * I am afraid, sir, that monetary policy alone can never, never adjust gold flows. I give you as one example the effectiveness of the so-called interest-equalization tax, which did more at one stroke to stop international gold flows than

raising the interest rate by 2 full percentage points would have done.

Mr. Vanik. That is correct. I want to say that I see nothing in the Full Employment Act that relates anything, any of its objectives, to the gold flow. Perhaps at the time the act was adopted in 1946 this was not comprehended as a problem.

But the law still stands. Also, I want to say I don't think the Telstar statement Professor Barger mentioned meant President Kennedy gave priority to stemming the gold outflow over achieving full employment. I think he meant we'd defend the dollar with policies like the interest equalization tax (1371).

Professor Barger did, in fact, suggest that our payments deficit reflects a "fundamental disequilibrium" which cannot be corrected by monetary stringency. To correct the situation he stated:

> I think that a realinement of exchange values, particularly with Western Europe and the Far East through the agency of the International Monetary Fund, would be the proper procedure (1365).

Put otherwise, Professor Barger urged devaluation. Others agreed. Still other economists urged that we simply free the price of the dollar and let market forces determine its value. This would have the virtue of preventing deficits and surpluses though it might cause other problems.

Regardless of whether one favors freely fluctuating exchange rates, devaluation, or policies such as the interest equalization tax as the appropriate means of solving our payments problems, it is clear that monetary stringency is the most costly way of attacking the problem, and moreover, also the least likely to be effective. Secretary Dillon, in a recent speech quoted in the Washington Post, June 1 (20), expressed precisely this point of view when he stated:

> All of us recognize the need to improve the process of balance-of-payments adjustments among free industrial nations. We have found that the old "rules of the game"—whatever their value in the past—are no longer adequate. For instance the classical presumption that balance-of-payments deficits call for the restriction of domestic activity has had little relevance to the situation facing the United States in recent years.

The Federal Reserve's restrictive policy from 1956 to 1962 may have been aimed at solving our payments problem without dwarfing our domestic economic growth and causing unemployment, but if it was, it clearly failed. Monetary stringency, by itself, actually may have aggravated our payments deficit, and has certainly stunted our growth and caused unemployment.

D. SOME REPERCUSSIONS FROM FEDERAL RESERVE MONETARY POLICY

The political, social, and economic repercussions of monetary mismanagement these past 50 years are both numerous and vital. This report outlines only the most important effects of the Federal Reserve's recent errors.

Between January 1, 1956, and August 1962, our economy had to adjust to an extremely miserly monetary policy. The money supply—whether deliberately or because the Open Market Committee did not know what it was doing—grew from $135.3 to $144.8 billion or by only 1.1 percent per year during this period. During this same period, we had two recessions, one from July 1957 to August 1958 and the second from May 1960 to February 1961. Long-term yields on Government bonds reached 4.37 percent just before this latter recession.

Population and knowledge, the human resources of our economy grew much faster than 1.1 percent per year during this nearly 7-year period. Thus we were compelled to find ways of making dollars do more work or to suffer the strains of unemployment. We found some ways of making our dollars work harder. But these were not enough to prevent a significant rise in long-term unemployment. Moreover the ways we found to compensate for monetary stringency were detrimental to our economy's growth.

1. Effect of monetary stringency on private investment and Government spending and therefore on economic growth

This report earlier pointed out that politicians are held responsible for achieving full employment (without inflation, of course) whether they like it or not. Thus, if monetary policy fails, fiscal policy will be used to do the job. Professor Shapiro (Harvard) put the argument this way:

> * * * if the central bank * * * maintains a monetary policy which dampens demand * * * [then] with a deficit of sufficient size, it may be possible to offset this restrictive monetary policy (1099–1100).

Professor Brownlee (Minnesota) was one of those who pointed out that we have followed this course. He told the subcommittee:

> For a given desired gross national product, we have a choice between easy money and a tight budget (a surplus) or tight money and an easy budget (a deficit). We have chosen the latter policy (1066).

Expansion of Government spending, then, was the principal way which we found to substitute for the adverse effects of the Federal Reserve's policy of monetary stringency during the 1956–62 period. Monetary policy strangled private investment during these years. Private borrowers (investors) found that funds were too costly or simply not available. So spending was increased at all levels of government by way of trying to make up the gap. From 1956 through 1962 net private investment fell from 8.4 percent of GNP to 6.7 percent, or by one-fifth of the initial rate. In the same period, Government expenditures rose from 25 percent of GNP to 29 percent. Moreover, Government transfer payments, which constitute a good measure of welfare spending, rose from 23 percent of all Government expenditures to 27 percent.

It is not at all clear that the President and Congress, acting for the electorate, would have chosen to sacrifice private investment to Government spending, and especially welfare spending, if they had been allowed to choose. But the President and Congress have not been allowed to choose. Our elected officials could only react—to counterpunch—with an expansionist fiscal policy when the Federal Reserve throttled private investment with a policy that deliberately or accidentally held the average annual growth of the money supply to 1.1 percent for almost 7 years. Professor Samuelson (MIT) spoke of the consequences when he observed:

> * * * we have gone along with the image of an adversary procedure, where it is the business of the Federal Reserve, the central bank, to worry about the price level, as if that was its brief, and its mandate; while it is supposed to be the business of somebody else, I suppose the executive branch—you cannot call it the Treasury because the Treasury does not decide these things—to determine what the unemployment rate will be and what the rate of growth will be.
>
> You cannot divorce these two.
>
> But if you try to, you will get something like what we have had in recent years; namely, a biasing of policy toward fiscal ease which means a low-capital-formation economy, because we keep tighter money and we offset it by a looser fiscal policy. * * * What we see in the tax bill is an example of that. We are encouraging the use of resources by tax reduction in the direction of current consumption, even though it is true that there are aspects of the tax bill which have a bearing upon capital formation. And the Federal Reserve is prepared to—in fact, it has warned us that it is prepared to—mop up any inflation that may result from that by tightening money and credit, which means putting the tourniquet around capital formation.
>
> Well now, under such a procedure, where I can only move the white man in chess and you can only respond with the black man in chess, you are not going to get the optimum from anybody's point of view (1121).

Representative Hanna (California) made a similar analysis the day before Professor Samuelson appeared, except Mr. Hanna put his in terms of "jousting between knights."

But regardless of whether we frame the problem in terms of jousting knights or chessplayers, it is clear that when, as in the 1956–62 period, the Federal Reserve's monetary policies are too tight our fiscal policies will be affected. In an article written in November 1963 which he submitted for the record, and which we have earlier cited, Professor Samuelson noted that fiscal policies—

> have thereby to be so much the looser. The result even at full employment will be a bias against capital formation and a bias toward present consumption.

He continued:

> The founders of the Federal Reserve really didn't know what they were doing. But surely none of them thought they were designing an engine that would be a bulwark against growth (1125–1126).

2. Effect of monetary stringency on the Government's debt

Obviously, inasmuch as Government spending had to increase to prevent widespread unemployment, the Government debt was increased by the Federal Reserve's policies of monetary stringency. It is impossible to measure precisely how much Government debt monetary mismanagement has caused. But for the Federal Government's debt a rough approximation or estimate can be obtained by adding the taxes that would have been collected and could have been applied to the debt plus the spending, including interest payments, that need not have occurred if only monetary policy had been more sensible and matched changes in the money supply with changes in our economy's productivity.

To accomplish this task it is necessary to have some idea of the difference between what GNP would have been at full employment and stable prices and what it actually was. The Economic Report of the President provides these facts. Based on our entire postwar experience the President's report concluded that for the 1956–62 period the economy's output potential grew at an annual rate of 3.5 percent, whereas actual growth was at the slower rate of 2.7 percent. In 1962 prices the cumulative excess of potential GNP over actual GNP totals about $190 billion for the same period. If we had realized our full economic potential and also maintained tax collections (measured as a percent of GNP) at the 1955 rate, the Federal Government would have collected nearly $35 billion more in taxes than it did during the 1956–62 period.

Also, if we had realized our full potential, Government expenditures, especially transfer payments to individuals, grants-in-aid to States and local governments, and business and farm subsidies, would have been appreciably reduced during the period. It is difficult to estimate by how much transfers, grants, and subsidies would have been cut. To avoid arguments this sum will be ignored. Of course this procedure will minimize our estimate of total debt savings.

Interest payments also would have been lower if a more appropriate monetary policy had been followed during the period in question. If the rate of growth in the money supply had been a modest and noninflationary 3 percent per year, instead of 1.1 percent, rates of interest now, in 1964, *might* be what they are, or even higher, but during most of the intervening years, possibly through 1962, probably could have been maintained at roughly 1955 levels. In 1955 the computed rate of interest on the Federal Government's debt was 2.3 percent. If this rate had been maintained, and if all additional tax collections from realizing our full economic potential plus all interest savings were applied to the debt in the years they were achieved, the cumulative savings in interest payments on the debt for the fiscal years 1956–62 would have been nearly $17½ billion. When this sum is added to the $35 billion additional taxes that would have been collected in this period if we had experienced full employment, we find that the debt could have been only $251 billion at the end of fiscal 1962, rather than $303.5 billion. Further savings in interest payments and so additional debt reduction might have been achieved in fiscal years 1963 and 1964.

This $52½ billion plus debt reduction could have been achieved without inflation. It could have been achieved if only the Federal Reserve had managed the money supply so that it grew roughly at an annual rate of 3 percent. This rate would not have brought an economic paradise but it would have been large enough to accommodate the expansion of our population and technical know-how and yet small enough to prevent inflation. Moreover, it would have permitted Congress either to retire debt or undertake Government investment in pressing social overhead programs.

3. Effects of monetary stringency and monetary recessions on our economy's marginal workers

From 1956 to 1962 the Federal Reserve did not "furnish" the economy with a money supply that was "elastic" enough to permit "accommodating" our growing labor force and know-how, and, by inference, "with a view of accommodating commerce and business." Monetary stringency and monetary recessions have differential effects on our Nation's people. Some are hurt far more than others. All of us know that some people are more employable than others. People who live in depressed areas are, by definition, not as employable as those who live elsewhere. Monetary stringency and recessions compel these people to stay where they are because there are very few jobs elsewhere. Teenagers and persons over 60 years old are not as employable as workers in intermediate age groups. And, nonwhites are not as readily employed as whites. From the standpoint of the entire economy, the young and the old and nonwhites are observed to be the last to be hired and the first to be laid off. These, then, are the persons who suffer the most from monetary stringency and monetary recessions.

The term "structural unemployment" is sometimes used to define present-day unemployment. According to this definition the problem is "structural" and "technological" and has little, if anything, to do with recent monetary developments. But though there doubtless are some nonmonetary roots of unemployment the principal cause in recent years, as in the past, has been monetary stringency and monetary recessions. It is significant that we did not hear the term "structural unemployment" in 1952–53 when, as Prof. Dudley Johnson (Washington), observed in a previously cited statement:

> Aggregate monetary demand was sufficiently high * * * so that unemployment was only 3.1 percent in 1952 and 2.9 percent in 1953, even in the face of rapid technological change (1436).

The fact that monetary developments have been the principal root of the recent unemployment problems of the aged was brought out by Professor Friedman (Chicago) in answering a question put to him by Representative Widnall (New Jersey). Representative Widnall asked:

> Now, do you think that a change in the money stock would have helped those who do not have the skills in today's unemployed? Do you think it would help those who are frozen out of employment because of age today?

Professor Friedman replied:

> If you had not had the sharp decline in the rate of growth of money from 1959 to 1960 I believe that the 1958–60 expansion would have continued for a longer period.
>
> I believe that that would have meant more jobs for people, including the people who are low in skill and including the people who are at advanced ages.
>
> The circumstances under which a man of 60 can get a job depend on the general buoyancy of the market. In a boom,

> at a time when there are many job opportunities, he will get a job more easily than at the time of a recession.
>
> So I think the answer I would make is, "Yes." A more stable, steady monetary policy during that period would have meant that fewer people would have been unemployed and among them would have been some of the people you mentioned (1145).

The fact that a more stable and steady monetary policy also would have meant less unemployment in depressed areas and for the young and nonwhites as well as among the aged is observable in employment trends in the most recent months. Since the recession of 1960–61, monetary policy even though possibly because of a happy accident, was first moderately expansive and then (since the fall of 1962) expansive enough to produce our currently robust and growing economy. The employment benefits have included decreases between 1961 and today in total unadjusted but comparable unemployment figures from 8.1 to 6.2 percent; among persons over 60 years old from 6.1 to 5.5 percent; among persons 14 to 19 years old from 16.1 to 14.4 percent; in "Appalachia" from 9.2 to 7.9 percent; and among nonwhites from 15 to 11.2 percent.[3] These facts will be enough to convince reasonable men that our marginal workers are not insulated from monetary developments but rather are significantly affected by what happens to money. One must conclude, as Dean Walden (North Dakota University School of Law) did, that:

> * * * as long as the executive and the Congress have concurred in a national policy to obliterate the enclaves of poverty in our midst, to promote full employment, to increase our annual rate of economic growth * * * divergency of policy between the central bank and the Central Government should not be permitted * * * (1534).

The Federal Reserve cannot be permitted to force the economy to suffer again from monetary strangulation and recessions. Congress must instruct the System to give us a money supply that is truly elastic and grows as it has in the period as a whole since August 1962 at about the same pace as our know-how and other productive resources, a pace large enough to create maximum employment and yet small enough to prevent inflation. Only if this is done can attempts to eradicate poverty succeed. Education, manpower retraining, area redevelopment, and other antipoverty programs are all obviously worth while, but none of these efforts can possibly succeed if monetary policy does not allow. On the first day of the hearings Chairman Martin stated:

> We want to regulate the money supply, to be sure. And, as you say, Mr. Patman, the volume of money, we like to see it increase, to use my simile of the stream, as the riverbed can absorb and handle it (48).

For our part, we, too, wish only this much. But we are mindful of the years gone by like 1929–33, 1937–38, 1948–49, 1953–54, and most recently the 7 long years from 1956 to 1962 when, because of Federal Reserve policies, "the riverbed" was "parched."

[3] Information made available by the BLS. Figures are for February 1961 and February 1964 and are not seasonally adjusted, except for "Appalachia." In the case of "Appalachia" the data are for the years 1960 and 1963.

PART IV.—THE NEED FOR CHANGE

A. THE NECESSITY OF RESTRUCTURING THE FEDERAL RESERVE SYSTEM

In the middle of the recession of 1960–61, the volume of money, narrowly defined and seasonally adjusted, was $140 billion. Fifteen months later it was $145 billion. It had increased at an annual rate of roughly 3 percent. This was enough to end the recession and initiate the upswing that now is in its 40th month. The expansion faltered in the latter part of 1962 because for the first 9 months of that year there was no increase in the money supply. But in the 21 months from September 1962 to now, in June 1964, the money supply has grown at an annual rate of 4 percent. Together with the tax cut, which was initially proposed in January 1963 because first the growth of the money supply and then the business upsurge had faltered in 1962, this latest increase in the volume of money has underwritten continuation and even acceleration of the current business expansion.

If the Nation could be assured that these recent monetary developments have been the result of deliberate policy, and moreover that this policy will not be significantly modified in the future, there might be a less compelling need to restructure the Federal Reserve and terminate its authority to act independently of the administration and Congress. But the assurance is not forthcoming. Indeed by reason of influences discussed below, the objective reviewer can only expect present policy to devolve into overreaction to balance-of-payments difficulties or carefully selected ad hoc harbingers of future inflation. In fact, the signs of renewed monetary stringency are again appearing as this is written in June 1964; the growth of the money supply as now defined and measured by the Federal Reserve, has fallen steadily recently. Hopefully this trend will be reversed.* If not, then, as in the past, the results of renewed monetary stringency will be economic stagnation, increased Government spending to bolster consumption as opposed to needed private and public investment programs, increased Government debt, and excessive unemployment. The reason for gloomy expectations that past errors will be repeated in the future—though perhaps not in the immediate future—stems from the very structure and independence of the Federal Reserve System, in the opinion of staff. It was for this reason that Professor Shapiro (Harvard) told the subcommittee:

> I do regret, however, the intrusion of consideration of the "tenor of monetary policy" into these proceedings. I say this because even if the *present* course of monetary policy were letter perfect, it should not preclude the discussion and enactment of necessary structural changes which might improve the effective discharge of monetary policy in this country in the *future* (1099). [Emphasis supplied.]

***In this connection, see note on p. 53.**

B. OUR MONETARY FAILURE AND THE FEDERAL RESERVE'S STRUCTURE

The failures of U.S. monetary policy, documented in part III of this report, were in Prof. Harry Johnson's judgment "inherent in the conception, constitution, and operating responsibilities and methods of an independent monetary authority" (970), and we must add that they are particularly rooted in the operating methods and prejudices of the Federal Open Market Committee.

1. Structure of the Federal Reserve and its intellectual myopia

As was earlier observed, the Federal Open Market Committee, which is the System's principal monetary control body, consists of the 7 Governors of the Federal Reserve Board, the president of the New York Reserve Bank, and 4 of the other 11 Reserve bank presidents. The Cleveland and Chicago presidents serve as voting members of the Committee every other year, and the other nine presidents every third year. The seven presidents not currently serving as voting members of the Committee participate in its deliberations as invited discussants.

The argument for continuing this arrangement whereby all 12 Reserve bank presidents participate in open market policy deliberations, and 5 join the 7 Governors in determining policy was initially given by the Board of Governors in answering a questionnaire submitted by the Patman subcommittee in 1952. The Board's argument was iterated by Chairman Martin in his testimony at the present hearings. Referring to the present arrangement, the Board stated in 1952 and Chairman Martin repeated in 1964 that—

> It provides a means whereby the viewpoints of the presidents of the Federal Reserve banks located in various parts of the country, with technical experience in banking and with their broad contacts with current credit and business developments, both indirectly and through their boards of directors, may be brought to bear upon the complex credit problems of the System (13–14).

But, without impugning the integrity of any person or groups, it is legitimate to question whether banking experience and contacts with credit developments lend themselves to the formulation of sound monetary policies or, on the contrary, to an intellectual myopia which prevents effective monetary control.

Everyone agrees that not every occupational experience is conducive to the formulation of sound monetary policies. H.R. 9631 proposes making the Secretary of the Treasury Chairman of the Board of Governors. The testimony argued persuasively for rejecting this proposal on the ground that the Secretary of the Treasury is unduly concerned with the cost of carrying the Government debt. This problem is directly and immediately in any Treasury Secretary's line of vision. If, therefore, the Secretary were also Chairman of the Federal Reserve Board, monetary policy would tend to be unduly concerned with this problem and, in turn, this would bring monetary and economic instability.

The argument has widespread applicability. Treasury Secretaries are not the only persons who can't "see the forest for the trees." In the sense that people take on the colorations and limitations of their occupational surroundings, intellectual myopia is very nearly a universal affliction. Perhaps that is the basic reason for maintaining civilian control over the National Defense Establishment. Because human beings tend to select facts and appraise problems in terms of their particular specializations, it is more in point to determine what, if any, are the views and concepts with which Federal Reserve officials feel most at home and the sources of such views and concepts.

The Federal Reserve has many direct ties to the banking business, and some indirect ones to bankers. No one denies this. Indeed, as Chairman Martin's statement (above) indicates, some believe that these ties promote monetary and economic stability and prosperity. Later we will explore this question. First we must delineate the ties.

Governor Mitchell's testimony is pertinent here. He stated:

> I think there are lots of relationships between the Federal Reserve and bankers because they are both in essentially the same business and so they speak a common language in a great many respects, and the Federal Reserve engages in supervisory operations which bring them in close contact with the bankers (1201).

The formal ties between the Federal Reserve and the commercial banking business were described briefly and clearly by the American Bankers Association in a monograph prepared for the Commission on Money and Credit. The association observed:

> Member banks are entitled to certain privileges such as the use of various Federal Reserve facilities, the ability to borrow from the Federal Reserve banks under certain conditions, the right to participate in the election of two-thirds of the directors of their Federal Reserve banks, and a 6 percent dividend on their investment in capital stock of the Federal Reserve banks. In turn, members undertake to abide by the laws and regulations governing the System. Nonmember banks may also be permitted to use certain of the System's facilities.
>
> The commercial banks thus have close relationships with their local Federal Reserve banks. They also have indirect but nonetheless important relationships with two other agencies of the Federal Reserve System, the Board of Governors, and the Federal Advisory Council.[1]

As indicated by both Governor Mitchell and the American Bankers Association, our Nation's monetary authority is specifically tied to the commercial banking business in two ways. First, commercial banks elect two-thirds of the directors of their Reserve banks. Chairman Patman, early in 1964, conducted a confidential inquiry as to the banking affiliations of class B and class C directors of the Federal Reserve banks. Individual responses remain confidential, in sole custody of the chairman and available only to members of the committee. Only aggregative figures were made available to staff. These indicate that out of 36 class B directors, 20 presently own stock in banks, and 11 others have owned bank stock in the past. In addition, 17 have been commercial bank directors before becoming Federal

[1] "The Commercial Banking Industry," a monograph prepared for the Commission on Money and Credit by the American Bankers Association, p. 381.

Reserve directors, and 12 have held other positions and officerships in banks.

Of the class C directors, 18 had formerly been directors of banks and 20 of the present class C directors owned bank stock in the past. When it is considered that class A directors are directly chosen from the banking community, the heavy incidence of banking connections of the B and C directors all add up to a strong banking orientation among those who direct the affairs of the Reserve banks and select men who participate in open market deliberations.

The second way in which our monetary authority is tied to the commercial banking business is that the Federal Reserve, in addition to being the Nation's monetary authority, also is one of the several Government agencies which supervises and regulates the commercial banking business.

Inescapably, those who make our Nation's monetary policy get a considerable proportion of their information and "feel" about the economy's problems and trends from their contacts with the commercial banking business. This was recognized by Professor Bach (Carnegie Tech), who, as a director of the Pittsburgh Federal Reserve Branch bank, is especially qualified to speak on the matter, when he said:

> * * * Federal Reserve officials have ready access to recent developments in financial and business affairs and to the views of financial and business leaders * * * I suggest, however, that this may provide a somewhat unbalanced flow of information * * * (1391).

The degree of imbalance was brought out in a short colloquy between Congressman Minish, of New Jersey, and President Shuford (St. Louis). Mr. Minish asked about memberships purchased for Reserve Bank personnel in the St. Louis Chamber of Commerce. President Shuford stated: "We get a lot of information from the chamber of commerce. We work closely with these people * * *." Mr. Minish then asked: "Do you consider * * * the labor organization out there—do you think about talking with those people?" President Shuford answered: "* * * Personally, I have not" (407). Given the present structure of the Federal Reserve, there is no reason why he would. As the Commission on Money and Credit observed, one of the hazards inherent in a close agency-clientele relationship such as that between the Federal Reserve and commercial banks is that "* * * parties on both sides come to take too parochial a view of the national interest."[2] And this view is not necessarily the wisest one.

In addition to obtaining a disproportionate amount of information on the nature of the economy's trends from their contacts with the banking business, the Federal Reserve inescapably also gets an exaggerated notion of the remedial effects of using monetary control tools to treat the problems encountered by bank managers and, more specifically, bank examiners. The Federal Reserve's bank supervisory and regulatory responsibilities contribute to the development of expertise in problems that are unique to the credit market and the

[2] Commission on Money and Credit, "Report," p. 92.

banking business. It is this very involvement in bank supervision and regulation, which, together with the ties to men with "technical experience in banking," gives rise to the myopic concept that the problems of the credit market and the banking business are problems a monetary authority must solve. This is not necessarily a sound working hypothesis, as will be developed later.

2. An unwarranted inference

The evidence is overwhelming that the close agency-clientele ties between the Federal Reserve and the banking business lend themselves to a parochial view of what the Nation's monetary problems are, and also to a myopic concept of how these problems can best be treated. Before proceeding to a more precise analysis of the occupational limitations that characterize the Federal Reserve's interpretation of the economic winds as well as the concepts that dominate its day-to-day operations, it is useful to examine a charge that is sometimes heard in the context of this subject matter: namely, that bankers profit from their close contacts with the Federal Reserve. This allegation has historical as well as immediate significance. It was vigorously put by Congressman Charles Lindbergh, Sr., in 1913, in his minority report on the Federal Reserve bill. Mr. Lindbergh charged that instead of "providing relief from existing economic evils, the Glass bill proposes to incorporate, canonize, and sanctify a private monopoly of money and credit of the Nation—to remove all the people's money from the U.S. Treasury and place it in the vaults of the banks to be used by them for private gain." [3]

It is to be stressed that no one made such an allegation in the current hearings, nor has the committee or its staff found any shred of evidence to support the notion. However, since it often looms up in the background of monetary policy discussions, it is prudent to deal with it at this time.

Analytically the charge can be broken into two separate accusations. One is that the Federal Reserve's policymaking executives are corruptible. The second is that commercial bankers use their contacts with Federal Reserve officials to shape monetary policy so that it benefits banks regardless of its impact on other economic sectors. Either accusation, if true, would be scandalous. But both must be true for the charge that bankers profit from their ties to the Federal Reserve to be valid. We examine first the suggestion, or innuendo, that Federal Reserve officials are liable to corruption.

If there was any tendency for anyone to believe that the Federal Reserve's executives, including both the Governors and the Reserve bank presidents, are in any sense whatever corrupt, or partial to the banking community in any penal sense, it should have been completely erased by the many forceful and straightforward statements on the subject which were made by Reserve bank presidents and Governors of the System, and the non-Government witnesses who testified on the matter.

President Hayes (New York) stated:

> I reject as imaginary, and as unfounded in my experience, the theoretical argument that suggests that the member banks are able to make felt in the Open Market Committee

[3] Congressional Record, Sept. 11, 1913, p. 4743.

> a narrow partisan interest that influences the six directors of the Reserve banks whom they elect and in turn the presidents who are elected by the directors, and, thereby, the Committee itself. Such an argument is fallacious, not only because the bankers, even if they wanted to, could not by such a means exert leverage on the presidents for this purpose, but also because it cynically assumes that the presidents, whose appointments must be approved by the Board of Governors, are men of such little scruple that they would violate their oaths of office as members of the Committee, by subordinating the public good to the private interest. The presidents and the staffs of the Reserve banks are public servants in the finest sense of the word (528).

President Irons (Dallas) put it this way:

> * * * I am not going to cotton to the bankers in our district, and I just know that that is typical of the Federal Reserve presidents. I do not do anything under pressure, suggestion, or connivance with the bankers in our district. I consider I am in my job because the Board of Governors said "Yes, we will accept you" (896).

Governor Robertson's comment also was very persuasive. Answering a question by Congressman Weltner (Georgia), he told the subcommittee:

> * * * But I must say that on the basis of my observation of open market operations over the past 12 years, I do not believe that any Federal Reserve bank president could have been more objective if he had been an employee of the United States rather than the Federal Reserve. It has been amazing to me to see the extent to which they have remained objective.
>
> And I think the traditions within the System are such as to assure real effort on the part of every individual to remain impartial and objective, and avoid any conflict of interest (119).

Similar comments could be listed. But there is no need to do this. Beyond any doubt the men who administer the Federal Reserve System are men of great integrity and fairness.

Attention now is called to the accusation that bankers try to use their contacts with Federal Reserve officials to shape monetary policy to the benefit of banks. Professor Friedman (Chicago) was questioned about this by Chairman Patman (Texas). Their dialog is instructive. Congressman Patman asked:

> Now, the question is, Professor, Do you believe that because of people who are subjected to the bankers' influence all the time, people like the 12 Federal Reserve bank presidents, and all of these advisory groups who are always conferring with our money managers, that the views of the bankers have a special influence on our money policies and this is not good because if it is handled right one way the bankers gain a lot and if it is not handled that way they do not make as much money?

Mr. FRIEDMAN. Well, I think that this is a very difficult and complicated question.

My impression, on reading the evidence and looking over the history, is that the bankers who have been associated with the Reserve System in all capacities have been, in the main, public-spirited citizens who have been trying to promote the interests of the public.

To this extent I would not agree that they have, in any deliberate way, used their position of influence on the System to promote their private interests.

On the other hand, there is no doubt that each of us is very much affected by the environment in which we are and know best those things which we are familiar with. And there is no doubt that from the point of view of the bankers, what they are individually familiar with is the credit and investment market.

To them it seemed perfectly natural and understandable in trying to serve the public interest to place major emphasis on interest rates and credit conditions, rather than on the aggregate quantity of money. From this point of view, I think it has been an unfortunate thing that we have had a Reserve bank which has been as closely linked to the banking community and to the lending and investment process as it has, not at all because the individuals are trying to feather their own nests, not for that reason, but because they naturally interpreted the instrument they were dealing with in terms of the environment they knew best and were most familiar with.

And this was wrong interpretation, as I see it, from the point of view of the public interest.

The CHAIRMAN. Substantially I agree with you, Professor. I do not impugn the motives of these people.

I think they are in an environment where they just naturally think that way and they think, honestly, to serve the public interest you have to serve the bankers and by serving the bankers you have to serve the public interest.

Mr. FRIEDMAN. Pardon me, but I do not believe that is the case either, because I think I can name times in history where bankers did things that they thought were against the——

The CHAIRMAN. Oh, I will agree with you; there have been times.

Mr. FRIEDMAN. So I do not think it is because they thought they were trying to serve the banks' interest.

The CHAIRMAN. I did not go that far. I said where they honestly believed——

Mr. FRIEDMAN. Oh, yes. (1163).

The dialog between Chairman Patman and Professor Friedman, confirmed by numerous other witnesses and observations, would appear to dispose effectively and thoroughly of innuendoes that the contacts between the Federal Reserve and commercial bankers have been exploited to promote the private interests of bankers. Any such innuendo is totally unwarranted.

On the other hand, the colloquy also forcefully reminds us that, though corruption definitely is not the cause of the Federal Reserve's policy errors, occupational myopia, or "tunnel-vision," as Representative Hanna (California) put it, may be the root of our monetary instability. This is because monetary policy has been formulated and put into effect by persons with banking experience and therefore expertise in the problems of the credit and investment market, and this expertise has often led the Federal Reserve to aim monetary policy at the wrong targets.

3. The defects of monetary policy and the Federal Reserve's myopia

As indicated in the preceding analyses of testimony, occupations tend inevitably to produce a limited and ofttimes parochial view of what is in the national interest and how best to achieve these goals, based essentially on an exaggerated application to the rest of the world of the concepts and precepts that are uniquely suitable to the particular professional subject area. Men in the banking business, like Treasury Secretaries, union leaders, and clergymen, are not immune to this affliction. Since it has already been established that the ties between the Federal Reserve and the banking business and bankers provide both an unbalanced flow of information about the nature of the economic winds and a nearsighted view of how to treat whatever windstorms are thought to be blowing, it is important to find out how men with technical experience in the commercial banking business view the economy. What, if any, are their misconceptions and prejudices?

(*a*) *The Federal Reserve's immediate targets.*—Many persons believe that "technical experience in banking," as Chairman Martin implied, qualifies a man to manage the Nation's money. Obviously this view prevailed when the Federal Reserve Act was passed in 1913 and again when it was amended in 1933 and 1935. But not every Member of Congress agreed. Representative Graham of Illinois, for example, tried to persuade his colleagues that banking experience lends itself to the formation of erroneous conceptions concerning the Nation's money system. Mr. Graham told the House:

> The ordinary banker devotes very little of his time to a study of financial systems. He devotes himself rather to the immediate management of his bank, such as determining the soundness of the paper he discounts, the character of the loans and investments made for the bank, and all that. In fact, he is so close to this part of the field that it is quite difficult for him to have a clear and disinterested view of the entire field.[4]

As indicated by Congressman Graham back in 1913, men trained in the banking business will tend to conceive the problems faced by individual banks as a miniature of the economy's monetary problems. To them, therefore, it will be important to control the variables that are vital to an individual bank's functioning and, as a corollary, its solvency, liquidity, and profits. Some of the things that are vital to a bank's functioning are the quantity and quality of its credit; who wants to borrow; the daily quotations on "Federal funds"; the loan rate to dealers in Government securities; the daily price of Treasury bills; excess and free reserves, etc. These variables have served and

[4] 63d Cong., 1st sess., p. 4843, Mr. Graham of Illinois.

continue to serve as the target or instrument variables of the Federal Reserve. The System's officials explain the fact that the manager of the Open Market Committee's account engages daily in so-called defensive operations—from which longrun money supply changes emerge—as necessary to insulate these variables from the effects of strikes, snowstorms, and other essentially random disturbances. Unfortunately they are the wrong targets. It would be far better to aim at controlling the money supply rather than, as at present, having the money supply emerge as a byproduct from controlling bank credit and other banking variables.

In the present hearings, almost all of the economists who testified were disturbed by the Federal Reserve's choice of targets. Professor Lerner (Michigan State) called attention to the fact that expertise in the banking business simply does not qualify a man as an expert in monetary policy when he observed that:

> The historical accident that the management of the national money supply developed out of the banking business is responsible for monetary policy being distracted from its proper objectives by the bankers' natural but irrelevant concern with such matters as the quality of bank credit (1398).

Professor Friedman put the matter even more strongly when, in an article he submitted for the record, he stated that—

> an independent central bank will almost inevitably give undue emphasis to the point of view of bankers * * * (and) since the banking community is concerned primarily with the credit market, central banks are led to put altogether too much emphasis on the credit effects of their policies and too little emphasis on the monetary effects * * * (1172–1173).

Money and credit are not the same thing. Nor are they two sides of the same coin. Most important, the volume of money and the supply of credit do not behave in the same way. Sometimes the growth of the money supply accelerates faster than that of credit; sometimes the converse is true. For example, in 1963, as reported by the Federal Reserve, "The money supply increased by 3.8 percent * * * a substantially *faster* rate than in 1962 * * *." In the same year, "Commercial bank credit increased * * * a little *less* than in 1962 * * *."[5]

In view of these facts it is unfortunate that the Federal Reserve should conceive of monetary expansion and bank credit expansion as identical. Professor Meltzer (Carnegie Tech) called attention to the fact that this mistaken idea prevails among Federal Reserve executives. He observed that—

> When asked by the Joint Economic Committee to distinguish between monetary expansion and credit expansion, the Board submitted the following written reply:
>
> "No difference was meant by the two terms 'bank credit expansion' * * * and 'monetary expansion' * * *
>
> "* * * 'bank credit expansion' and 'monetary expansion' are essentially two sides of the same coin" (930).

[5] "50th Annual Report, "Board of Governors of the Federal Reserve System, p. 6. (Emphasis supplied.)

But as Professor Friedman pointed out, they—

> are not the same thing. Monetary policy ought to be concerned with the quantity of money and not with the credit market. The confusion between "money" and "credit" has a long history and has been a major source of difficulty in monetary management (1151).

The problems created by confusing credit and money and acting to change credit—money supply being an economic, not a banking concept—were brought out by Professor Meltzer. He pointed out that the Federal Reserve has—

> permitted larger rates of growth in the money supply during periods of expansion than during periods of contraction. This is the direct opposite of a policy designed to expand economic activity during recession and to control inflation.

On the other hand—

> When we look at this stock of "bank credit" for the same periods, we note "credit expansion" has behaved in a countercyclical way. The rate of "credit expansion" has been greater during periods when unemployment and recession were our national concern. And the rate of "credit expansion" slowed during periods of expanding economic activity (930).

His observation squares with the facts cited immediately above from the Board's "50th Annual Report" on the increases in money and bank credit in 1962.

Using the quantity of bank credit as a target variable is apt to amplify cyclical changes. Since the sum of bank loans and investments, i.e., bank credit, expands most rapidly during recessions, the Federal Reserve's executives will be misled by looking at this total into believing their policy is easy in recessions and tight in inflations. If they looked at the volume of money instead of the volume of bank credit they would not make this mistake because money expands most rapidly in inflations and expands little, if at all, during recessions.

Using the quality of bank credit as a guide to action also leads to error. This is because credit quality is determined by monetary policy and hence cannot be itself a determinant of this policy. On this, it is astonishing, as Professor Strotz (Northwestern) pointed out, that the Federal Reserve is so concerned with the quality of credit. This indicates—

> * * * little confidence in the banking community. My feeling is that the problem of judging credit quality is a problem for the commercial bankers and others who run lending institutions. In the past they have been in serious difficulty only when the Federal Reserve System has permitted the quantity of money to fall drastically, thereby producing a situation very unlike anything that would constitute a proper environment for the determination of terms of credit (1455).

The Federal Reserve's use of other banking phenomena as its immediate target variables also was criticized. Professor Brownlee (Minnesota) was one of those who brought out that—

> * * * many different levels of total reserves, and hence of the potential money supply, can exist with a given amount of "free reserves"—the target variable used by the Committee. An increase in free reserves can be compatible with an increase or a decrease in the potential money supply (1063).

Professor Shapiro (Harvard) was among the witnesses who were disturbed by the Federal Reserve's concern with the Government bond market. He told the subcommittee:

> Preoccupation with the minute variations in the financial markets tends to cause erratic behavior on the part of the Fed, and subjects these markets to uncertainties which, in my opinion, are not helpful either to the outcome of monetary policy or to the effective functioning of these markets.
>
> I believe that the bond market is more viable than is suggested by the Fed's almost minute concern with it. Moreover, the concern with the state of the bond market appears to me to constrain the Fed in pursuing monetary policies which might substantially affect bond prices.
>
> In this sense, I agree with the Commission on Money and Credit report, when it states: "The monetary authorities should make full use of the fact that monetary measures can be varied continually in either direction and reversed quickly at their discretion."
>
> If, in fact, our economic system contains more rigidities than was true in the past, I believe a more active response to projections in the rate of change of economic activity may be desirable. For, if the Fed delays its action in the face of an increasing number of signs of recession, and then later reacts with an overactive policy of increasing reserves, it tends to get the worst of two worlds. That is to say, unemployment is larger than it need be, and the subsequent increase in economic activity tends to be associated with more price rise than is necessary (1103).

Professor Bach (Carnegie Tech) stated the objection of economists to the Federal Reserve's operating methods at some length. His criticisms merit attention and are given below.

> The Federal Reserve has not made it clear that it has a clear, explicit framework, or rationale, for its monetary policy, specifying the mechanism or steps connecting particular Federal Reserve policy changes with the desired end results. * * * Federal Reserve policy statements indicate recognition of a multiplicity of possible channels of impact for their policy actions (open market operations and rediscount and reserve requirement changes) on the economy. But without firm knowledge of the links connecting Federal Reserve actions with their immediate targets (for example, free reserves or interest rates) and in turn with later goals (for example, the money stock or availability of credit) and with ultimate objectives (employment, output, and prices), neither Federal Reserve officials nor the public can be at all sure of the appropriateness of particular policy measures.

> Federal Reserve officials speak of influencing "free" reserves, total reserves, the supply of money, the supply of credit, interest rates, the "tone" of the market for Government securities, and other intermediate variables. At times, at least, these steps appear to be inconsistent.
>
> For example, the supply of money and the supply of credit often change at quite different rates, so it is critical for the Federal Reserve to be clear and to make clear which it is trying to influence and why. The System's heavy focus on "free reserves" as an apparent central intermediate goal of policy actions is another example.
>
> While the Fed can substantially control free reserves, merely making free reserves larger or smaller may have little relation to whether money will be easier or tighter. For example, in mid-1963, the Fed announced a policy of "less active ease" and apparently reduced its target level of free reserves. Yet at about the same time, higher interest rates and the rising demand for funds apparently led banks to reduce even further their desired level of free reserves. Thus the Fed's policy of "less active ease" appears to have been associated with a more rapid increase in bank reserves, and hence a more rapid increase in both bank credit and the stock in money, than was true in the preceding period of presumably "more active" ease (1389–1390).

Prof. Harry Johnson (Chicago) summarized why economists object to the Federal Reserve's concentrating on banking phenomena. He told the subcommittee:

> * * * the methods of monetary management, which involve the central bank concentrating its attention on money market conditions and interest rates, and on member bank reserve positions and lending, rather than on the performance of the economy in general, are extremely conducive to the behavior pattern of overreaction and delayed correction of error already mentioned (971).

The money supply behaves erratically because changes in the volume of money emerge as a byproduct from the Federal Reserve's attempts to offset random daily disturbances in float, the price of Treasury bills, etc. And, as was amply demonstrated by the testimony summarized in part III of this report, it is the behavior of the money supply that matters. Of course, Federal Reserve officials remain unconvinced, as a recent article in Business Week recognized when, referring to the money supply school of theorists, it observed—

> They can muster *piles of evidence* to show that business downturns have been *preceded by* declines in the money supply, but the Fed thinks the evidence is inconclusive.[6] [Emphasis supplied.]

A change in targets is essential. But to date there is no evidence that the Federal Reserve is sufficiently flexible to make the required changes.

[6] Business Week, May 16, 1964, p. 76.

(*b*) *The Federal Reserve's prejudices.*—Professor Reagan (Syracuse) made an interesting observation about prejudices in general when he told the subcommittee:

> I do not doubt for a moment that Reserve bank presidents are dedicated to the public interest and so think of themselves, and that the members of the Board of Governors are devoted to the public interest, and the President is devoted to the public interest, and that the Secretary of the Treasury is devoted to the public interest. And I will hopefully assume that Dean Walden and I, myself, are. The trouble is each of us sees the public interest a little bit differently (1587).

The Federal Reserve's deepest prejudice is that inflation is our No. One economic enemy. This was recognized by Professor Fishman (West Virginia). In an article submitted for the record, he stated:

> The Federal Open Market Committee has consistently regarded avoidance of inflation as the primary objective of monetary policy, and has not regarded reduction of unemployment as an objective of comparable importance (1951).

Federal Reserve officials did not deny this. For the Federal Reserve, is, as Chairman Martin told the Senate committee during the 1957–58 recession, "always fighting inflation." [7]

The trouble with this philosophy is that sometimes, like the time this statement was made, the enemy is deflation and unemployment. The Federal Reserve's executives pay lipservice to the goal of maximum employment but nearly always they direct the power of monetary policy against an inflation which, in some mystical way, they see in the future. The result is the economy usually must squirm in order to fit into a tight monetary coat.

The testimony also indicated that the Federal Reserve has—if not a deep prejudice, then at least an operating bias—which favors higher interest rates. In part, this bias is a natural corollary of the Federal Reserve's deep fear of inflation. Higher interest rates are the classical prescription for inflation and are used to fight both real and imagined inflations. This, as Prof. John Kenneth Galbraith (Harvard), who served President Kennedy as an economic adviser and Ambassador to India has pointed out, puts those who urge higher interest rates in an enviable position.

> Producers of wheat, copper, cotton, and even steel are assumed to prefer higher prices for the larger revenues they return. Those who lend money, in contrast, are permitted to urge higher interest rates not for the greater return but as a selfless step designed to protect the Nation from the evils of soft money, loose financial practice, and deficient economic morality. An economist who sees the need for a higher weekly wage may well be suspected of yielding to unions; one who urges an increase in the rediscount rate, is however, invariably a statesman.

[7] "Investigation of the Condition of the United States," hearings before the Senate Finance Committee, August 1959, p. 1345.

But, Professor Galbraith continued:

> This should not keep anyone from penetrating to the fact. There is a lively, insistent, and durable preference by the money-lending community for high rates of return; this is related to an intelligent view of pecuniary self-interest.[8]

It goes without saying that Federal Reserve officials would be horrified at the thought they moved to higher interest rates because this added to the profits of those in the lending business. Still, this is one of the effects of higher interest rates, and, in view of the fact that inflations the Federal Reserve fought in the post-Accord period were more imagined than real, it may have been their only important benefit. Professor Lerner (Michigan State) suggested this when he told the subcommittee:

> The other point that I wanted to make is that I do not believe the bankers in the Federal Reserve System deliberately twist their advice so as to raise the rate of interest in order to increase bank earnings. I think they regard it as an honor to work for the "Fed" and they try to serve the public interest the way they see it.
>
> I think, however, that there is good reason for doing what the chairman recommends, of having the Governors of the "Monetary Authority" consist only of people appointed as public servants, because even though the bankers do not consciously try to pervert things, they nevertheless cannot get away from their habits and prejudices as bankers which makes them tend to prefer higher rates of interest to lower rates of interest.
>
> This is one of the reasons why we have been suffering from somewhat higher rates of interest than we should have had up to the last year or so (1431).

By now the bad effects of the prejudices which have dominated Federal Reserve policy will be familiar. Briefly, in past years the combined effect of the Federal Reserve's neurotic fear of inflation and preference for higher interest rates was to cause economic stagnation and recurrent recessions. It, therefore, would seem urgent to agree with Mr. Goldfinger (AFL-CIO) that:

> The Nation's monetary management is much too pervasive in its influence to be left in the hands of people whose training and experience are mainly in big business and banking and who are further insulated from the major currents of American life by the "independence" of the Federal Reserve. The entire Federal Reserve System must be made into a public system, fully a part of the U.S. Government and broadly representative of the population (1473).

In addition to the bad economic effects which have resulted from the large part now played in the formulation and execution of monetary policy by those whose training and experience is in banking, there is a compelling political reason for freeing the monetary authority from the occupational prejudices and myopic concepts of those

[8] J. K. Galbraith, "The Balance of Payments: A Political and Administrative View," Review of Economics and Statistics (May 1964), p. 118.

who are expert in extending credit and making investments in individual business enterprises and households. Chairman Patman (Texas) called attention to this when he observed:

> * * * One of these days Congress is going to wake up to this thing and say that the bankers have no right to set monetary policy any more than the owners of railroads have the right to be on the ICC and set freight rates and the passenger rates, or the broadcasting industry to be on the FCC and determine the rights and privileges and responsibilities of the broadcasting industry (897).

It would appear that Chairman Martin's argument for keeping the present Open Market Committee intact, which, recall, is in order that the "viewpoints" of those "with technical experience in banking * * * may be brought to bear upon the complex credit problems * * *" flies in the face of both the economics and the political morality of the matter.

4. The Federal Reserve's independence and its inability to change its ways

The Federal Reserve has authority to act independently, even at variance with the administration whenever it chooses, and it has in the past so chosen.[9] Moreover, the Federal Reserve's decisions, under the law, are not, as this report has shown, subject to review and cannot be reversed by any authority or authorities including the President and the Congress. It is foolish to believe the Federal Reserve is in any meaningful sense an arm of Congress. Its executives do what they want independent of the desires of Congress. The late Speaker of the House of Representatives, the Honorable Sam Rayburn, recognized this when he said, in 1959:

> I have been forced to the conclusion that the Federal Reserve authorities * * * consider themselves immune to any direction or suggestion by the Congress, let alone a simple expression of the sense of Congress.[10]

But most important of all, the executives of the Federal Reserve System cannot be penalized by the President or the Congress for their policies and actions no matter how mistaken and costly to our people and free enterprise economy their policies and actions are.

The seven Governors of the System serve 14-year terms and so are effectively insulated from public pressures. The Reserve bank presidents are directly accountable to their banks' directors and indirectly to the seven insulated Governors, and so they, too, need not fear public disapproval.

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[9] In this connection, a dialog between Senator Long (Louisiana) and Chairman Martin which occurred in the 1957 Senate Finance Committee hearings, "Investigation of the Financial Condition of the United States," is enlightening. Excerpts from the colloquy which appears on p. 1362 are as follows:

"Senator LONG. And you believe that the Federal Reserve * * * has the right to pursue a policy that is completely contrary to the policy that the administration proceeds to follow * * *?

"Chairman MARTIN. Under the law we feel it is our prerogative; yes, sir.

* * * * * * *

"Senator LONG. Yes. Has the administration of recent date * * * been urging you to take a position or adopt a policy contrary to the one that you have been pursuing?

"Chairman MARTIN. * * * They have tried on a number of occasions to persuade us that we should not take action which we did take. * * *"

[10] Cited in Labor, Aug. 1, 1959, p. 1.

The executives of the Federal Reserve are not accountable to any public authority, not even the electorate. Thus, though 50 years have elapsed since the Federal Reserve was conceived, it still has not, as Professor Brunner (UCLA) observed:

> * * * acquired a validated knowledge about the monetary process (1053).

Other witnesses also were critical of the Federal Reserve's failure to develop a valid understanding of what it is actually doing. In a passage which was more fully quoted earlier, Professor Meltzer (Carnegie Tech) put the matter this way:

> After 50 years, the Federal Reserve has little verified knowledge to form the basis of its policy actions (927).

The comments of Dr. Warburton (FDIC) and Professor Bach (Carnegie Tech) on the Federal Reserve's "knowledge gap" also are noteworthy. Dr. Warburton told the subcommittee:

> One of the most serious problems in the formation of the Federal Reserve policy has been a lack of adequate research regarding the relation of central bank operations to business conditions * * *. The lack of research on the relation of changes in the supply, velocity, and value of money to fluctuations in output, employment, and gross national product becomes most evident when inquiries are made regarding the character of the information used by the Federal Open Market Committee in arriving at its decisions. It is not known what quantitative guides, if any, the Committee uses in deciding what rate of growth in money or bank reserves is needed or how much fluctuation is desirable when they adopt differing degrees of "restraint" or "ease." The policy record of the Committee published each year in the annual report of the Board of Governors does not provide such information (1323–1324).

Professor Bach said:

> Surely, improving our understanding of the behavior of money, and of the linkage between central bank action and ultimate policy goals, should be a major responsibility of the central bank. The Fed has an excellent research department for keeping it informed on current economic developments and for providing staff work on current issues. But unfortunately, nearly all of its expertise has been devoted to these activities and in my judgment the recent rapid growth in tested knowledge on the behavior of money in our economy has come primarily from academic economists. I believe that the Fed deserves criticism for its failure to push more actively on the fundamental research that must be done to continue to improve further our monetary policy. If the Fed is to make better policy, the sine qua non is a better base of tested knowledge on which to base that policy (1390).

The Federal Reserve's "knowledge gap" and the corollary lack of guidelines for monetary policy will not be corrected if the present structure of the System remains intact. This is because the present structure of the Federal Reserve lacks an educational feedback. The 14-year terms of the seven Governors and the complete insulation of the Reserve bank presidents from the public's criticism in cases of error, make it unnecessary for ranking Federal Reserve officials to further their knowledge. If the present structure is maintained, monetary policy will continue to emerge from the misguided operating methods and prejudices which the Federal Reserve has taken secondhand from the business of extending credit and making investments, under the false assumption that the problems of this business are a miniature of the economy's problems. With the present structure, these misguided methods and biases will persist and the recessions and other costs that result from them will continue to be inflicted on our economy.

C. ANALYTICAL CONCLUSIONS

This brief set of analytical conclusions is based on our staff review of the testimony heard by the subcommittee. It will, in fact, serve as a summary of this testimony.

While there is always a subjective element in evaluating testimony received from many persons, representing individual as well as organizational points of view, it is our belief that we have reviewed and considered all points of view given in testimony before this committee. Upon such review the staff reached the inescapable conclusion that the Federal Reserve has erred in the past and that these errors derived from defects still present in the structure of the System.

One glaring deficiency in the Federal Reserve Act is the lack of adequate guidelines. Members of the subcommittee were troubled about this defect. Congressman Vanik (Ohio) indicated his concern when he stated:

> We would not be so critical of these actions if we understood some rule or regulation that would guide the conduct of the Open Market Committee, the Board members, and the presidents when you are acting on these important decisions.
>
> For example, if we knew that there was some established rule, and the presidents of the banks, that if certain conditions would occur, the discount rate would rise or fall, we could understand that and then we could argue with the reasoning that supports the rule.
>
> As it stands now, it is a completely arbitrary decision. Arbitrary because we do not have any guide points on which we can fix this course of action. In other words, if you were to have some rulemaking body which said that if certain conditions happen in precisely such-and-such a way then "our decision will be to do thus and so," then we could study the wisdom and analyze the thinking behind the rulemaking on which you have established your actions. Then we would have an opportunity to know whether or not your guideposts or decisions were in the public interest.
>
> I think this is the area that we complain about. The arbitrary decisions that can be made without any review, without any conformity to rule or regulation (658–659).

Chairman Patman (Texas) put the matter this way:

> That discretionary power is preferable to fixed laws for the performance of some functions seems unquestionable, but definite norms must be present to guide progress toward clearly defined objectives.
>
> Congress set up the Federal Reserve to regulate the country's money. I am suggesting that the guidelines for policy and responsibility furnished the Fed by Congress in the original 1913 act have for many years been inadequate for the severe demands of a more modern society (1534).

In this connection, the 1946 Employment Act declares—

> it is the continuing policy and responsibility of the Federal Government to use all practicable means * * * to coordinate and utilize all of its plans, functions, and resources * * * to promote maximum employment, production, and purchasing power.

Professor Fishman (West Virginia) pointed out that—

> Other portions of the act indicate more specifically that it is the President who has the responsibility of achieving the required coordination of "all plans, functions, and resources" to achieve these ends.

And moreover, that during the debates—

> on one or two occasions it was observed that monetary policy would be used by the President to promote the purposes of the legislation (1955).

But, even if there had been no awareness in 1946 concerning the importance of monetary policy for the prosperity of the Nation, both fact and theory now demonstrate that mismanaged money can and all too often has prevented our achieving the goals of the Employment Act.

The facts show that money matters, and especially that a mismanaged money supply can retard our economy's growth and cause unemployment and business failures. Thus as Senator Clark (Pennsylvania) and Congressman Reuss (Wisconsin) pointed out a few years ago—

> omission of monetary and credit policies, on the ground of the independence of the Federal Reserve System, is a serious misconstruction of the Employment Act. It defeats its very purpose, which was to enable the President to come forward with a coherent overall economic program directed to the Employment Act's targets.[11]

Clearly the Employment Act contemplates that the President will be responsible for the determination of monetary policy but not necessarily for its day-to-day management.

Our analyses also have shown that the Federal Reserve Act is defective because it has established a system which is inherently prone to exaggerate the danger of inflation, and, as a corollary, to understate

[11] H. Rept. 539, 86th Cong., 1st sess., Committee on Government Operations, to accompany H.R. 6263, amending the Employment Act of 1946 to provide for its more effective administration, and to bring to bear an informed public opinion upon price and wage increases which weaken economic stability, 1959.

the peril of unemployment, and also to select the wrong target variables for exercising monetary control. The facts of recent economic history demonstrate that money must be watched and controlled. But the testimony has shown clearly that the growth of the Nation's money supply is not controlled. Rather it emerges in fits and starts as a byproduct of operations to control such variables as the quality of credit, free reserves, and the loan rate to dealers in Government securities. Congress did not make the Federal Reserve responsible for the behavior of these variables. But because of its contacts and ties to credit institutions it has unfortunately assumed this responsibility. The combined effect of the Federal Reserve's excessive fear of inflation and bad choice of target variables is to cause the long-term money supply growth trend to be deflationary and short-term movements to be destabilizing.

The testimony also has revealed that because of its independence from public pressures the Federal Reserve lacks an educational feedback. Such a feedback is required to assure that mistakes lead to critical reevaluations of operating objectives and methods. Without it past errors are almost sure to be repeated in future years.

Secretary Dillon told the subcommittee:

> If there are persuasive reasons for particular proposals * * * by all means, this committee should act (1233).

Clearly, the hearings have established that there are valid and vital reasons for restructuring the Federal Reserve System. And so the question becomes one of formulation by the subcommittee of specific proposals to remedy the deficiencies and defects brought to light by the hearings.[12]

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[12] The set of proposals released by all of the majority members of the subcommittee precedes this report.

PART V.—AUDIT BY THE GENERAL ACCOUNTING OFFICE AND OTHER SPECIFIC PROPOSALS

A. THE NEED FOR A GAO AUDIT

One of the bills before the subcommittee, H.R. 9631, provides, inter alia, for an annual audit of the Federal Reserve System by the General Accounting Office. The General Accounting Office was created in 1921 as an instrument of the Congress, to assist congressional review of the expenditure of public funds. The GAO's integrity and effectiveness are well known, and do not need further documentation here. Such supersensitive agencies as the State Department and Defense Department are audited by the GAO, and many of its reports are top secret for this reason. The Federal Reserve System, however, is not audited by the GAO or any other public auditor.

The operating expenses of the System run to over $200 million a year. Yet the System is not subject to any public audit. Federal Reserve officials were quick to point out that while the System is not audited by the GAO, it does conduct numerous internal audits and, further, calls in a commercial auditing firm to examine the accounts of the Federal Reserve Board of Governors. But testimony given before the subcommittee established that the work done for the Federal Reserve banks by public accountants is not really an independent audit, and moreover is only a review of internal audits. A tripartite colloquy among Representatives Ashley (Ohio) and Bolton (Ohio) and Chairman Martin established the fact that work done by a commercial auditing firm which is paid for by the Federal Reserve is not the same as a public audit performed by the GAO. The further finding that the commercial public accounting firm only reviews internal audits of the banks was brought out in a dialog between Representative Multer (New York) and Chairman Martin. The relevant testimony follows: [1]

> Mr. BOLTON. * * * the audit of the System, as I understand it, is an audit conducted by auditors who are hired by the Board * * *. Is that correct?
>
> Mr. MARTIN. That is correct.
>
> Mr. BOLTON. So, in effect, it is a public audit, though it is not made by the public auditor.
>
> Mr. ASHLEY. Who pays for it?
>
> Mr. BOLTON. I believe the System pays for it.
>
> Mr. ASHLEY. Then it is really not as public as it might be; is it?

[1] Representatives Ashley and Multer are members of the full committee and participated in the subcommittee's questioning of Chairman Martin.

Mr. Bolton. The only point I was trying to make is that it is an audit and a public audit, though not in the sense—and I understand——

Mr. Ashley. I don't mean to quarrel with the gentleman. I think it is a private audit, the results of which are made public. But I think that is a very different thing from a public audit as performed by the GAO (45–46).

* * * * *

Mr. Multer. I wish somebody would clarify whether or not this is a complete audit or just a review of an audit.

Mr. Martin. Mr. Multer, as I have pointed out, we have independent auditors that are continuously auditing in each of the 12 banks that are subject only to the direction of the board of directors, not to the officers of the bank.

Mr. Multer. I am referring now to the independent audit by Haskins & Sells, or Price Waterhouse, or whoever you are using for the System. Is that a complete audit?

Mr. Martin. No. That is only of the Board. But they go in with our examiners. We have a field force. They are very dedicated individuals, because they are on the road most of the time, and it is hard to get people to——

Mr. Multer. I wasn't questioning that. I am trying to find out what they do. And you leave the impression with me Price Waterhouse or Haskins & Sells looks over the shoulder of your auditors and examiners, rather than doing the work themselves.

Mr. Martin. That is correct. You are right (46).

In addition, testimony given before the subcommittee indicated that despite the System's internal audits and reviews of same, its remarkable freedom from any external public audit has led to many questionable expenditures. A random sample by the committee staff of the System's expenditure vouchers reveals such items as $4,697.61 for an employees' dinner, including $125 for a comedian and $435 for an orchestra; $462.59 for an employees' bowling banquet; a contribution of over $5,000 to a local chapter of the American Institute of Banking; and $5,350.35 for a luncheon given by the New York Federal Reserve Bank for the New York Bankers Association at the Waldorf-Astoria. No expenditures of these kinds without congressional approval would be allowed in the case of other Government activities subject to the Budget and Accounting Act.

These expenditures were not even mentioned by the Board's examiners. Nor did the examiners question tuition payments for courses in Shakespeare, art, history, philosophy of religion, and metropolitan politics, as examples, for System employees. Similarly, the System's own examiners found nothing questionable in a substantial annual contribution by the Federal Reserve Bank of Boston to the New England Council for Economic Development, a regional organization formed to attract industries to New England. Nor did they question the appropriateness of an agency entrusted with monetary policy hiring a specialist in "labor retraining." Conceivably, such expenditures are justified. As Chairman Patman pointed out:

> We are not trying to do your auditing for you but to learn the extent to which you have built up standard expenditures that vary considerably from the rest of the Government.

Elsewhere, Chairman Patman expanded on this point:

> So when you spend this money, you spend money that would otherwise go into the Treasury—and help the taxpayers. And that being true, I am disappointed in you in not agreeing, and also the whole Federal Reserve System, in not agreeing that public funds should be audited like they are in all other agencies of all kinds—this and one or two small ones are the exception. That is my disappointment.
>
> I don't criticize you for entertaining foreign guests, that is all right. But I do criticize you for not wanting to make a report to the Federal Reserve Board and to the Congress about it. And I happen to know that the last few years, not only have you not made a report, but they have been hidden.
>
> And we had an awful time finding them ourselves.

There are several reasons for the failure of the System's audits to uncover expenditures considered improper under the rules governing other Government departments. In the first place, the standards set by the Board and the directors of the banks are often vague, so that there is considerable variation in their application among the 12 regional banks. This is well illustrated by the following colloquy between Representatives Reuss and the president of the New York Federal Reserve Bank, Mr. Hayes:

> Mr. REUSS. I think we all recognize that, Mr. Hayes. But my question was, Where are the standards governing expenditures by the Federal Reserve Bank in this entertainment field—where are they set forth, what do they say?
>
> Mr. HAYES. I think they are set forth only by the rule of reason, Mr. Reuss. I think—if you would let me——
>
> Mr. REUSS. Then there are no standards at all?
>
> Mr. HAYES. No, there are.
>
> Mr. REUSS. Tell we what they are.
>
> Mr. HAYES. In conducting these foreign operations, the bank performs, I think, an immense service to the country in the way of—just for illustration, the last year of swap arrangements, up to about $2 billion, we have helped the Treasury sell bonds——
>
> Mr. REUSS. My time is limited. I will have to ask you to be responsive to the question which is, What are the standards?
>
> Mr. HAYES. Well, I will summarize that in conducting these relations, it is common courtesy to treat the representatives of these foreign central banks courteously and cordially when they come over here, just as they treat us cordially when we go over there.
>
> And it seems to me the maintenance of a friendly relationship between our people and these representatives of foreign central banks is of immense importance to the country, and has been proven to be very useful to the country in the achievements we have made all along the line. I don't say they are doing it just because we are taking them to dinner and to the theater. But I think that is part of the whole relationship between central banking organizations that is widely accepted, generally throughout the world.

> Mr. REUSS. But your answer to my request to you to designate the standard is that there is no standard (626–627).

But the vague mass of directives is not the only reason for the System's apparent laxness. As Mr. Reuss pointed out:

> Mr. REUSS. Mr. Swan, you say in your statement, and I am quoting from page 3: "I hope that no one disputes that the Federal Reserve banks are closely supervised and audited, and are required to observe criteria established by the board of directors and by the Board of Governors."
>
> Mr. SWAN. Yes.
>
> Mr. REUSS. Well, of course, this committee disputed that quite decisively in the matter of the mysterious disappearance of $7.5 million worth of U.S. securities from your bank last year when we found in our report, dated May 29, 1963, that though your Federal Reserve bank had a manual which provided, on page 53, "wastepaper should be scrutinized daily," in fact wastepaper was not scrutinized daily and, as a result, according to your own version of what happened, the $7.5 million worth of securities were burned or destroyed * * * .
>
> Well, then your statement that no one disputes that the Federal Reserve banks always follow their criteria is a little too broad, is it not?
>
> Mr. SWAN. Well, I would say "No."
>
> Mr. REUSS. Well, I will have to stay with this point then because the criterion listed on page 53 of your manual of miscellaneous instructions, dated May 21, 1956, is that wastepaper should be scrutinized daily.
>
> That was not followed, was it?
>
> Mr. SWAN. Well, I am not denying that there are not occasions when errors are made. Certainly that is true. That is true in any organization.
>
> Mr. REUSS. Thank you, Mr. Swan (717–718).

It is noteworthy, moreover, that this $7½ million bond disappearance was not reported to Congress and was discovered only accidentally by a staff investigator of this committee during the random check of Federal Reserve expenditures mentioned above.

With the exception of Governors Balderston and Daane and President Bryan, who did not comment, all the Governors and presidents of the Federal Reserve System oppose a GAO audit. Essentially, the Federal Reserve's executives argue that a GAO audit would reduce the System's independence. Also, they argue that the present internal audits are adequate and a GAO audit would therefore be mere duplication.

As shown by colloquies already cited, internal audits and reviews by public accountants are not equivalent to comprehensive audits by the GAO. Still another dialog which points up this conclusion, and is worth noting here, took place between Representative Vanik, of Ohio, and Mr. Smith, the Deputy Director of the GAO Accounting and Auditing Policy Staff. The dialog follows:

> Mr. SMITH. In an ordinary public accountant's audit of the financial statements of a corporation, he is primarily concerned with expressing an opinion as to the fairness of those

statements and how they are presented. He looks at those statements to see whether they are in accord with certain principles of accounting, whether the disclosures are adequate so that the reader is not misled, and so forth.

Mr. VANIK. Here, when we are dealing with a public agency, we are going a step further.

Mr. SMITH. Yes, sir.

Mr. VANIK. We are not saying it is a correct audit or it represents a fair situation. It also must represent that in all respects whatever has been done complies with the law (919).

The point brought out by Congressman Vanik and Mr. Smith is that, by definition, a comprehensive independent audit would not be performed by a commercial accountant.

The question of the System's independence is, to the Federal Reserve officials, apparently the most worrisome aspect of a GAO audit. They fear that such an audit would somehow allow pressure to be brought to bear on the Federal Reserve, that it would confer on the GAO power to dictate Federal Reserve policy and to cut off Federal Reserve funds, and that it would undermine the authority of the Board of Governors and the bank directors. Testimony by Mr. Smith, however, demonstrated that these fears are based on a misconception of GAO's powers and functions. In the first place, it is important to distinguish between the Federal Reserve's monetary policy and its internal management policies. The GAO would not be concerned with monetary policy. This distinction was brought out in the following discussion between Representative Widnall, of New Jersey, and Mr. Smith:

Mr. WIDNALL. When you audit the affairs of the Export-Import Bank, do you make recommendations as to interest rates or terms of loans?

Mr. SMITH. No, sir.

Mr. WIDNALL. You do not in any way go into the policy of the Export-Import Bank?

Mr. SMITH. In one of our reports we did raise some questions about them borrowing from the outside at rates that were higher than they would have to pay to borrow from the Treasury. That borrowing was specifically authorized in law. We are only questioning the cost of doing it (917).

The GAO would, of course, discuss the Federal Reserve's internal management, but this would not permit it to control or influence policymaking. In response to a question by Representative Minish, of New Jersey, Mr. Smith made it perfectly clear that the GAO's power is limited to enforcing existing law when he stated:

The General Accounting Office has no authority to direct the operation of an agency as such. Our authority is based in law, and it is generally geared to our authority to disapprove or disallow illegal expenditures.

In the course of our audits, many of them, we have called the attention of the Congress and agency managers to policy matters which we think were inefficient or ineffective; that were not in accordance with the purposes of the agency as set forth in law (909).

Thus there seems to be little reason for Federal Reserve fears that the GAO would dictate System policy. Indeed, President Clay of the Kansas City bank confirmed this in a discussion with Representative Harvey, of Michigan. The relevant colloquy follows:

> Mr. HARVEY. Well, you know the GAO has 20/20 hindsight vision with regard to all of its examinations and this bothers the departments of our Federal Government. It bothers the Defense Department particularly to have these persons breathing over the shoulder and coming in and substituting their judgment and yet I have not been convinced that it really impairs their judgment over the long run or whether it affects their future actions and so forth and I wonder do you feel it would affect the future actions of the Board here to have somebody come in an say, "You did wrong the last time," or "We would have done it some other way."
>
> Mr. CLAY. I think we would go ahead just as we have in the past * * * (811–812).

The GAO cannot cut off an agency's funds, though it will refuse to approve expenditures which were illegal. It can and does recommend more effective and efficient means of accomplishing objectives, but its recommendations are not binding. The authority of the Board of Governors and the directors of the Federal Reserve banks to control the expenditures of the System would not, therefore, be undermined by a GAO audit. As Mr. Vanik said:

> * * * it is not that the GAO dictates policy. It reports on the effect of policy * * * It puts it on the table (384).

Representative Weltner (Georgia), in his discussion with Mr. Kelly, president of the American Bankers Association, brought out the point that all of the internal audits of the Federal Reserve System failed to reveal extremely important information. The exchange of views follows:

> Mr. KELLY. Well as we discussed earlier, I think the public is getting the information through the process which is now established.
>
> Mr. WELTNER. Getting information that the subject desires for it to have. Now, you believe in a system of checks and balances, most assuredly, that we have in this Government. We have three branches of Government. Yet on this matter there is no check and no balance, because the only information that the public gets is what the Federal Reserve System itself desires it to have. I just don't think that is a healthy situation (1920–1921).

B. THE NEED FOR CONGRESSIONAL APPROPRIATION

A related proposal on which testimony was heard, H.R. 9685, would require that the Federal Reserve banks pay to the Treasury all of the interest earned on their portfolio of Government securities. The bill would also provide that funds to defray the expenses of the System be appropriated by the Congress, thus bringing into line the practices established with respect to other Government departments.

With the exception of a few special agencies and the Federal Reserve System, the departments and agencies of the United States operate on congressional appropriations. Each year the amounts requested by the executive departments are carefully reviewed, by the Bureau of the Budget and the Appropriations Committees; this budget review process is the chief means by which Congress assures an efficient and effective use of public funds and by which Congress exercises a control on aggregate expenditures.

The agencies that have been exempted from budgetary review are usually Government corporations supported by the sale or rental of services and are apparently regarded as quasi-business organizations. In the case of the Federal Reserve, however, almost all of its earnings (over 99 percent) come from interest payments on the Government securities in its open market portfolio. As indicated in earlier sections of this report, the Federal Reserve purchases U.S. securities and pays for them by creating deposits in favor of a commercial bank and the deposits are added to that bank's reserve account. The portfolio at present amounts to $34 billion with interest income of over $1 billion a year.

Significantly, while the present open market portfolio has been accumulated primarily as a function of money market and credit management, the earnings derived from it are obviously far in excess of the requirements of the Federal Reserve System at the present time. However, this was not always the case. In the early days of its history, the Federal Reserve acquired securities for the purpose of obtaining sufficient earnings to support itself while maintaining its independence of the appropriations process. Unlike the Comptroller of the Currency and the Federal Deposit Insurance Corporation, the Federal Reserve does not support itself by levies on the institutions it oversees; rather, it supports itself by its power to tax the public at large—its ability to create deposits with which to purchase interest-bearing obligations of the United States.

The System's expenses currently approximate $200 million per year. Unexpended funds are returned to the Treasury, or set aside as surplus. The System's billion dollar annual income is so huge that it could expand its operations and quadruple its expenditures without requiring any congressional appropriation. Thus, the System is in the unusual position of having neither the practical nor legal need to go before any congressional committee for review of its expenditure policies.

Under such circumstances it is not surprising that the Federal Reserve System shows a definite tendency toward liberality in expenditures. The Federal Reserve Bank of Boston, for example, contributes to regional booster groups and has conducted studies on the feasibility of such local activities as ski resorts, which are of course quite unrelated to monetary policy and bank supervision, the areas in which the Federal Reserve is mandated to operate.

Of the 15 highest salaries paid by the Federal Government, 13 are enjoyed by Federal Reserve officials. Only the President of the United States and the Chief Justice of the Supreme Court rank with the top officials of the Federal Reserve System.

A theater party given by the Chicago bank for its employees cost over $3,000. Presumably, such expenditures are approved by the

Board of Governors which has ultimate control over the operating policies of the System. Upon approval, these expenditures may well be technically legal under the present regulations, but certainly they would remain open to question by any objective observer comparing them with the more stringent budgetary standards applied to executive departments generally.

Twelve of the nineteen leading Federal Reserve officials testified in opposition to placing the Federal Reserve System under the appropriations process. The other seven Federal Reserve officials did not comment. Essentially, the Federal Reserve position hinged on the contention that congressional review of its appropriations would weaken the independence of the System and perhaps impair its efficiency.

President Bopp of the Philadelphia bank cited the U.S. Mint as—

> unable to secure sufficient appropriations from Congress to see that we have available an adequate supply of coins. I then move from that to currency and ask myself, if this were required also with respect to currency, then the problem would be even more difficult (468).

In reply to Mr. Bopp's point, Representative Reuss raised the question as to whether or not logic did not suggest that all agencies of Government, all the bureaus and departments, upon that reasoning, should be serviced by Treasury back-door financing. In short, the fear expressed by Federal Reserve officials that Congress would be able to exert pressures on the Federal Reserve's monetary policies by threatening to cut off money would seem to be just as valid if applied to the military and international activities of the Nation. The absence of any indication that these latter activities are handicapped by congressional review would seem to argue convincingly for a similar review of Federal policies. The fact is, appropriations committees concern themselves with the effective and efficient use of funds, but their jurisdiction does not normally extend to substantive matters such as military policy or, for that matter, monetary policy. As Chairman Patman said of the proposal:

> [Do] you think I would want a subcommittee, an appropriations subcommittee, to determine policy for the Federal Reserve? Of course not (384).

It is an axiom of public law and public administration that unwarranted variations in public policy and procedure, as between one agency and the other, are capricious and undesirable. When a case can be made out for differentiation, variations in procedure of course are acceptable. But in the opinion of staff, no valid case has been made for exempting the Federal Reserve from the budgetary process. On the contrary, the absence of congressional review appears to have engendered variation in policy from bank to bank with some more stringent than others in the standards applied. In particular, some banks showed a strong propensity to become involved in community affairs that seem remote from their monetary and banking responsibilities, or to carry on research projects that are only remotely related to their institutional responsibilities.

Chairman Patman's colloquy with Mr. Hayes on the audit question is equally applicable to the issue of whether or not the Federal Reserve

System should be brought under congressional appropriations procedures:

> Mr. HAYES. Well, just before we leave that audit subject, it seems to me that if there were any evidence of corruption or bad management, inefficiency, I think there would be a prima facie case for making some change. But it seems to me that the reputation of the Federal Reserve System for integrity and honesty in the way they handle their affairs is unrivaled. Certainly no one is better that I know of.
>
> The CHAIRMAN. Of course, you can say that when there has been no audit by a Government auditor or an independent auditor acting on his own. Who could not say the same thing? They could just challenge anybody to show any corruption. I don't say there is any corruption; I don't accuse you or Mr. Martin or anybody else of being dishonest or not trustworthy—of course, I don't. I trust you. But at the same time this is public business. It involves a billion dollars a year. And there is no audit, none of any kind—50 years with no audit (623).

C. OTHER ISSUES

1. The tax and loan accounts

The testimony on H.R. 9686, which would require banks to pay interest on the Government's "tax and loan" balances and remunerate them for services rendered to the Government revealed some conflict of opinion. Secretary Dillon told the subcommittee that the Treasury is seeking to determine the value of these balances. The gross value depends primarily on the Treasury bill rate. The net value equals gross value less the imputed costs of services banks render to the Treasury in assisting in selling savings bonds, etc. Probably today, when the Treasury bill rate is about 3½ percent, banks gain about $150 million a year net from handling these accounts. Also, some who testified indicated that some banks gain from these deposits while others lose.

The argument against H.R. 9686, expressed in Secretary Dillon's supplementary statement, is as follows:

> If the Treasury did not have an effective procedure for smoothing the impact of its own operations on the banking system and the money market, the Federal Reserve would itself have to try to counteract the effects of Treasury operations. This would mean essentially that the Federal Reserve would have to buy large amounts of Treasury bills whenever net Treasury receipts were taking reserves out of the banking system, and would have to sell equally large amounts when the Treasury, by net expenditures, was putting funds back into the banking system. These purchases or sales would be almost a daily necessity, and there would be a serious question as to the capacity of the market to handle this volume of activity without severe repercussions on prices and yields (1269).

The "market" has, of course, been coddled so long that Secretary Dillon's statement may well be correct. But many expressed the opinion (though not necessarily in the context of this bill) that the Government securities market is much more durable than is assumed by the Treasury Department officials. Professor Shapiro's statement (1103) cited previously at page 75 is one example of this opinion.

2. Interest on demand deposits

Almost all of the economists who testified favored H.R. 9687, which would eliminate the prohibition against commercial banks paying interest on demand deposits. They were against the ban for precisely the same reason that they oppose all price ceilings; namely, a price rigidity interferes with the working of the free market's allocative process.

The argument for continuing the ban is that, as put by Mr. Milner, the distinguished chairman of the legislative committee of the IBA:

> Commercial banks in the financial centers characteristically hold a higher percentage of demand deposits with appropriately shorter term investments. Hence, the financial center banks would enjoy greater flexibility in competition for deposits. Furthermore, it is likely that larger banks, possessed of a wider market for investments of funds, including in some cases foreign markets, would outbid their smaller community bank competitors for deposits. There could be some raiding of customer accounts by correspondent banks which would weaken correspondent banking relationships (1705).

But, if Mr. Milner is correct, it follows consumer sovereignty dictates shifting demand deposits to large banks, and, this being so, it is a fair question to ask whether the Government should impose a price ceiling to prevent this shift from occurring. Like many other questions raised at these hearings, definitive answers require further discussion.

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