William McChesney Martin, Jr., Papers

Box 21/Folder 1

Series V, Subseries A

FRB Official Correspondence, 1951-68

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TO: Mr. Martin

ELTING ARNOLD

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Fiscal Assistant Secretary

TO: Mr Martin

Did you get
one of these.
I hope the
Fed may see
its way clear
to exchange

E.F.B

3/23/51

Mr. Bartelt

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appears quite logical on the surface but
careful analysis ~~leads one to~~

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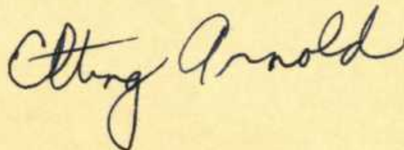
STANDARD FORM NO. 64

Office Memorandum • UNITED STATES GOVERNMENT

TO : Mr. Martin DATE: MAR 19 1951

FROM : Elting Arnold

SUBJECT:



Problem

You have asked my opinion as to whether there would be any legal obstacle to your retaining the position of Executive Director, without compensation, of the International Bank for Reconstruction and Development after becoming Chairman of the Board of Governors of the Federal Reserve System.

Conclusions

1. There is no general provision of law or provision of the Bretton Woods Agreements Act which would preclude your retaining the position of Executive Director after becoming Chairman of the Board of Governors; but

2. Members of the Board are required by section 10 of the Federal Reserve Act to "devote their entire time to the business of the Board. * * *"; and

3. Section 10 of the Act also provides that no member of the Board shall be "a director of any bank." While it might be argued that Congress could not have had in mind such a post as a directorship of an international banking institution when this provision was adopted in 1913, it literally would preclude your holding the directorship of the International Bank.

Discussion

You will recall that a similar question was considered in my memorandum to you of October 25, 1949, with respect to the positions of Assistant Secretary of the Treasury and Executive Director of the International Bank. That memorandum concluded that if it should be determined that the duties of U.S. Executive Director on the International Bank were not such as to interfere with the performance of your duties as Assistant Secretary of the Treasury there would appear to be no legal prohibition to holding both offices. It was pointed out that the Bretton Woods Agreements Act itself merely provided that no compensation should be received from the United States for services as an executive director.

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It was also pointed out in that memorandum that, in general, on the subject of conflicts of interests in two positions, the Attorney General has stated that public officers should not engage in activities which are incompatible with the duties of public office but in the absence of "legal incompatibility" the question of the propriety of appointing the same person to each of two offices belongs to the appointing power and that it is for him to decide whether one person can properly perform the duties of both offices. The question of the compatibility of the two offices is complicated in the case of a member of the Board of Governors by the provision in section 10 of the Federal Reserve Act (12 U.S.C. 241) that "The members of the Board shall devote their entire time to the business of the Board * * *."

Another serious question arises, moreover, in connection with a member of the Board of Governors of the Federal Reserve System holding the office of U.S. Executive Director of the International Bank. Section 10 of the Federal Reserve Act (12 U.S.C. 244) provides in part:

> "No member of the Board of Governors of the Federal Reserve System shall be an officer or director of any bank, banking institution, trust company, or Federal Reserve bank or hold stock in any bank, banking institution, or trust company; and before entering upon his duties as a member of the Board of Governors of the Federal Reserve System he shall certify under oath that he has complied with this requirement, and such certification shall be filed with the secretary of the Board. * * *"

This provision has appeared in the Federal Reserve Act without substantial change since its first enactment in 1913. The House and Senate Reports on the Federal Reserve Act do not add much to an understanding of the applicability of this section to the present situation. House Report No. 69 of the 63rd Congress, 1st Session, states at page 44:

> "For obvious reasons it is considered wise that every member of the Federal reserve board designated by the President shall surrender any banking connections he may have had at the time of his nomination * * *."

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It seems clear that the Congress did not intend to limit this prohibition to a member bank of the Federal Reserve System since other provisions of the Act provide that members of the Board shall be ineligible to hold any office, position, or employment in any member bank. It must be noted that the language of this provision does not even limit the prohibition to an office or directorship in a banking institution in the United States. On the other hand, it might be argued that the Congress had no reason to consider at the time that the Federal Reserve Act was adopted a directorship on an international institution such as the International Bank for Reconstruction and Development and that what they were concerned about was a possible conflict in interest between a private U.S. banking interest and the performance of duties as a member of the Board of Governors. Accordingly, the proper interpretation is not certain, but literally the Federal Reserve Act would preclude your holding the directorship of the International Bank.

It is suggested that if you wish to give further consideration to holding both posts, you should consult the legal staff of the Federal Reserve Board which could more appropriately give you an opinion than I can. Conceivably, it might even be desirable to request an opinion of the Attorney General.

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MAR 19 1951

Mr. Martin

Elting Arnold (Signed) Elting Arnold

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It is suggested that if you wish to give further consideration to holding both posts, you should consult the legal staff of the Federal Reserve Board which could more appropriately give you an opinion than I can. Conceivably, it might even be desirable to request an opinion of the Attorney General.

EArnold:CRMcNeill:cr - 3/19/51

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: March 21, 1951

To: Executive Committee of the Federal Open Market Committee

Subject: Possible Conversion of System Holdings of 1967-72 Bonds

From: Messrs. Thomas and Youngdahl

Confidential

Decision will need to be made by the Executive Committee of the Federal Open Market Committee as to whether the Treasury bonds of June and December 1967-72 in the System's open market portfolio should be converted into the new 2-3/4 per cent bonds. Four different options are open to the Committee:

1. Retain the 2-1/ 2 per cent restricted marketable bonds.

2. Convert all of the holdings into 2-3/4 per cent nonmarketable bonds and immediately exercise the option to exchange them for 1-1/2 per cent 5-year notes.

3. Convert all into the 2-3/4's and exchange them for the 1-1/2 per cent notes in partial amounts at intervals over an extended period of time.

4. Retain part of the 2-1/2 per cent restricted bonds and convert the remainder either for immediate or subsequent exchange into notes.

The reasons for and against each of these options may be summarized as follows:

1. Retention of 2-1/ 2 per cent bonds

Advantages

(a) This would enable the System to retain bonds that might be useful for market operations at times in the future when bond prices might tend to rise too sharply.

(b) It is not appropriate for the System to hold nonmarketable bonds.

Disadvantages

(a) One major objection in principle to this choice is that it is generally better for a central bank to hold

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principally short-term securities and operate primarily through the short-term market.

(b) In practice, moreover, for many years the System is likely to have enough of other long-term bonds to influence that market if it desires.

(c) One of the purposes of the exchange offering is to reduce the supply of long-term bonds in the market, for the System to retain its holdings and later sell them in the market would defeat this purpose.

(d) Substantial System holdings might serve as a threat overhanging the market and discourage investors from buying long-term bonds.

2. Full conversion and immediate exchange into notes

Advantages

(a) The exchange would provide the System with additional medium-term securities, which would be available for use as may be needed in influencing the medium or short-term market and bank reserves.

(b) It would swell the aggregate amount of the conversion and give favorable publicity to the conversion operations.

(c) Conversion would help get the Federal Reserve out of the long-term market. It might, therefore, strengthen the market for long-term securities by removing the largest block of bonds overhanging the market and thus suggesting that over the next several years the Federal Reserve does not intend to operate directly to prevent declines in the long-term interest rate.

(d) The amount paid for interest on the Government debt would appear to be reduced. Most of these savings,of course, would be lost through corresponding reductions in the amount repaid by the Federal Reserve to the Treasury, although that loss would show up in reduced receipts which are not specifically earmarked as an off-set to interest payments under existing procedures.

Disadvantages

(a) The Federal Reserve portfolio already has a large concentration in the 5-year maturity area with 3.2 billion

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dollars of the 1-3/4 per cent notes of December 1955. The exchange would add 2.4 billion in that range.

(b) The future market for the exchange note of April 1956 would be heavily tied to Federal Reserve operations because the System would probably own most of the issue. Even more than with the November 1951 note, this might present a problem in avoiding domination by the System of the market for these issues.

(c) The System would give up ammunition for directly preventing a fall or promoting a rise in the long-term rate should such action be under consideration during the period that the 1967-72 issues will be within that maturity range.

3. Full conversion with subsequent partial exchanges into notes

Advantages

(a) This procedure would make it possible for the System to obtain medium-term notes as they may be needed for market operations.

(b) It would permit a distribution of note holdings among different dates and avoid undue concentration on a single date.

(c) It would increase the apparent success of the conversion offer.

(d) It would reduce the supply of marketable long-term bonds outstanding, as explained under 2(c) above.

Disadvantages

(a) There may be some question as to whether the Federal Reserve should hold nonmarketable, high-interest securities, even though on a transition basis.

(b) The Treasury would have to pay out more interest from appropriated funds, even though the Government would recover most of the addition from Federal Reserve earnings.

(c) It would reduce the System's ability to influence the long-term market.

4. Partial conversion

This procedure would have in varying degrees the various advantages and disadvantages of the other options.

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Postscript

Since preparing this memorandum we have had a discussion with Treasury representatives who indicated that the Treasury is likely to convert all of the 67-72 bonds held for trust and agency accounts. There may still be a little difference of opinion in the Treasury and a final decision has not yet been made on this matter. They seem to hold the view that it would be advisable for both the Treasury and the Federal Reserve to convert all of their holdings partly for the publicity value in indicating a large conversion of the bonds.

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STANDARD FORM NO. 64

Office Memorandum • UNITED STATES GOVERNMENT

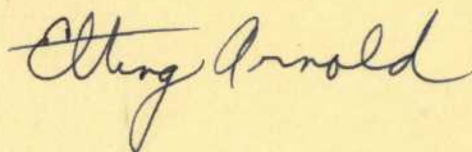
TO : Mr. Martin DATE: MAR 22 1951

FROM : Mr. Arnold

SUBJECT: Procedure relative to your becoming Chairman of Board of Governors

It is my understanding that it is prerequisite to your becoming a member of the Board of Governors both that the President issue you a commission and also that you take the oath of office. The President then, either simultaneously or at a later date, would by letter designate you as Chairman of the Board of Governors, for the President makes this appointment as a separate matter without the advice and consent of the Senate. I have been informed by the office in the Department of State handling the procedures for this type of appointment that your commission as a member of the Board of Governors was sent this morning to the White House for the President's signature.

With regard to terminating your duties as Assistant Secretary and as Executive Director of the International Bank it is customary to submit to the President separate resignations for each of these positions. Under the practice followed in this Department, these two resignations should be transmitted by letter to the Secretary, who in turn will send them to the President. It is, of course, desirable that the resignations be submitted before you take the oath of office as a Board member, particularly with reference to the statute concerning affiliation with any bank which was discussed in my earlier memorandum.



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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date April 18, 1951.

To Chairman Martin

From Miss Benton

MESSAGE:

Attached is the list of Board membership which you requested.

On page 3 are listed the present members of the Board, with term expiration dates. On page 4, a list of the Chairmen of the Board since its organization.

N. 15, 1934 14
N. 15, 1948

Power-Chapman

J. 31
N. 15 1947 D. 15 J. 15 2
N. 15, 1934
13, 2 1/2 mths

- - - - - - - - - - - - - - - - - - - -

Message delivered by ______________

F.R. 468
Rev. 1/47

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MEMBERSHIP OF THE BOARD OF GOVERNORS
OF THE FEDERAL RESERVE SYSTEM
1913-1951

- - -

	Federal Reserve District	Effective date of Appointment	
Charles S. Hamlin	Boston	Aug. 10, 1914	Reappointed 1916 and 1926. Served until Feb. 3, 1936, on which date his successor took office.
Paul M. Warburg	New York	Aug. 10, 1914	Term expired August 9, 1918.
Frederic A. Delano	Chicago	Aug. 10, 1914	Resigned July 21, 1918.
W. P. G. Harding	Atlanta	Aug. 10, 1914	Term expired August 9, 1922.
Adolph C. Miller	San Francisco	Aug. 10, 1914	Reappointed in 1924. Reappointed in 1934 from the Richmond District. Served until Feb. 3, 1936, on which date his successor took office.
Albert Strauss	New York	Oct. 26, 1918	Resigned March 15, 1920.
Henry A. Moehlenpah	Chicago	Nov. 10, 1919	Term expired August 9, 1920.
Edmund Platt	New York	June 8, 1920	Reappointed in 1928. Resigned September 14, 1930.
David C. Wills	Cleveland	Sept. 29, 1920	Term expired March 4, 1921.
John R. Mitchell	Minneapolis	May 12, 1921	Resigned May 12, 1923.
Milo D. Campbell	Chicago	Mar. 14, 1923	Died March 22, 1923.
Daniel R. Crissinger	Cleveland	May 1, 1923	Resigned September 15, 1927.
George R. James	St. Louis	May 14, 1923	Reappointed in 1931. Served until Feb. 3, 1936, on which date his successor took office.
Edward H. Cunningham	Chicago	May 14, 1923	Died November 28, 1930.
Roy A. Young	Minneapolis	Oct. 4, 1927	Resigned August 31, 1930.
Eugene Meyer	New York	Sept. 16, 1930	Resigned May 10, 1933.
Wayland W. Magee	Kansas City	May 18, 1931	Term expired January 24, 1933.
Eugene R. Black	Atlanta	May 19, 1933	Resigned August 15, 1934.

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	Federal Reserve District	Effective date of Appointment	
J. J. Thomas	Kansas City	June 14, 1933	Served until February 10, 1936, on which date his successor took office.
Joseph A. Broderick	New York	Feb. 3, 1936	Resigned effective September 30,1937.
John K. McKee	Cleveland	Feb. 3, 1936	Served until April 4, 1946, on which date his successor took office.
Ronald Ransom	Atlanta	Feb. 3, 1936	Reappointed effective February 1, 1942. Died December 2, 1947.
Ralph W. Morrison	Dallas	Feb. 10, 1936	Resigned effective July 9, 1936.
Chester C. Davis	Richmond	June 25, 1936	Resigned effective March 7, 1940, to accept reappointment effective March 8, 1940, for term of 14 years from February 1, 1940. Resigned effective April 15, 1941.
Ernest G. Draper	New York	Mar. 30, 1938	Served until September 1, 1950, on which date his successor took office.
Lawrence Clayton	Boston	Feb. 14, 1947	Died December 4, 1949.
Thomas B. McCabe	Philadelphia	Apr. 15, 1948	Resigned March 31, 1951.

Note: Under the provisions of the original Federal Reserve Act the Federal Reserve Board was composed of 7 members, including 5 appointive members, the Secretary of the Treasury, who was ex-officio chairman of the Board, and the Comptroller of the Currency. The original term of office was 10 years, and the five original appointive members had terms of 2, 4, 6, 8, and 10 years, respectively. In 1922 the number of appointive members was increased to 6, and in 1933 the term of office was increased to 12 years. The Banking Act of 1935, approved August 23, 1935, changed the name of the Federal Reserve Board to the Board of Governors of the Federal Reserve System and provided that the Board should be composed of 7 appointive members; that the Secretary of the Treasury and the Comptroller of the Currency should continue to serve as members until February 1, 1936; that the appointive members in office on the date of that Act should continue to serve until February 1, 1936, or until their successors were appointed and had qualified and that thereafter the terms of members should be 14 years and that the designation of Chairman and Vice Chairman of the Board should be for a term of four years.

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PRESENT MEMBERS OF THE BOARD OF GOVERNORS

	Federal Reserve District	Effective date of Appointment	
M. S. Szymczak	Chicago	June 14, 1933	Reappointed effective February 3, 1936, and February 1, 1948. Present term expires January 31, 1962.
Marriner S. Eccles	San Francisco	Nov. 15, 1934	Reappointed effective Feb. 3, 1936, March 8, 1940 (switched terms with Chester Davis - see above), and February 1, 1944. Present term expires January 31, 1958.
Rudolph M. Evans	Richmond	Mar. 14, 1942	Appointed for unexpired portion of Chester Davis' term, which expires January 31, 1954.
James K. Vardaman, Jr.	St. Louis	Apr. 4, 1946	Appointed to fill vacancy at expiration of John McKee's term. Present appointment expires January 31, 1960.
Edward L. Norton	Atlanta	Sept. 1, 1950	Appointed to fill vacancy at expiration of Ernest Draper's term. Present term expires January 31,1964.
Oliver S. Powell	Minneapolis	Sept. 1, 1950	Appointed to fill vacancy caused by resignation of Ralph Morrison, which had never been filled. Present term expires January 31, 1952.
Wm. McC. Martin, Jr.	New York	Apr. 2, 1951 2 52 2 53 2 54 2 55	Appointed to fill vacancy caused by resignation of Thomas McCabe, who was appointed for the unexpired portion of Ronald Ransom's term. Present term expires January 31,1956.

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CHAIRMEN OF THE BOARD

Charles S. Hamlin .... August 10, 1914-August 9, 1916
W. P. G. Harding .... August 10, 1916-August 9, 1922
D. R. Crissinger .... May 1, 1923-September 15, 1927
Roy A. Young .... October 4, 1927-August 31, 1930
Eugene Meyer .... September 16, 1930-May 10, 1933
Eugene R. Black .... May 19, 1933-August 15, 1934
Marriner S. Eccles .... November 15, 1934-January 31, 1948
Thomas B. McCabe .... April 15, 1948-March 31, 1951
Wm. McC. Martin, Jr. .... April 2, 1951-

VICE CHAIRMEN OF THE BOARD

F. A. Delano .... August 10, 1914-August 9, 1916
Paul M. Warburg .... August 10, 1916-August 9, 1918
Albert Strauss .... October 26, 1918-March 15, 1920
Edmund Platt .... July 23, 1920-September 14, 1930
J. J. Thomas .... August 21, 1934-February 10, 1936
Ronald Ransom .... August 6, 1936-December 2, 1947

Note: Prior to August 23, 1935, the Chairman and Vice Chairman of the Board were known as Governor and Vice Governor, respectively.

EX-OFFICIO MEMBERS OF THE BOARD

Secretaries of the Treasury

W. G. McAdoo .... December 23, 1913-December 15, 1918
Carter Glass .... December 16, 1918-February 1, 1920
David F. Houston .... February 2, 1920-March 3, 1921
Andrew W. Mellon .... March 4, 1921-February 12, 1932
Ogden L. Mills .... February 12, 1932-March 4, 1933
William H. Woodin .... March 4, 1933-December 31, 1933
Henry Morgenthau, Jr. ..... January 1, 1934-February 1, 1936

Vinson, Snyder, Humphrey

Comptrollers of the Currency

John Skelton Williams ..... February 2, 1914-March 2, 1921
D. R. Crissinger .... March 17, 1921-April 30, 1923
Henry M. Dawes .... May 1, 1923-December 17, 1924
Joseph W. McIntosh .... December 20, 1924-November 20, 1928
J. W. Pole .... November 21, 1928-September 20, 1932
J. F. T. O'Connor .... May 11, 1933-February 1, 1936

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FEDERAL RESERVE BANK
OF NEW YORK

NEW YORK 45, N. Y.

May 28, 1951

Personal

Hon. William McC. Martin, Jr., Chairman,
Board of Governors of the
Federal Reserve System,
Washington 25, D. C.

Dear Bill:

Enclosed is a list of those who have accepted Bob Stevens' and my invitation to the dinner in your honor, Wednesday evening, June 6th. There may be one or two late additions or changes, but this is most of the group you will be meeting.

It will all be pretty informal. Bob Stevens will welcome the guests, and then will call on me to introduce you. After that, the floor will be yours to say whatever you want to say to this group of System associates, and old friends and acquaintances. You can either close it out with your remarks, or expose yourself to questions.

We are looking forward to the dinner, and also to having you with us at the luncheon and meeting of our Board of Directors on Thursday, June 7th.

Yours sincerely,

Allan Sproul

Enclosure

Received in
Chairman's Office
MAY 29 1951
Board of Governors
of the
Federal Reserve System

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List of Those Who Have Accepted Invitation
to Dinner for
Hon. William McC. Martin, Jr.
Wednesday, June 6, 1951,
at the Links Club, New York City

Members of the Board of Directors of the
Federal Reserve Bank of New York

Burr P. Cleveland	President, First National Bank of Cortland, New York
Jay E. Crane	Vice President, Standard Oil Company (New Jersey)
Marion B. Folsom	Treasurer and Director, Eastman Kodak Company
William I. Myers Deputy Chairman	Dean, New York State College of Agriculture, Cornell University
Robert P. Patterson	Patterson, Belknap & Webb
Roger B. Prescott	President, The Keeseville National Bank
Robert T. Stevens Chairman	Chairman, J. P. Stevens & Co., Inc.
John C. Traphagen	Chairman, Bank of New York and Fifth Avenue Bank

Members of the Board of Directors
of the Buffalo Branch of the
Federal Reserve Bank of New York

George F. Bates	President, Power City Trust Co., Niagara Falls, N.Y.
Bernard E. Finucane	President, Security Trust Co., Rochester, N.Y.
George G. Kleindinst	President, Liberty Bank of Buffalo, Buffalo, N.Y.
C. Elmer Olson	President, The First Natl Bank of Falconer, N. Y.
Edgar F. Wendt	President, Buffalo Forge Company

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Heads of Principal New York City Banks

will not be back in time - ~~Winthrop W. Aldrich~~ or Percy J. Ebbott	Chairman and President, respectively, Chase National Bank
William Gage Brady, Jr.	Chairman, National City Bank
W. Randolph Burgess	Chairman, Executive Committee, National City Bank
J. Luther Cleveland	Chairman, Guaranty Trust Company
S. Sloan Colt	President, Bankers Trust Company
William S. Gray	Chairman, Central Hanover Bank and Trust Co.
J. Stewart Baker	Chairman, Bank of the Manhattan Company
Dunham B. Sherer	Chairman, Corn Exchange Bank Trust Company
Alexander C. Nagle	President, First National Bank of City of New York
Charles J. Stewart	President, New York Trust Company
Henry C. Alexander	President, J. P. Morgan & Co., Inc.
E. Chester Gersten	President, Public National Bank and Trust Co.
James G. Blaine	President, The Marine Midland Trust Co. of N. Y.
Benjamin Strong	President, United States Trust Company
Harold H. Helm	President, Chemical Bank and Trust Company

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Others

William A. Lyon	Superintendent of Banks, State of New York Banking Department

Federal Reserve Bank of New York

Allan Sproul	President
L. R. Rounds	First Vice President

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Nov. 9, 1951

Excess Profits Tax and Banks

Dear Governor Martin -

I thought you might be interested in seeing a copy of the Questionnaire we worked out in what seemed to us a very successful meeting yesterday. Mr. Horbett tells me that he is preparing a report and supporting explanations for your return and possibly for the Board meeting Tuesday.

The staff have been effective and cooperative all the way through and Mr. Horbett particularily - although never forgetting to make sure that everything was in order from the Federal Reserve Board viewpoint on every point.

The other agencies as far as staff level are concerned seem all in agreement also. They are only waiting for approval from the tops and Dan Bell tells me

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you have been in touch with both Secretary Snyder and Chairman Harl on that. The Secretary leaves for Europe on Wednesday I am told and will have to give his final approval before then probably if there is to be time to get out the questionnaire in time.

It has been a pleasure to work with the Fed people on this to all of us - Hal Stonier included.

sincerely

Rowland Hughes

(ROWLAND HUGHES)

The questionnaire is of course still being refined in a few particulars but seems pretty close to what we agree is needed at present.

[illegible]

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A substantial part of the information requested by this Questionnaire will have to be estimates since 1951 is not yet closed and 1952 has not even begun. It is understood that any estimated figures reported (which are expected to be in round figures) are only for the purpose of this compilation and are not binding on you for any purpose. Particularly in connection with 1952, you may want to show a maximum and minimum rather than a specific figure. In all cases your best estimate after a reasonable amount of consideration and research is all that is expected - in no case is elaborate extra work just for this purpose desired. It is hoped you will answer all, but in any case, where you can not arrive at a reasonable approximation on this basis just mark that item "n.a.," which will be understood as "not available" or "not answered."

In the case of 1952 figures it will be understood that they will generally be on the basis of 1951 adjusted for known or foreseeable probable changes in capital, rates of tax, bond portfolio etc. but will not be adjusted for any estimate of possible changes in general conditions such as in business activity, employment, war etc.

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Form _________ Budget Bureau No. ______
November 1951

Schedule __ - Tax Questionnaire

(See accompanying instructions)

NAME OF BANK ________________________ CITY AND STATE ______________

According to latest Call Report

Total Capital Funds ________________ Total Resources ________________

Number of Shareholders (common stock) ________________ Number of common shares outstanding ______________

1. (a) Were you subject to Excess Profits Tax on 1950 earnings Yes __ No __
   (b) Do you estimate that you will be subject to Excess Profits Tax — 1951 Yes __ No __
   1952 Yes __ No __
   (c) If the answer is no, check circumstances relating to that year:

	1950	1951 Est.	1952 Est.
Excess profits net income (line 23 of Schedule EP 1, form 1120) less than $25,000	___	___	___
Non-recurring losses or expenses	___	___	___
Credit sufficient to offset income subject to tax	___	___	___
Other	___	___	___

   (d) Under the law you may use the most advantageous of either the invested capital or base period income methods for computing the excess profits credit. Which is your option?

	1950	1951	1952
Invested Capital	___	___	___
Base Period Income	___	___	___

NOTE: If all answers under (a) and (b) above are "No", you may disregard the following questions, although completion of the questionnaire as far as possible would be helpful to a successful completion of the survey.

- -

2. Inadmissible Assets

	Total Inadmissible Assets	Total Assets
	(In thousands of dollars)	
At opening of business (use call report close of previous period)		
- July 1, 1946		
- Jan. 1, 1947		
- Jan. 1, 1950		
- Jan. 1, 1951		
- Jan. 1, 1952 (estimated)		

NOTE: Inadmissible assets are obligations on which the interest is fully or partially exempt from Federal income tax, and stocks of corporations including Federal Reserve Bank stock.

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3. Capital stock

(a) Has new capital stock been issued since Dec. 31, 1949 (do not include stock dividends) ________ (Yes or No)

Year issued ________

(b) If so, please indicate price at which issued $________ per share.

(c) If readily available, latest market or bid price $________ per shar

(d) What has been, or possibly will be, the effect of the excess profits tax in obtaining new capital, particularly in relation to your bank?

4. Only banks on Average Earnings Basis should answer this question.

83% of **AVERAGE BASE PERIOD NET INCOME**
(This is 83% of the amount shown on line 26 of Schedule EP2 of the Excess Profits Tax Return - in thousands of dollars).

1950	________
1951 Estimated	________
1952 Estimated	________

SCHEDULE 1

NET EARNINGS AND INCOME TAXES

	1950	1951 Estimated	1952 Estimated
	(In thousands of dollars)		
(a) Net income from inadmissible assets	________	________	________
(b) Net earnings from current operations before income taxes (Item 3, Report of Earnings & Dividends)	________	________	________
(c) Profits before income taxes (Item 6, Report of Earnings & Dividends)	________	________	________
(d) Normal tax net income (Item 34, Form 1120)	________	________	________

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	1950	1951 Estimated	1952 Estimated
	(In thousands of dollars)		
(e) Surtax net income (Item 5, Tax Computation, Form 1120)	________	________	________
(f) Adjusted excess profits net income (Item 27 of Schedule EP-1, Form 1120)	________	________	________
(g) Taxes on Net Income (Item 7, Report of Earnings & Dividends) Subdivided as to:			
(1) State	________	________	________
(2) Federal - Normal tax & surtax	________	________	________
(3) Excess profits tax	________	________	________
(4) Total	________	________	________

(h) What is your approximate average rate of return on excess profits tax invested capital (corresponding to Schedule 2, Item (c) herein) for the three highest years during the base period 1946 - 1949?

______%

It will be understood that the answer under (g) is not a determination of the liability for any purpose whatsoever and will only be used, in conjunction with figures for other banks, in statistical compilations. It may be estimated in round figures.

SCHEDULE 2
CAPITAL FUNDS & EQUITY INVESTED CAPITAL

	(In thousands of dollars)		
(a) Total capital accounts (Item 29 of Report of Condition)	________	________	________
(b) Total adjustments for such items as reserves for bad debts and other valuation reserves, excess expense, tax and other reserves for which no deduction has been taken for tax purposes, adjustment of assets from book to tax basis, and borrowed capital.	________	________	________

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	1950	1951 Estimated	1952 Estimated
	(In thousands of dollars)		
(c) Equity capital for excess profits tax purposes (a) minus (b) (This will be the amount shown, or expected to be shown, as equity capital in the excess profits tax return for each year)	________	________	________
(d) Equity capital per common share	________	________	________
(e) Cash dividends per share of common stock	________	________	________

(All references to excess profits and income tax forms are based on the 1950 blanks.)

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

January 21, 1952

My dear Mr. President:

In accord with our recent conversation, I would like to suggest, for any consideration you may care to give them, the following two names as appointees to the Board of Governors of the Federal Reserve System:

For unexpired term of Marriner S. Eccles -- Expiry January 31, 1958

Abbot L. Mills, Jr., San Francisco District

For unexpired term of Edward L. Norton -- Expiry January 31, 1964

James Louis Robertson, Kansas City District.

COPY

A brief biography of each of these men is attached.

Yours respectfully,

Wm. McC. Martin, Jr.

The President
The White House

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Chairman Martin

October 27, 1952.

Mr. Malcolm Bryan, President,
Federal Reserve Bank of Atlanta,
Atlanta, Georgia.

Dear Malcolm:

Enclosed are three documents that will come up for discussion at the Ad Hoc Subcommittee meeting on Friday.

First, there is a numbered draft copy of the Subcommittee's report as it has just come off the mimeograph. We have been putting lots of night work in on it. I thought we had everything cleaned up, but in going over the first few pages just now I see some rough spots, particularly in the Preface. Please excuse them. The section on housekeeping has been drafted in light of the views expressed at the last meeting of the Subcommittee. It is not nearly so well done as your draft. I feel it is good enough, however, to permit the Subcommittee to choose how they want to handle this delicate problem.

Second, there is a numbered draft memorandum prepared from the material in the minutes and files of the Open Market Committee dealing with relations with dealers.

Third, there is a numbered draft memorandum of the material from the minutes, files of the Open Market Committee, and the dealer discussions of the Ad Hoc Subcommittee, relating to J. B. Roll and Aubrey Lanston.

It is my suggestion that the Subcommittee decide on Friday whether or not to distribute immediately these latter two memoranda to the Board and Presidents. They give necessary background material for consideration of the final report.

As ever,

Winfield W. Riefler, Secretary,
Federal Open Market Committee.

Enclosures

WWR:cls
cc: Governor Mills
Chairman Martin

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April 8, 1953

STRICTLY CONFIDENTIAL

Dear Randy:

Herewith a draft of changes along the lines I discussed from time to time with George Humphrey, you and the President. I thought you might like to have this before we have our next discussion.

I seriously question the use of the Reorganization Act, although, technically, a good case could be made, perhaps, for making it applicable. I am confident it is the wrong way to handle such a situation as this one.

I am also enclosing a tabulation of the membership of the Board of Governors since February 3, 1936 which indicates that during the period of February 3, 1936 through February 28, 1953, the Board has consisted of seven members for only three years and eight months, and consisted of six members for eleven years and ten months, and five members for one year and five months.

Incidentally, if we could find a really good man, it might be wise to consider filling the present vacancy preparatory to moving along these lines.

Sincerely yours,

Wm. McC. Martin, Jr.

Honorable W. R. Burgess
Special Deputy to the Secretary
Treasury Department
Washington, D.C.

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February 17, 1953.

Chairman Martin — Changes in membership of Board

Mr. Vest — and Open Market Committee.

Following our recent conversation, I have given some thought to possible changes in the composition of the Board on the basis of five members with ten-year terms and in the Open Market Committee to make appropriate and corresponding changes. I attach drafts of possible amendments to the law which would make changes of this kind. However, there are a number of important questions that arise in connection with any such changes, and these should have careful consideration before any definitive legislative draft is prepared.

<u>How Should Change in Board Members Be Effected</u>. - Assuming that the membership of the Board is to be changed to five members with ten-year terms, there are two possible ways in which the new set-up might be brought about. First, it could be done by having the law completely reorganize and reconstitute the Board. In other words, all present terms would be ended on a given date, say February 1, 1954, and new appointments by the President, confirmed by the Senate, would be necessary for membership on the new Board. This would, of course, not preclude the President from reappointing any present members of the Board that he wished. This method would be similar to the method which was followed when the Board was reorganized in February 1936 as the result of the Banking Act of 1935. The only other way that occurs to me by which a reduction in membership to five could be brought about would be by dropping off of the Board two out of the seven members now provided for. Since there is now one vacancy, this as a practical matter would mean the elimination of any one of the present six members. The remaining five members of the Board would continue and serve out their present terms. Upon the expiration of their present terms, the President could either reappoint them for terms of ten years or could appoint new members in their stead for a like term.

The attached legislative draft would provide for a complete reorganization of the Board similar to the method used under the Banking Act of 1935. If you should wish a draft which would use the method of dropping off two of the seven members now provided for by the statute, I will be glad to furnish it.

<u>Reappointment of Members Who Have Served Full Terms</u>. - Present law does not permit the reappointment of a new member who has served a full term of fourteen years. In your reply to the Patman Questionnaire, you suggested terms of six years, with the prohibition against reappointment eliminated. The Patman Subcommittee Report recommended a term of

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six years with the prohibition against reappointment eliminated, but Senator Flanders suggested a ten-year term also permitting eligibility for reappointment. The attached draft providing for five members with ten-year terms does not include any ban against reappointment of members.

Geographical Distribution of Board Members. - The attached draft makes no change in the present requirements of the law that not more than one Board member may be appointed from any one Federal Reserve district and that the President shall have due regard to a fair representation of the financial, agricultural, industrial and commercial interests and geographical divisions of the country. If desired, of course, the provision regarding one member from one district could be eliminated, as was indicated in your reply to the Patman Questionnaire and in the Patman recommendations.

Term of Chairman. - The attached legislative draft makes no change in the terms of office of the Chairman and Vice Chairman of the Board, the provision for four-year terms in present law being retained.

Composition of Federal Open Market Committee. - In considering who should constitute the Federal Open Market Committee, one of the first questions which suggests itself and one which has been often discussed is whether the Federal Reserve Board should not have vested in it the functions and responsibilities of the Open Market Committee. The Committee performs governmental functions, and in one view of the matter it would seem that it should be made up of officials appointed by the President with the advice and consent of the Senate and that it should not include any other persons, notwithstanding their official connections with important institutions like the Federal Reserve Banks. However, the placing of these functions in the Board or any similar agency in Washington would mean a sacrifice of desirable decentralization.

Assuming that there is to be such decentralization, the question as to the extent of decentralization arises and also whether membership on the Committee should include representatives from all Federal Reserve Banks or from some lesser number of Federal Reserve Banks. From 1933 to 1935, the Open Market Committee consisted exclusively of representatives of the twelve Federal Reserve Banks. This did not work satisfactorily notwithstanding that the Board had the power of regulation over open market transactions. It would obviously be too unwieldy to have representatives of all of the Reserve Banks plus all of the Board members on the membership of the Committee. By process of elimination, therefore, it seems a necessary conclusion that if we are to have decentralization in this matter, the present system of combining the membership of the

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Board with representation from some but not all of the Federal Reserve Banks is the plan that has the least objection to it. In your reply to the Patman Questionnaire, you stated, after considerable discussion of the matter, that it was desirable that the Reserve Banks should participate to the greatest extent practicable in the consideration and formulation of open market policies, and that there appears to be no compelling reason in the public interest for disturbing the present arrangement.

Assuming that the membership of the Board is to be reduced to five, it is logical to reduce the Federal Reserve Bank representatives on the Open Market Committee to either four or three. Arguments could perhaps be made either way with respect to whether such representation should be four or three, but since the Board members would predominate in number in either case, there is something to be said for four Reserve Bank representatives in order to have more Federal Reserve Banks directly concerned with the activities of the Committee at any one time and to have a broader base of decentralization. This would mean a total membership of nine on the Open Market Committee. Presumably the constant representation of the Federal Reserve Bank of New York would be continued; provision to this effect was placed in the law by special amendment in 1942.

The attached draft of legislation provides for an Open Market Committee of nine members, effective March 1, 1954, consisting of the five members of the Board and four representatives of the Federal Reserve Banks, one of which would be the Federal Reserve Bank of New York. One representative would be elected by the directors of the Federal Reserve Banks of Boston, Philadelphia, Richmond and Atlanta, one by the directors of the Federal Reserve Banks of Cleveland, Chicago and St. Louis, and one by the directors of the Federal Reserve Banks of Minneapolis, Kansas City, Dallas and San Francisco. This grouping could, of course, be changed in any way that might seem preferable.

Staff and Funds of Federal Open Market Committee. - Consideration might be given to providing in any new legislation authority for the Federal Open Market Committee to employ its own staff and to obtain funds with which to pay its expenses and salaries of its employees. The attached draft does not presently include such provisions.

Legislative authority for this purpose might be desirable if a completely separate staff of the Open Market Committee were to be set up. However, the matter might be worked out without legislation if there were an understanding that the Board would employ and pay any persons designated by the Committee and at salaries specified by the

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Committee. However, if statutory authority should be sought, it would be most important that Committee employees and Committee funds be exempted from the various Federal statutory provisions relating to Government employees and Government funds, such as the Civil Service laws, the Classification Act, the General Accounting Office, Budgeting, etc. For this purpose, provisions could be inserted in the proposed legislation to give the Committee the same exemptions in this regard as has the Board, but it would be necessary to spell out these provisions in a paragraph for this purpose. This would invite the possibility of Congress considering and possibly amending the existing law giving these exemptions to the Board. The results could not be forecast.

Reorganization Act. - The Reorganization Act of 1949 has recently been extended for two more years. It applies in very broad language to all agencies in the executive branch of the Government. While not completely clear, the legislative history indicates that it was intended to apply to such agencies as the Board. It is believed, therefore, that a reorganization of the Board reducing the number of its members could be carried out under the procedure of the Reorganization Act. In such case compensation of Board members would be fixed at a rate found by the President to prevail for comparable officers in the executive branch of the Government. However, if any change were made in the length of the term of the members, it appears that the terms would have to be fixed at not more than four years.

There is considerable doubt as to whether the Federal Open Market Committee could be included in such a reorganization. The chief reason for this is the fact that the reorganization plan would undertake to reduce the number of representatives from the Federal Reserve Banks, and this would mean that there would have to be a change in the present scheme of election of representatives. Changes of this kind are not specifically provided for in the Reorganization Act. Moreover, although the Act makes provision for the appointment and compensation of agency members, it provides that in such case the appointment, if not under classified Civil Service, shall be by the President with the Advice and consent of the Senate. To have such appointments to the Open Market Committee made by the President would, of course, completely change the set-up of the Federal Open Market Committee. While it is possible that a reorganization plan merely changing the number of Federal Reserve Bank representatives and the grouping of the Reserve Banks for the purpose of electing them (and not providing for appointments by the President) would go through Congress without successful challenge, it would be open to legal doubt, and objections in Congress on this score might very well prevent the plan from becoming effective.

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REORGANIZATION OF THE BOARD OF GOVERNORS AND OF THE FEDERAL OPEN MARKET COMMITTEE

A BILL

To amend sections 10 and 12A of the Federal Reserve Act, as amended, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the first two paragraphs of section 10 of the Federal Reserve Act, as amended (U.S.C., Title 12, secs. 241-2), are hereby amended to read as follows:

"The Board of Governors of the Federal Reserve System (hereinafter referred to as the 'Board') shall be composed of five members, to be appointed by the President, by and with the advice and consent of the Senate, after the date of enactment of this amendment, for terms of ten years except as hereinafter provided, but each member of the Board in office on such date shall continue to serve as a member of the Board until February 1, 1954, at which time each such member shall be deemed to have served the full term for which he was appointed. The President shall fix the term of each member of the Board at not to exceed ten years from February 1, 1954, as designated by the President at the time of nomination, but in such manner as to provide for the expiration of the term of not more than one member in any two-year period, and thereafter each member shall hold office for a term of ten years from the expiration of the term of his predecessor, unless sooner removed for cause by the President. In selecting the members of the Board, not more than one of whom shall be selected from any one Federal Reserve district, the President shall have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country.

C1,1954

C1,1954,

"The members of the Board shall be ineligible during the time they are in office and for two years thereafter to hold any office, position, or employment in any member bank, except that this restriction shall not apply to a member who has served the full term for which he was appointed. Of the persons appointed as members of the Board, one shall be designated by the President as chairman and one as vice-chairman of the Board, to serve as such for a term of four years. The chairman of the Board, subject to its supervision, shall be its active executive officer. The chairman of the Board shall receive an annual salary of $22,500 and each of the other members of the Board shall receive an annual salary of $20,000. Such salaries shall

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be payable monthly, together with actual necessary traveling expenses. The members of the Board shall devote their entire time to the business of the Board. Each member of the Board shall within fifteen days after notice of appointment make and subscribe to the oath of office. Upon the expiration of their terms of office, members of the Board shall continue to serve until their successors are appointed and have qualified."

Sec. 2. Effective March 1, 1954, the first two sentences of subsection (a) of section 12A of the Federal Reserve Act, as amended (U.S.C., Title 12, sec. 263), are hereby amended to read as follows:

"There is hereby created a Federal Open Market Committee (hereinafter referred to as the 'Committee'), which shall consist of the members of the Board of Governors of the Federal Reserve System and four representatives of the Federal Reserve Banks to be selected as hereinafter provided. Such representatives shall be Presidents or First Vice Presidents of Federal Reserve Banks and, beginning with the election for the term commencing March 1, 1954, shall be elected annually as follows: One by the board of directors of the Federal Reserve Bank of New York, one by the boards of directors of the Federal Reserve Banks of Boston, Philadelphia, Richmond and Atlanta, one by the boards of directors of the Federal Reserve Banks of Cleveland, Chicago and St. Louis, one by the boards of directors of the Federal Reserve Banks of Minneapolis, Kansas City, Dallas and San Francisco."

2/17/53

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Changes in membership of Board during period Feb. 3, 1936, through Feb. 28, 1953

Date	Change	No. of Members	Elapsed period before change Yr.	Mo.	Da.
February 3, 1936	Board composed of Governors Eccles, Ransom, Szymczak, McKee, and Broderick	5			7
February 10, 1936	Governor Morrison took oath of office	6		4	15
June 25, 1936	Governor Davis took oath	7			14
July 9, 1936	Governor Morrison resigned	6	1	2	21
September 30, 1937	Governor Broderick resigned	5		6	-
March 30, 1938	Governor Draper took oath	6	3	-	15
April 15, 1941	Governor Davis resigned	5		10	29
March 14, 1942	Governor Evans took oath	6	4	-	20
April 4, 1946	Governor McKee's service terminated: Governor Vardaman took oath	6		10	10
February 14, 1947	Governor Clayton took oath	7		9	18
December 2, 1947	Governor Ransom died	6		4	13
April 15, 1948	Chairman McCabe took oath	7	1	7	19
December 4, 1949	Governor Clayton died	6		8	27
September 1, 1950	Governor Draper's service terminated: Governors Norton and Powell took oath	7		7	-
March 31, 1951	Chairman McCabe resigned	6			1
April 2, 1951	Chairman Martin took oath	7		3	12
July 14, 1951	Governor Eccles resigned	6		6	17
February 1, 1952	Governor Norton resigned	5			17
February 18, 1952	Governors Mills and Robertson took oath	7		4	12
June 30, 1952	Governor Powell resigned	6		7	28

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February 28, 1953

Board consisted of the following number of Members during the periods indicated below:

Dates	Elapsed Period Yrs.	Mos.	Days
FIVE MEMBERS			
February 3 - 10, 1936			7
September 30, 1937 - March 30, 1938		6	-
April 15, 1941 - March 14, 1942		10	29
February 1 - 18, 1952			17
	1	5	23
SIX MEMBERS			
February 10 - June 25, 1936		4	15
July 9, 1936 - September 30, 1937	1	2	21
March 30, 1938 - April 15, 1941	3	-	15
March 14, 1942 - February 14, 1947	4	11	-
December 2, 1947 - April 15, 1948		4	13
December 4, 1949 - September 1, 1950		8	27
March 31, 1951 - April 2, 1951			1
July 14, 1951 - February 1, 1952		6	17
June 30, 1952 - February 28, 1953		7	28
	11	10	17
SEVEN MEMBERS			
June 25 - July 9, 1936			14
February 14 - December 2, 1947		9	18
April 15, 1948 - December 4, 1949	1	7	19
September 1, 1950 - March 31, 1951		7	-
April 2 - July 14, 1951		3	12
February 18 - June 30, 1952		4	12
	3	8	15

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MEMBERSHIP OF BOARD OF GOVERNORS

(SINCE FEBRUARY 3, 1936)

Year							
1936	Morrison 2-10-36 to 7-9-36	Eccles 11-15-34 to 7-14-51	Ransom 2-3-36 to 12-2-47	Davis 6-25-36 to 4-15-41	McKee 2-3-36 to 4-4-46	Szymczak 6-14-33	Broderick 2-3-36 to 9-30-37
1937							
1938							Draper 3-30-38 to 9-1-50
1939							
1940							
1941							
1942				Evans 3-14-42			
1943							
1944							
1945							
1946					Vardaman 4-4-46		
1947	Clayton 2-14-47 to 12-4-49						
1948			McCabe 4-15-48 to 3-31-51				
1949							
1950	Powell 9-1-50 to 6-30-52						Norton 9-1-50 to 2-1-52
1951			Martin 4-2-51				
1952		Mills 2-18-52					Robertson 2-18-52
1953							

Mr. Allan Sproul,
President,
Federal Reserve Bank of New York,
New York 45, New York.

Dear Allan:

From your letter of July 16, 1953, I gather that you are under the impression that "political pressures" were in some sense responsible for the recommendations on Housekeeping advanced by the Ad Hoc Subcommittee on the Government Securities Market. Let me reassure you completely on that point. We in the System have no need to take account of such pressures, provided only that we are right. If our existing organization can be defended, we can, as you say, "rely on the ordinarily quiet majority in the Congress to support us if the matter comes to an issue."

This brings us back to the basic question, "What about our present organization? Is it right? Can it be defended on an impartial, informed and objective basis?" I have gone over again your comments on the Ad Hoc Subcommittee Report, both those you made in February as well as those in your letter of July 16. They have much merit and I find much in them with which I agree. It seems to me that in most cases the considerations you advance have been stated either explicitly or implicitly in the Report of the Subcommittee.

However, I still feel that the organization of the Federal Open Market Committee deserves consideration especially with respect to the position of Manager of the Account, and his relationship to the eleven members of the Federal Open Market Committee outside New York. These eleven members, in your words, "share full measure of responsibility" with you for the open market policies of the Federal Reserve System. At the same time, as you take pains to point out in your February comments on the Ad Hoc Subcommittee Report, the management of the Account, if it chooses, may be able to make a lot of policy on its own.

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I am most sympathetic to your strong conviction that "there does not seem to us to be a practicable way, consistent with his duties either as Reserve Bank President and his location in New York, or as Vice Chairman of the System Open Market Committee and its executive committee, to lessen the real and special responsibility of the New York President for System operations affecting the Government securities market." The question, however, is whether it is possible to achieve a practical organization of the Federal Open Market Committee that is also consistent with the duties and responsibilities of the other eleven members of the Committee. You yourself hold that the Federal Open Market Committee has no real option to delegate the management of the Account to any Reserve Bank other than the Federal Reserve Bank of New York. You base this on grounds of "geographical necessity" and practical administration. In view of this situation, does not your own reasoning, as revealed in your comments and communications, lead you to the conclusion that the other eleven members of the Committee are now placed in a position where they share full responsibility while the President of the Federal Reserve Bank of New York can, if he chooses, be a "free planet" making quite a little policy on his own?

This is an objective statement of the situation taken from your own comments without any implications whatever that this has happened. We are discussing organization,not personalities. I do not think it is fair to you, to the Ad Hoc Subcommittee, or to the other members of the Open Market Committee, to take the position that, "giving credit for good faith", we face no problem in the way we have organized the Federal Open Market Committee "so long as the institution and the men involved in the present arrangements for executing open market policy are directly and wholly responsive to the directions of the Federal Open Market Committee."

The fact is that the present arrangement by which the management of the Open Market Account is delegated to the Federal Reserve Bank of New York might, under certain circumstances, seriously impair public confidence in the Federal Open Market Committee, particularly if the impression were generated that members of the Committee were not really in control of operations or were uninformed with respect to important aspects of them.

That this hazard exists was brought home forcefully to me in the course of the discussion with the dealer organizations. In

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most cases, the discussions were warm and friendly, though cautious in tone, and, in most cases, the dealers had the friendliest attitude toward the Federal Open Market Committee, the Subcommittee, the Federal Reserve Bank of New York, and the day-to-day operations of the Committee. There was an undertone, however, that was distinctly critical of many of the technical aspects of our operations. In most cases, those who were critical felt that these techniques were not always wisely conceived and that they failed to give sufficient considerations to the realities of the marketplace.

Now, these critics did not usually blame the management of the Account. They seemed to feel that the management was working reluctantly under restrictions imposed by the Federal Open Market Committee. One reason the dealers gave for welcoming the discussions was that it afforded them a chance to explain directly to members of the Federal Open Market Committee why they felt that some of its practices were not well conceived. This caught all of us on the Subcommittee by surprise. In some cases, we were not even familiar with the criticized techniques.

The fact is that our present form of organization inevitably leaves individual members of the Federal Open Market Committee in positions that might be difficult, if not impossible, to defend. For example, if the discussions before the Subcommittee had been before a committee of the Congress, as they might well have been, and if a Congressman, prompted by a hostile dealer, had called up each member of the Federal Open Market Committee to account for and justify certain directives for which he shared responsibility, the result would scarcely have contributed to confidence in the technical competence of the Committee.

The problem before us is an organizational problem. It relates to the discharge of shared responsibilities. It is not the sort of problem that can be disposed of merely by "giving credit to good faith."

I agree with you that the problem is created by the "twilight zone" of operations where the discretion that is necessary to effective conduct of operations leaves a risk that decisions reached at the policy level may be modified in execution. Many organizations face this type of problem. It is not unique to the Federal Open Market Committee.

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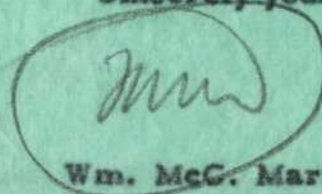
I am under the impression that the most generally recommended solution is the one which the Ad Hoc Subcommittee recommended for consideration by the full Open Market Committee, namely, (1) that the policy making body choose an executive in which it has confidence, (2) that it hold that executive strictly responsible for the objective exercise of such discretion as is essential to effective operations, and (3) that it change the executive if it is dissatisfied with his operations. Delegated discretionary powers, such as we have, in a situation where the responsible body cannot in practice change the management is, I think, an anomaly.

After reading your communications, I feel very certain that the Open Market Committee does face a problem which deserves the most candid examination.

Sincerely yours,



Wm. McC. Martin, Jr.

Letter drafted revised and OKd by Thurston, Ruffler et al

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November 5, 1953

Memorandum To: William McChesney Martin, Jr.

From: Hawthorne Arey

Reference is made to your memorandum for the National Advisory Council on the subject "Lending Policies of Export-Import Bank." The last paragraph of the "Recommended Action" provides as follows:

> "In order that the volume of new Export-Import Bank lending, in the period immediately ahead, shall not constitute an undue financial burden, the Council proposes that each loan application in the future be subjected to more severe scrutiny, with the requirement of a more positive showing that the proposed financing would be in the national interest of the United States and that the funds cannot be raised on reasonable terms from private sources."

The use of the terms "more severe scrutiny" and "more positive showing" do not establish very accurate tests. The Act under which the Export-Import Bank operates requires findings along the lines indicated and it is assumed that this statement implies either that the Bank will establish tests more severe than have been established in the past operations of the Bank or more severe than the law requires. I believe it may be assumed that past Administrations have been in full compliance with the law.

It occurs to me, however, that this paragraph lacks clarity in a more important aspect. The use of the words "in the period immediately ahead" and the words "shall not constitute an undue financial burden" would indicate that the purpose of the severe scrutiny of the Bank's operations is to minimize net drawings upon the Treasury. To the extent that the Bank's loans do not exceed repayments, the Treasury's position is not adversely affected. To the extent that the Bank utilizes its power to guarantee so that only a contingent liability falls upon the Treasury, its operations do not "constitute an undue financial burden" any more than do those of the International Bank. Accordingly, it would seem that words should be inserted to indicate that the more severe tests are to be applicable in the consideration of those applications for loans which would require a withdrawal of funds from the Treasury. If the tests are to be applied on any other ground then it would appear to be illogical for the Council to take such a position with respect to the Export-Import Bank and not take an identical position with respect to its instructions to the United States representatives on the Board of the International Bank.

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If it is concluded that it is necessary to include a statement similar to that in your memorandum, it is suggested that consideration be given to language substantially as follows:

For the period immediately ahead, the Council is of the opinion also that, in the consideration of each application for a loan by the Bank which would require a withdrawal of funds from the Treasury, special attention should be given to (a) the extent to which the national interest of the United States is involved, and (b) the unavailability of funds on reasonable terms from private sources.

HA:mm

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FEDERAL RESERVE BANK
OF NEW YORK

NEW YORK 45, N. Y.

February 15, 1954

Hon. Wm. McC. Martin, Jr., Chairman,
Board of Governors of the
Federal Reserve System,
Washington 25, D. C.

Dear Bill:

In your letter of February 9 you inquire whether I might have some questions or suggestions concerning the enclosed galley proofs of the Board's Annual Report for 1953. I have some views concerning galley number 4, which I give you frankly, while remaining acutely aware that this is the Board's Annual Report, and that my views on the matters discussed, as a member of the Federal Open Market Committee, have so far been distinctly minority views.

In the first place it seems to me that most of the section on "Steps toward freer, more self reliant financial markets" takes over and substitutes for the policy record of the Federal Open Market Committee. While the Federal Open Market Committee rejected the idea of publishing "rules of the game", this is another step beyond previous statements, intimations, and interpretations, and beyond the record of the Federal Open Market Committee itself, which does just that. It also omits reference to the possibility of change by the Federal Open Market Committee, which gives the whole thing an air of timelessness or permanence which could be misleading, and which the Federal Open Market Committee has renounced. The howl from one or two vocalists in the market, that we had broken our pledged word when we made some piddling swaps recently, is perhaps significant.

The transition from a definition of a free market to the purpose of Federal Reserve purchases and sales of Government securities in such a market, I find less than clear. I think we must start from the premise that we haven't a free market as defined, but a market in which borrowers and lenders have to and do take account of possible action by the Federal Reserve System to increase or reduce the supply (and cost and availability) of funds. Then, I think it is sliding over a difficulty to say that "in such a market Federal Reserve purchases and sales would be

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June 7, 1956

To: Chairman Martin

From: Mr. Riefler

Subject: Letter from Arthur Condon to Arthur Burns citing effects of credit restrictions on the trucking industry.

It is a little surprising that a person of the standing of Mr. Condon would send a letter of this character to an economist of the standing of Arthur Burns. It appears obvious that the writer is unfamiliar with the "facts of life" of a competitive economy. There may very well be undesirable, as well as desirable, effects of credit restraint on the economy as a whole, and on the trucking industry. We are watching the situation with the most painstaking care to obtain straws on what is happening. We welcome information that bears on the point.

Unfortunately, the type of information conveyed in this letter tells nothing. It is the sort of information that could be gathered and verified in a competitive economy at any time--in a period of credit ease as well as credit restraint. It is axiomatic, in a competitive economy, that some businessmen who would like to expand further their borrowing find lenders unwilling to go along. This letter does nothing but cite a number of such individual instances. It implies dire aggregative effects on the economy, but gives not one scintilla of information that bears on this point.

There are a few facts that one would think would have given the writer some pause. For example, the output of heavy trucks is running at record levels. When this is happening, it is a little stiff to have a supposedly knowledgeable person drag in prophecies of impending collapse of our national defense due to a failure to replace, modernize and expand our trucking equipment.

It is also surprising to have a presumably informed person accept, as a valid explanation, a statement by a bank in Houston that it was refusing to extend a certain line of credit because its consumer credit portfolio was close to the limits it wished to maintain. Anyone remotely familiar with consumer instalment credit knows that it is written on a monthly repayment basis, and that a portfolio of this paper will run off very rapidly unless it is constantly renewed. The statement of the Houston bank, while couched in kindly language, clearly implied that the bank preferred to confine its new acquisitions to the paper of borrowers other than the applicant.

Something of the same sort of explanation must apply to all the other cases of credit turndown cited. The writer of the letter probably did not realize that the commercial banks in this country now hold business loans in record volume. As those loans have a fairly rapid turnover, it follows that the number of new loans being made currently must also be in record volume. It further follows, axiomatically, that any individual businessman who fails to secure the loan he desires does not because the lender is making fewer loans but because he has preferred to loan to another businessman instead.

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All this is implicit in a competitive enterprise economy, and therefore tells us nothing of value concerning the general economic situation or of the availability of credit to the trucking industry as a whole. If Mr. Condon wishes to be constructive and helpful in illuminating the implication of the current business situation, any aggregative information he would furnish on the course of total borrowings by the trucking industry and on total unfilled orders for heavy trucks and trailers would be illuminating.

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May 24, 1956.

Dear Arthur:

Thank you for forwarding the letter in connection with the trucking industry. I am glad to have this.

Sincerely yours,

Wm. McC. Martin, Jr.

The Honorable Arthur F. Burns,
Chairman,
Council of Economic Advisers,
Washington 25, D.C.

Note: Mr. Sanders, Chrm. Finance Committee, Fruehauf, Detroit, in to see Mr. Martin 5/24/56

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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

May 23, 1956

Mr. William McChesney Martin, Jr.
Board of Governors of the
Federal Reserve System
Washington, D. C.

Dear Bill:

I think the enclosed letter will be of interest to you.

Sincerely yours,

Arthur F. Burns

Enclosure

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TELEPHONE NATIONAL 8-4056
CABLE ADDRESS "DAVJON"

ADRIEN F. BUSICK
OF COUNSEL

May 22, 1956

Honorable Arthur F. Burns
Chairman
Council of Economic Advisors
Executive Office
Washington, D.C.

COPY

Dear Dr. Burns:

This letter summarizes the distressing effect upon the trucking industry of the current credit situation, which was the basis of the discussion Mr. Roy Fruehauf and I had with you and Governor Sherman Adams at the White House last Friday.

The government, in trying to hold down consumer installment credit by making funds scarce, embraces within this policy the financing of trucking equipment, which, of course, is not consumer credit. There is no logical justification for this treatment of the trucking industry, and the welfare of this industry, so vital to national defense and economy, and of the 11,000,000 Americans whose livelihood depends upon the trucking industry, is jeopardized.

In contrast, the federal government is anxious for the railroads to obtain flat cars, freight cars, boxcars, and other railroad equipment sufficient for defense requirements, and the railroad's financing is facilitated by the use of railroad equipment trust certificates. The government lends as much as 87½% of the cost of new merchant ships. The phenomenal expansion of commercial aviation under the Civil Aeronautics Board subsidies attests the government's interest in strengthening that transportation arm. In contrast, the trucking industry, on which 92% of our commerce moves and which is our largest industrial employer, is restricted by the

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government's credit policies to the point where it cannot replace worn-our equipment, or expand, or modernize, to meet the nation's growing defense and economic needs.

Sales activities of trucking equipment dealers are being destroyed by the credit squeeze. In Houston, Texas, a bank which in the past has extended regularly a credit line of a million to finance trucking equipment sales, advised the local distributor for a large manufacturer that the bank's installment consumer credit portfolio was so close to its limit in proportion to total loans that the bank could not establish the requested million dollar line of credit. √ The disastrous effect for the trucking industry of treating equipment credit in the same category as consumer goods credit is manifested by this occurrence, which is typical.

There follow several recent typical examples of the unavailability of credit for small truckers. In each instance the trucking concern is regarded by its local bank as credit-worthy and in the past has had no difficulty in borrowing similar amounts for similar purposes:

A trucker in Bridgeport, Pennsylvania, needs $50,000 for working capital. In Nashville, Tennessee, a trucker needs $115,000 to finance the purchase of additional operating rights, which would increase the scope of his business and, hence, his profits. In Chicago a trucker needs $65,000 for working capital, and in Salt Lake City a trucking concern requires $50,000 for the same purpose. In Madisonville, Kentucky, a trucker needs $36,000 for a terminal to consolidate his operations, and in Roanoke, Virginia, another trucker needs $216,000 for operating capital.

The foregoing examples indicate that the tight credit situation for the truckers has no geographical boundaries, and will effect the extinction of the companies concerned. Current industry credit experience shows that the small truckers are the most acute sufferers - those who need from $25,000 to $200,000.

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The larger concerns are having their credit troubles also. A trucking company which is one of the nation's largest, needs 300 diesel truck-tractors costing $10,000 each, of a type manufactured by one concern which cannot finance the transaction at the present time, nor arrange credit through normal banking channels. The trucking company is unable to finance the purchase through its own banks. Of all the tractor manufacturers, there is only one at the present time which could finance this transaction, but this one does not make a vehicle which will suit the trucker's requirements. This case points up a result of the credit squeeze which the federal government surely wants to discourage; namely, forcing all purchasers of truck-tractors to buy from the one and only manufacturer large enough to finance its own sales.

Any steps which the government will take to remedy this grave credit situation will be in the interest of our national economy and defense, because whatever burdens or operates to destroy the trucking industry endangers the entire country, for whose welfare an adequate and strong trucking industry is vital.

We enjoyed the opportunity to meet and discuss this matter with you, and will appreciate very much your further consideration of and advice upon this pressing problem.

Sincerely,

Arthur D. Condon

11/md

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Congress of the United States

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WILLIAM B. WIDNALL, N.J.

March 12, 1960

The Honorable William McChesney Martin, Chairman
Federal Reserve Board
Washington 25, D. C.

My dear Chairman Martin:

We are addressing this letter to you in the hope that the Federal Reserve Board may adopt certain very definite reforms which, if accompanied by parallel action on the part of the Treasury, may remove or greatly lessen the very real dangers to the people of the United States which we believe would be created by the lifting or removal of the interest ceiling on long-time government bonds. Combined with needed Treasury reforms, these would have the effect of increasing the price and lowering the yield and hence the interest rate on government bonds without resorting either to "pegging" the market or inflationary devices. Somewhat similar proposals for reforms were made to you during 1959 and in January of this year by certain majority members of the Joint Economic Committee. At those times you were firm in your refusal to accept these reforms.

We wish to help the country and reduce the tension which is developing between the Board and a large section of Congress, and we hope that further reflection upon these matters may have induced a greater willingness on your part and that of the Board to reconsider basic issues of policy.

We now appeal to you to signify your intent and that of the Board to make at least four basic reforms or improvements in the conduct of the Board's affairs:

1. To recommend the establishment of margins on the purchase of government securities by customers of security dealers, and to regulate the activities of the security dealers themselves.

As the debacle of the summer of 1958 clearly showed, it is intolerable that there should be such widespread speculation in government securities on infinitesimal or non--existent margins. This can be damaging to the credit of the United States of America. We have waited for you to give us a lead on this matter on the basis of your long study of the incident and have been disappointed by your silence and your failure to act.

This offers the possibility of fruitful cooperation between your Board and Congress, and if you will assign some of your experts to work with us, we shall be glad to draft legislation which will deal with the great abuses which have been revealed and yet be fair to all parties.

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Honorable William McChesney Martin

2. A second reform which we believe the Reserve Board should adopt is to abandon its "bills only" policy. We have scarcely been able to find a single competent economist who endorses this policy to which, with rare exceptions, you have held for so many years. The abandonment of this mistaken policy would be desirable in itself and would clear the way for further reforms.

3. In our judgment, it is imperative that you should, over a period of time, permit an increase in the money supply (currency plus demand deposits) at approximately the same rate as that at which the real gross national product is growing. This would not be inflationary. Rather it would be a stabilizing force.

We regret that,during the years from 1953 to 1959 when the economy was growing at the excessively slow rate of 2.3 percent a year, your Board would only permit the money supply to grow at the still slower rate of 1.8 percent a year. The increase in population cut the growth of the money supply on a per capita basis to .1 percent per annum. In our judgment, this slow rate of growth was one of the causes which artificially increased the interest rate and hence retarded home building, expansion by small business, and state and local investment. It was therefore one of the causes for the increasing unemployment during this period and for slowing down the rate of growth itself.

We must honestly state that your failure to expand the supply of money at an adequate rate has been in large part responsible for this.

Let us, however, emphasize two things: First, we want relative stability in the price level, with the long-time growth in the money supply only matching the long-time growth in the real gross national product.

Second, we are not opposed to some cyclical variations in the growth of the money supply. The availability of credit could, for example, be relatively increased in periods of recession or depression, or slightly dampened down in an undue upswing. But these variations should not be used to alter the long-run policy of expanding the money supply in line with the increase in the production of goods and services so as to avoid both inflation and deflation, but also with a view to maximum employment and adequate growth.

4. The Federal Reserve should use open market purchases to provide the increase in member bank reserves for the needed long-time or secular expansion of the money supply. Taking normal velocity into account, this would be at the rate of about 3 to 4 percent per year.

As you know, such expansion could be achieved by one of two ways: a) the reserve requirements of the member banks could be lowered; or b) the same end could be accomplished by open market purchases.

You have stated publicly that you felt that the reserve ratios should be lowered still further and the banking system appears to be aiming for an

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ultimate average level of about ten per cent as preferable to the present level of approximately 16 per cent. A reduction in reserve requirements from 16 to 10 per cent would support, with present member bank reserve balances, an expansion in demand deposits from the present $110 billion to about $190 billion, or an increase of $80 billion.

If the creation of this $80 billion is accomplished by lowering reserve requirements, it would be done without any increase in the capital assets and earnings of the Federal Reserve System. The interest on these additional sums and the profits from this great expansion of credit would accrue entirely to the private commercial banks, without the Reserve System or the government sharing in the profits then made through having delegated the government's power to create monetary purchasing power or money to the banks. In other words, private banks will get all the interest and profits on this money, with little or no cost to themselves. In these circumstances, one can understand why the banks are so anxious to use this method and why those who support the banks find it possible to justify this method. Huge sums are at stake.

According to Federal Reserve System figures, the average rate of earnings of member banks on their combined capital, surplus and undistributed profits in 1958, the last full year for which figures are available, was 17.3 per cent before taxes and 9.7 per cent after taxes.

In view of the fact that the risks of bank stockholders have been decreased in the last decade by the guarantee of bank deposits and the abolition of double liability, this rate of earnings on capital and surplus (accumulated from prior earnings) would seem to be amply adequate.

Now, if you feel that the private banking system of the country, whose major source of profit is the loans and deposits created by the fractional reserve system at little cost to the banks themselves, deserves higher rates of earnings than these, then you should frankly say so for the record and justify your reasons. You should do this for that would be the effect of creating the long-run needed expansion of the money supply by the method of reducing reserve requirements which you advocate.

If instead, the creation of these amounts is done by open market purchases, the government will get 90 per cent of the interest and profits on one-sixth of the $80 billion, or on about $13-1/3 billion. The banks will still receive the interest and profits on $66-2/3 billion. Certainly the banks should not be unhappy to see the government and the people get this small profit for the delegation to them of the Constitutional power of the Congress to "coin money and regulate the value thereof."

As you understand, if the expansion were accomplished by open market purchases, then the Federal Reserve System would acquire added earning assets

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of approximately $13-1/3 billion in government bonds over the years at an initial rate of about $570 million a year and an average rate of about $740 million per year.

At 4 per cent interest, this would mean initial earnings of approximately $23 million a year and rising by slightly more than this amount each year to over $46 million in the second year, $69 million the third year, etc., until at the end of the period, the annual added earnings would be approximately $940 million a year and would continue from then on. The cumulative amounts of these earnings which would accrue to the Federal Reserve system in the period would be over $4.5 billion. Under prevailing practices, at least 90 per cent of these sums, or over $4 billion, would be turned over to the Treasury.

These may seem to be small and inconsequential amounts to you, Mr. Chairman, but to the hard-pressed taxpayers of this country and the members of Congress charged with the duty of fiscal responsibility, they are of great importance. They would help to balance the budget and provide needed services. Moreover, the large volume of annual purchases of government bonds would raise their prices and lower their yields and hence lower the basic interest rates on governments about which you and the Treasury have been complaining.

This action, along with a more appropriate fiscal policy, would result in long-term interest rates well below the 4¼ per cent ceiling and would make the question of whether the ceiling should be removed largely an academic one.

Instead of focusing on the question of the symptoms of our problem, namely the 4¼ per cent ceiling, we urge you and the Treasury to get at the basic causes of the problem, namely excessively high interest rates in a period characterized not by full employment, forced draft growth, and inflation but one characterized by excessive unemployment, a slow rate of growth, and stable prices.

We should emphasize that we are not proposing that present reserve requirements be raised but that they be kept at existing levels. Thus, we are not advocating that the government's share in the creation of additional purchasing power be increased, but merely that it not be reduced, as you would have it done.

When we have questioned you on this issue, you have objected on the grounds that in times of recession, lowering reserve requirements may be a faster and quicker way of expanding credit than through achieving these effects by open market purchases.

However, this answer has to do with the short-run and does not affect the question of the secular or long-run expansion about which we are concerned.

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The Honorable William McChesney Martin

It may be proper to lower and raise reserve requirements for cyclical or short-run purposes. Yet during the years 1951 to 1960, a period dominated by the tight money policy of the Federal Reserve System, the Federal Reserve has lowered reserve requirements during recessions but has not subsequently raised them during periods of expansion. The effects, therefore, have been to lower reserve ratios permanently.

In other words, since 1951 you have not raised reserve requirements and hence have not used them as a counter cyclical weapon in periods of expansion. This fact seriously diminishes the force of the single argument you have used in opposition to our view that open market operations are to be preferred to the method of lowering reserve requirements for secular expansion. In the first place, you have been using a short-run argument in reply to our point that the long-run expansion should occur by open market purchases. In the second place, even in the short run you have not used reserve requirements fully as a counter cyclical weapon for they have been changed only downward and have not been raised.

With respect to the long run, the ultimate effects of the two methods would, as you have admitted, be the same. Even the immediate effects would be substantially similar. The public interest calls for using the open market purchase method for the long run or secular expansion of the money supply and we call upon you and the Federal Reserve Board to issue a clear statement of policy to that effect.

In short, we believe that a proper sense of fiscal responsibility should lead you (1) to work cooperatively with Congress for requiring margins on the purchases of government bonds and for proper regulation of that market, (2) to abandon the discredited "bills only" policy, (3) to effect the long-time increase in the money supply at approximately the same rate as the growth in the real national product, and (4) to do this by open market operations rather than by lowering reserve ratios.

We will welcome your cooperation for these worthy ends.

With best wishes,

Sincerely yours,

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Dear :

Thanks for your letter of __________. I can understand your bewilderment at the scope and variety of published speculation concerning relationships between the incoming administration and me, for I am bewildered by it myself, including many of the ideas, opinions, ~~xx~~ conclusions and attitudes I have seen attributed in print to me.

You are very thoughtful to express concern to me, but please do not be troubled on my behalf. Let me try to explain how I do feel about these matters.

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Possible material for use in
letter re position

12/20/60 CM

On February 7, 1951, more than a month before the Treasury -Federal Reserve "Accord" and nearly two months before I entered upon service with the Federal Reserve System, ~~the~~ a Washington newspaper (Evening Star) ~~published~~ ran an editorial entitled "Our Threatened Dollar" that began in this way:

> "It is unfortunate -- exceedingly unfortunate -- that the really important facts of the difference of opinion concerning our Federal monetary policy are in danger of being submerged and lost in a clash of personalities.
>
> "The personality aspect is not very important. The economic future of this country does not depend upon what James K. Vardaman thinks of Marriner Eccles, what Mr. Eccles may think of Secretary of the Treasury Snyder, or upon what any or all of them think about the President. A great deal does depend, however, on whether Mr. Eccles or Mr. Snyder is right in the matter, and whether the correct view prevails.
>
> "The one thing that is clearly at stake, and which is of much greater importance to the country than the status of any of the individuals involved, is the future value of the American dollar. No one has to be told that the purchasing power of the dollar -- its real measure of value -- is shrinking. If this shrinkage continues it is only a question of time until public confidence in the dollar disappears and the public credit will be destroyed. If that time comes, our capitalist society is done for, and we will move, whether we like it or not, into some form of tightly regimented, socialistic economy..."

Although the particulars set forth have changed almost altogether in the ~~ten years since that editorial was written,~~ intervening decade, the general philosophy or principles then stated seem to me to be as true now

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as when that editorial was written.

My own interest, accordingly, is focussed upon just two things: 1) that a genuine effort be made, by those in authority, to preserve the purchasing power of the dollar that is so vital to our economy and the preservation of our society; and 2) that the Federal Reserve be allowed the freedom from political interference necessary for it to contribute its part to that effort.

It is these things that matter -- not what happens to me. If these values are preserved, then what happens to me or what I do in the future certainly can be classified as a matter of indifference to all, and most particularly so to me.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 11, 1961.

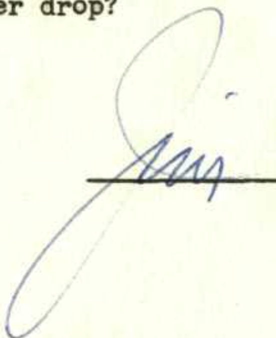
To Chairman Martin

From James L. Knipe

Subject: Reply to James Tobin's article in "Challenge," issue of January, 1961.

These comments, drafted in letter form, may be useful if attached to the reprint of the article in your file. I had not fully realized, on first skimming, just how unfairly Tobin's article was written.

In view of his new post, I suggest that you give consideration to sending him some sort of a letter, or inviting him over for lunch, or taking some other action. Perhaps such bias as he now seems to have is sufficiently important to justify action of some kind rather than to let the matter drop?



Attachment

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FIRST DRAFT

Letter to James Tobin

January 11, 1961.

Dear Mr. Tobin:

Your article which appeared in the magazine "Challenge" (January, 1961, issue) deals with matters which are of great concern to us in the Federal Reserve System. I am sure you want to know how we view the facts with which you deal, and I am also confident that you welcome the expression of our opinions on the various issues under discussion.

We are, of course, in full agreement with your conclusion, that it would be most unfortunate if the Congress, the Administration, and the Federal Reserve System (a creation of the Congress) were unable to reach general agreement on broad financial and economic policies for the nation. Such agreement always has been reached, despite occasional differences of opinion on specific problems, throughout the forty-eight years of the System's existence. Over those years the System has appeared to hold views on specific matters a bit closer to those of the Congressional leadership at some times and to the Administration at other times. In every case, at least during the ten years about which I can speak with direct knowledge, I am certain that System policies have been formulated with the independent and non-partisan regard for the national welfare which is expected of us by

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Congress and the Administration. Whatever inadequacies there may be in the record--and we are proud of the record--arise out of human fallibility in carrying out the difficult task of devising and implementing central bank policies which will be most conducive to the nation's economic health.

Along this line, permit me to point out, simply as an example, that significant differences of opinion have occasionally arisen in recent years, notably in 1956 and 1958, between the System and the Administration. It is not accurate for you to say, "Since 1953 the Board of Governors of the Federal Reserve and the Administration have been in uncoerced and enthusiastic agreement on the broad lines of policy." The differences which were reported in the press during the years mentioned were not the only ones which existed. Others were ironed out in the series of conferences which have been held steadily and frequently throughout the years. These conferences with Congressional leaders and Administration officials have made possible the constant airing of all problems and have resulted in what we regard as a fine atmosphere of understanding and cooperation.

The problems with which the Federal Reserve is concerned are, of course, precisely the same ones with which Congress and the Administration are dealing. Everyone with any share of the responsibility for a viable, growing American economy is eternally beset with the dilemma of how best to attain a satisfactorily high level of employment,

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a sufficiently rapid rate of national growth, and a reasonably stable purchasing power of the dollar.

In one sense, our share of the responsibility is more onerous simply because it is so restricted, as compared with the all-embracing power of Congress and the wide scope of Administration responsibility. Congress, for instance, can change the institutional structure in the wage-price area, if necessary, and can alter fiscal and tax policies, just as it can make statutory changes in the structure and functioning of the Federal Reserve System, if it wishes.

Looked at from another angle, our share of the responsibility is less burdensome in that we have relatively little to do with such great national issues as the foreign aid programs, and the accompanying balance-of-payments troubles. These troubles eventually plague us in our work, but all we can do is to recognize that they exist and deal with them as best we can. We do not feel that you convey a fair impression of the nation's international problems when you write, "But the dollar has come to its present pass under those very policies, administered by a conservative Administration and an independent central bank, both dedicated above all to sound finance." Surely it is not your feeling that a "liberal" Administration, and a "dependent" central bank, both dedicated to unsound finance, would have avoided the present balance-of-payments problem? You are just as fully aware as we are that the gold outflow is largely an outgrowth of the international necessities forced upon the United States if it is to play its proper role in a deeply disturbed world.

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Each of us has a perfect right to hold an opinion with respect to the attitudes, motives, and philosophies of any agency or individual. You will understand, I am sure, when I differ strongly with several of the opinions which you express about the Federal Reserve. First, we do not feel that there is a ". . . single correct policy--namely the course which, within the limits of human error, the Fed pursues." I do not know of any group of men more willing to spend long hours in study and discussion attempting to mold an institution's policies to the needs of the times.

Second, I think it grossly unjust for you to suggest, "This conviction may lead the Board of Governors to resist and to frustrate any effort . . . to gear the federal budget and other instruments of economic policy to higher levels of employment and production." I am confident that, as you think over such a suggestion, you will recognize that it should never have been made. Third, in similar vein, you comment, "In the era of Eisenhower, Martin, Humphrey, and Anderson, the operative belief has been, or often seemed to be, that monetary control and debt management cannot be effective unless they are expensive, and the more costly the more effective." I cannot believe that you, as an economist, think that the rise in interest rates which always accompanies a business cycle peak was deliberately brought about by the President of the United States and some of the country's financial officials.

Fourth, in discussing the Treasury's debt-management policies, you write, "The Treasury, seconded by the Federal Reserve, has favored

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The Federal Reserve System needs and, we believe, deserves the sympathetic aid and criticism of the Government officials who are concerned with these economic and financial matters. As a completely non-partisan organization, we are not consciously swayed in our judgments by either Party's programs or philosophies. In Committee Hearings, in conferences, and through written reports, we are constantly exposing our reasoning, so that the Congress and the Administration are always fully informed and thus in position to give advice or take any other action which seems proper to them.

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January 11, 1961.

Chairman Martin — Reply to James Tobin's article

James L. Knipe — in "Challenge," issue of January, 1961.

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February 16, 1961.

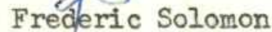
Chairman Martin:

As you will note, the attached has nothing to do with the work of the Division of Examinations.

It relates instead to a possible new security that might help to solve some of the current problems of the relationships between long-term and short-term interest rates.

The memorandum attempts to summarize the idea, which is based on a thesis I prepared in 1941 for the Graduate School of Banking. (The British Treasury briefly used a similar security in the 1920's.)

If the general idea seemed to you to have merit, it could, of course, be developed further as you might think appropriate.



Frederic Solomon

Attachment

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A NEW SECURITY TO HELP HOLD LONG-TERM INTEREST RATES DOWN AND SHORT-TERM RATES UP

PROPOSAL: The Treasury would issue a long-term or medium-term security that would pay interest for each interest-payment period at a rate equal to the average of the rates at which short-term Treasury bills had been auctioned during the period.

A floor of say 1% per annum, and a ceiling of say, 7% per annum, might be provided.

MECHANICS AND UNDERLYING PRINCIPLES: These are explained in a thesis entitled "How Variable Interest Bonds Can Help to Solve the Problems of Liquidity, Depression, and Defense". As shown there, the tying of the security's interest payments to short-term rates could be expected to maintain its market price approximately at par (just as Treasury bills show only slight market fluctuations). The thesis was prepared for the Stonier Graduate School of Banking operated by the American Bankers Association at Rutgers University, and is on file at the Graduate School Library, 12 East 36th Street, New York City.

ADVANTAGES: The new security would have the market characteristics of a short-term security. Hence, its issuance would have the effect of shifting the given volume of securities from the long-term to the short-term market, with a resulting shift of downward pressures on interest rates from the short-term to the long-term areas.

At the same time, the security would have the refinancing characteristics of a longer-term security. Since it would not have to be frequently refinanced, it would ease the problems of the Treasury and lessen interference with Federal Reserve operations.

Since the security probably would maintain a relatively stable market price approximately at par, it probably could be placed on continuous ("tap") offer, or made available on frequent auctions (like Treasury bills), with a minimum of market disturbance.

TO FACILITATE THE NEW SECURITY'S INTRODUCTION:

1. There should be thorough advance explanation of the security's features and advantages.

2. The new security probably should be made available as an alternative open to purchasers on some offering.

3. The first issues of the new security probably should have a relatively early maturity, say, 3 to 5 years. After the principle proved itself in the market, it could be applied to longer maturities.

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Mr. Master
For your information
Guy.

September 19, 1961.

Mr. Allan B. Kline,
4209 Grove Avenue,
Western Springs, Illinois.

Dear Mr. Kline:

Chairman Martin asked me to write to you about the relative merits of the administrative, cash and national income account approaches to analysis of the fiscal position of the Federal Government.

As is pointed out in the August Monthly Review of the Federal Reserve Bank of Kansas City, which I understand you have seen, each approach has a distinct usefulness in helping to provide the answers to certain questions. It cannot be said that one is superior to another for all purposes. The uses of the administrative budget are, of course, as the name implies, administrative rather than economic. It is obviously indisputable for the purpose for which it is intended; i. e., the consideration of implementing legislation, appropriations and revenue measures by the Congress.

The cash budget, as you understand I am sure, is most significant in focusing on the net new borrowing or repayment of debt which result from the Government's operations in a given period. In assessing the effect of fiscal policy on the money market and evaluating the Treasury's financing problems, it is clearly the most useful formulation.

The surplus or deficit in terms of the national income accounts differs from the cash accounts primarily in that it treats the accounts on an accrual basis, rather than a cash basis, and in focusing on Government outlays for goods and services. It does not include Government outlays under lending or other financial programs. It tends to focus attention on the effect of the Government's fiscal policies on the rest of the economy, rather than on the financial problems of the Government itself. Perhaps this can be made clear most easily in terms of an example. In the cash budget one includes in any given period the tax payments actually made by individuals and corporations during the period. In the national income accounts approach, the tax liabilities accruing in the period are substituted for the payments made. From the point of view of the effect of taxes on business-men's decisions, this latter approach might be more meaningful, since, for example, in a year of high

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SIDNEY MAESTRE
CHAIRMAN OF THE EXECUTIVE COMMITTEE

December 16, 1963

Mr. Wm. McC. Martin, Jr.
Chairman
Board of Governors
Federal Reserve System
Washington, D. C.

Dear Bill:

I had planned to write you before receiving your letter of December 13. It was very thoughtful of you to write me, and I do greatly appreciate the statements you have made.

I can only say that I enjoyed my association with you, the members of the Federal Reserve Board, and my fellow bankers, and I do hope I contributed something.

My final report to the Directors of the Federal Reserve Bank of St. Louis was made last Thursday, and my concluding remarks were that I hoped they would do everything within their power to keep you as Chairman in Washington.

With every good wish, I am

Sincerely,

Sidney Maestre

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FIRST NATIONAL BANK
IN WICHITA
WICHITA, KANSAS

CHARLES J. CHANDLER

December 30, 1963

Dear Bill:

Just a line to commend you and the other members of the Board for the issuance of the statement on December 26th. It means a great deal to those of us who are interested in sound banking to have the Board take the stand that it has on this and other occasions in opposition to the unwise and, if I may say so, ill-considered actions of the Comptroller.

Please do not trouble to respond.

My warmest regards.

Sincerely,

Mr. Wm. McC. Martin, Jr.
Board of Governors of
the Federal Reserve System
Washington, D. C.

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Federal Reserve Bank of St. Louis

M. Tanner

THE FIRST NATIONAL BANK
OF MEMPHIS

MEMPHIS, TENNESSEE

ALLEN MORGAN
PRESIDENT

CABLE "FIRBANK"
PHONE 527-6681

December 26, 1963
"Our 100th Year"

The Honorable William McC. Martin, Jr.
Chairman of the Board of Governors
Federal Reserve System
Washington, D. C.

Dear Bill:

Thank you for writing me about my appointment as a director of the Memphis Branch of the Federal Reserve Bank of St. Louis. I will be attending my first official meeting in January and am looking forward to seeing you when I am in Washington.

Bill, you are doing a grand job for your government, as well as the banking system. It is wonderful to see a man so dedicated and able serving as Chairman of the Board of Governors of the Federal Reserve System.

I remember the wonderful speech you made when you were president of the Export-Import Bank and I would certainly welcome having you back down here for a speech, as well as have you as my doubles partner for some tennis.

Best wishes for a happy and prosperous New Year.

Sincerely,

Allen

President

AM:ln

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4. What the Fed can and does do is to control the volume of reserves available to the banking system. This, in turn, influences the volume of bank credit and money that the banking system can create, which is one important factor, along with the flow of savings and the investment decisions of business, that goes into the determination of interest rates. Within limits, the marginal influence of the Federal Reserve is very important, but it is not determinative in any absolute sense.

5. Monetary policy should not, and in fact cannot, be focused solely on interest rate objectives--any more than it can ignore them completely as some economists argue that it should.

6. The immediate goal of monetary policy should be to provide the reserves needed to support a rate of growth in bank credit and money which will foster stable economic growth.

(a) It must take into account the international position of the dollar--for a collapse of the dollar as a reserve currency would certainly make havoc of our efforts to achieve stable growth. This continues to be a national danger.

(b) It must be constantly concerned for the full employment of both human and physical resources.

(c) It must take into account price developments and the possibility of inflation, or the widespread expectation of inflation, which would do great damage to healthy growth.

(d) It must surely also take into account interest rates and credit availability, to be certain that, without doing violence to the other essential components of stable growth, it is providing the maximum possible stimulus to the investment expenditures which are the basis of future growth.

(e) It cannot ignore, as much as it might like to do so, the soundness of the individual obligations that go to make up the growing total of public and private debt, for even a sizable minority of unsound loans could bring the whole structure down on our heads.

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(f) It must also be concerned with current output and sales. Credit must be readily available to move goods to market and from the market to the hands of the consumer on terms and at rates that are as reasonable as possible.

7. All these things, and many others, must be constantly weighed and balanced by the Open Market Committee at its tri-weekly meetings. We cannot produce, through monetary policy alone, high or low interest rates, balance of payments surpluses or deficits, rising or falling prices, more or less employment, or a sound or unsound financial structure. We do exert some influence on all these things, hopefully in the right direction--that of sound and sustainable expansion.

8. I believe that the record of the Administration and of the Federal Reserve in this period of expansion is an excellent one. The fact is that ample credit has been available to finance an expansion in GNP which was substantially larger than most private and Government observers anticipated a year ago. Credit remains readily available. Mortgage interest rates, probably the most important rates from the point of view of the general public and in their impact on over-all economic activity, are below a year ago, and corporate and municipal rates are still below the levels they reached in 1961, the first year of recovery.

(SIGNED) WM. McC. MARTIN, Jr.

Wm. McC. Martin, Jr.

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THE WHITE HOUSE

WASHINGTON

January 9, 1964

MEMORANDUM FOR THE SECRETARY OF THE TREASURY
THE DIRECTOR OF THE BUDGET
THE CHAIRMAN OF THE FEDERAL RESERVE BOARD
THE CHAIRMAN OF THE COUNCIL
OF ECONOMIC ADVISERS

I have just received the attached memorandum from Chairman Heller which gives me some concern. Would you meet with me on January 10th at 11:00 a.m. to discuss this memorandum and any other aspects of the domestic and the international monetary system which appear appropriate.

[illegible]

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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

Confidential

January 5, 1964

MEMORANDUM FOR THE PRESIDENT

Subject: Tighter Money in 1964?

1. Financial observers are increasingly predicting that interest rates will rise in 1964.

2. This prediction rests on (a) expectations of expanding business that will boost the demand for credit and (b) statements by Federal Reserve officials. Sylvia Porter's bond letter of December 20 says: "The market reacted very strongly to remarks by Federal Reserve Chairman William McChesney Martin, Jr., about the likelihood of higher interest rates when the economy expands ...."

3. During 1963, interest rates rose substantially:

   -- on 3-month Treasury bills, from 2.89% to 3.52%.

   -- on long-term U.S. Government securities, from 3.85% to 4.16%.

   -- on high-grade municipal bonds, from 3.11% to 3.32%.

   -- on corporate Aaa bonds, from 4.23% to 4.37%.

4. The average yield on long-term U.S. Government securities is now only 1/4th of a percentage point below its weekly postwar peak in 1960. This level has been exceeded in only about 6 months since the War.

5. The case for higher interest rates to date has been -- quite rightly -- that they were needed to help reduce our balance-of-payments deficit.

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6. Now, bankers are beginning to suggest that we need higher interest rates for domestic reasons -- to meet a threat of inflation or to protect the "quality of credit."

7. Some people think that it's somehow "natural" or "healthy" for interest rates to rise when demand for credit increases -- that it would be wrong for the money managers to increase the supply of credit enough to stop it. The answer is that we decided 50 years ago, when we set up the Federal Reserve System, that we couldn't and shouldn't let "money manage itself." In fact, it is the Fed that manages money and, together with the Treasury, can determine interest rates.

8. They should let interest rates rise, or push them up, only when this is good for the economy. The rise of rates in 1963 was not "natural," and it won't be "natural" if they go up in 1964.

9. Prices may rise a bit in 1964. We hope they won't, but we may not be able to prevent some price-wage creep. But if such a creep occurs, it won't be "inflation," and particularly not the kind that tight money can stop -- unless, of course, we have an unexpected boom that expands demand too fast in relation to capacity. In the face of such a boom, rising interest rates would be a healthy restraint.

10. In the absence of such a boom, rising interest rates could put a real crimp in our expansion as they did in 1959, when they occurred side-by-side with a big restrictive swing in our budget position.

11. Some people would tighten money to try to stop "deterioration in the quality of credit." Undoubtedly, some institutions are not as careful as they should be in lending money. But the best way to deal with this is to stop unsound practices by vigilant regulation -- the Federal Home Loan Bank Board's new regulations to curb unwise lending by savings and loan associations is a case in point. This pinpoints the target. To deal with this problem by restricting total credit would be a buckshot approach, and may even boomerang -- it could slow down output and income and thus weaken the base of existing credit.

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12. Up to now, long-term interest rate increases have lagged behind short-term increases, and home mortgage rates haven't risen at all. But if we tighten any more, long-term rates would surely rise. Mortgage rates, on which continued strength in housing and other construction depends, would go up.

13. The Bureau of the Budget stresses the 3-way boost in budget costs from higher interest rates:

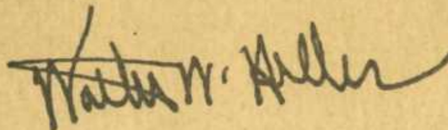
    a. Interest on the public debt would rise by $400 million a year on the marketable debt falling due in 1964 if interest rates rise by 1/2% -- and this cost would grow as the impact spreads to other portions of the debt.

    b. Direct Federal loans and mortgage purchases would rise because private funds would cost more and be less available. This could add several hundred millions to budget outlays.

    c. Sales of financial assets -- now counted on to pull the budget totals down by $2.2 billion -- would drop sharply as private rates of return rose, making the returns on Federal assets less attractive.

In summary, tight money and higher interest rates (in the range of 1/2%) could raise budget expenditures by well over $1 billion a year.

If we have to raise interest rates to stop balance-of-payments outflows -- and there's no evidence of such a need right now -- we'll swallow hard and take it. The tax cut would help us take it, economically. But before we use higher interest rates to try to head off price increases or credit deterioration, we should carefully count the high costs to the budget and the economy.



Walter W. Heller

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Lewis Hanneman
King

Abelson Philip
Neptunium
N. Powered submarine
Biophysics
Edwin Land
Polaroid

Julian Boyd
Ed Stockpo-Mystic M.

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HOMER D. CROTTY
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BERT A. LEWIS
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F. DANIEL FROST
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February 10, 1964

OUR FILE NUMBER

C 498-63

Mr. William McChesney Martin, Jr.
Chairman, Federal Reserve Board
Federal Reserve Building
Washington 25, D. C.

Dear Bill:

I telephoned to you in the middle of last week and, finding that you would be absent for some time, transferred my call to Mr. Hackley, Chief Counsel of the Federal Reserve Board.

We had a helpful talk on a narrow point about whether those capital notes and capital debentures which are "frozen-in", in the sense that they cannot be paid unless and until they are replaced by capital stock or earnings, or replaced by other similarly restricted capital debentures, should not be treated as capital at least for some purposes.

Mr. Hackley called my attention to the report in the January 1964 issue of the Federal Reserve Bulletin on the action of the Board of Governors concluding that capital notes and capital debentures, generally speaking, are not capital for the various purposes specified in the Federal Reserve Act. However, I outlined to him reasons why certain capital debentures with strict conditions on repayment of principal might well be exceptions from this general ruling and he suggested that this point be submitted to the Board of Governors for decision.

I am enclosing a copy of my letter to the Federal Reserve Bank in San Francisco asking that this question be submitted to the Board. I thought you might want to be acquainted with the problem in advance of its coming up at a Board meeting.

With best personal regards,

Sincerely,

Herbert F. Sturdy

HFS:mms
Enclosure

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February 13, 1964 C 498-63

Federal Reserve Bank
of San Francisco
San Francisco, California

Gentlemen:

C O P Y

I have read the statement in the January 1964 issue of the Federal Reserve Bulletin setting forth the conclusion of the Board of Governors that capital notes and capital debentures issued by member banks, even though subordinated to deposit liabilities, do not constitute "capital stock," "capital" or "surplus" for purposes of various provisions of the Federal Reserve Act that imposed requirements or limitations upon member banks.

I agree with the decision as a general proposition. However, there is a limited class of capital notes and capital debentures which we believe should be excepted from the general proposition. In those instances where the capital notes or capital debentures are precluded by their express terms from being paid unless or until they are replaced with the proceeds of the sale of stock, with subsequent retained earnings, or in effect refunded by the issuance of similarly limited capital notes or debentures, they serve every purpose which is served by capital and surplus and should be classified as such. The proceeds of such capital notes or capital debentures (hereinafter for convenience both referred to as capital debentures) become a permanent addition to the equity in the bank. To date there have been very few capital debentures which are so restricted and I feel confident that the Board of Governors did not have this limited class in mind when it made its decision. Attached as Exhibit "A" is an example of a capital debenture clause so limiting payment of principal. We would like to have this point reviewed by the Board with the request that it make an exception to the general proposition.

During our research in connection with recent issues of capital notes and capital debentures by state and national banks in California, certain facts were developed which the Board might find helpful in reaching a conclusion on our particular point.

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1. Capital debentures appear to have arisen in the mid-1930's because of the depression-born need to restore the impaired capital of many of the banks, both state and national. The Reconstruction Finance Corporation stood ready to furnish capital funds to such banks for preferred stock in order to restore their impaired capital, but was hampered by the fact that it could not buy such preferred shares in some states because of double liability imposed on shareholders of banks by the state law. Furthermore, some of the states either prohibited the issuance of preferred stock by banks or imposed the impractical requirement that a preferred stock issue be consented to by 100% of its existing shareholders. Nevertheless if Reconstruction Finance Corporation merely loaned funds to the banks on the usual form of note or debenture, the resulting fixed obligations could hardly be regarded as a restoration of impaired capital. Consequently a new security known as a capital debenture was conceived. As I view it, these were intended to be debt to the extent that they would come ahead of all payments to stockholders in the event of a liquidation; but would be equity capital so far as the protection of depositors and general creditors of the issuing bank were concerned. The distinguishing feature which would give capital debentures the character of equity capital so far as depositors and creditors are concerned (as distinguished from ordinary debentures even if subordinated) is an express provision restricting repayment of the principal of the capital debentures in ways which usually apply only to capital. As will be noted later, many states provide that capital debentures cannot be repaid while there remains any impairment of capital. Even beyond this, California seems to require that before capital debentures can be repaid they must be replaced by other forms of equity capital. This gives a permanence to the addition of the new capital funds through the issuance of capital debentures.

2. By the Bank Conservation Act of 1933, 48 Stat. 1, 6, Congress authorized the Reconstruction Finance Corporation to purchase the preferred stock of any bank or trust company in need of capital. Within a matter of weeks, Congress found it necessary to amend this Act to provide that the Reconstruction Finance Corporation could purchase the capital notes or debentures of the bank in order to avoid the double liability on Reconstruction Finance Corporation as a shareholder and to avoid the requirement of unanimous consent to preferred stock by the existing shareholders of the bank. As originally introduced the amending legislation provided that such capital notes or debentures had to have voting rights similar to those accorded preferred stock. However, this provision was eliminated as a result of a discussion on the floor of the

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Senate to the effect that there was a danger of the courts holding that capital debentures with voting rights were in fact preferred stock creating double liability on the holder, and requiring unanimous consent of stockholders. 77 Cong. Rec. 789, 813. The amendment as finally enacted provided in its pertinent part as follows:

> "Nothing in this section shall be construed to authorize the Reconstruction Finance Corporation to subscribe for preferred stock in any State bank or trust company if under the laws of the State in which said State bank or trust company is located the holders of such preferred stock are not exempt from double liability. In any case in which under the laws of the State in which it is located a State bank or trust company is not permitted to issue preferred stock exempt from double liability, or if such laws permit such issue of preferred stock only by unanimous consent of stockholders, the Reconstruction Finance Corporation is authorized, for the purposes of this section, to purchase the legally issued capital notes or debentures of such State bank or trust company."
>
> 48 Stat. 20, 21 (1933)

As a result, a substantial number of states passed legislation permitting state banks to issue capital debentures with the consent of the state banking authority.

It should be noted here that Congress never specifically authorized any bank to issue capital debentures. The above legislation only authorized Reconstruction Finance Corporation to purchase such securities. Since Congress was concerned with the purchase and not with the issuance of capital debentures, it made no specific provision for allocating these securities to the capital or debt structure of the national banks.

3. Though Congress has never authorized the issuance of capital notes or debentures, the Comptroller of the Currency, pursuant to the authority delegated to him, has authorized the issuance of capital notes or debentures by national banks.

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"Sec. 14.5 Capital debentures.

"(a) It is the policy of the Comptroller of the Currency to permit the issuance of convertible or nonconvertible capital debentures by national banking associations in accordance with normal business considerations.

"(b) Subject to the provisions of 12 U.S.C. 82, the bank may, with the approval of stockholders owning two-thirds of the stock of the bank, entitled to vote, issue convertible or nonconvertible capital debentures in such amounts and under such terms and conditions as shall be approved by the Comptroller, provided, however, that the principal amount of capital debentures outstanding at any time, when added to all other outstanding indebtedness of the bank, except those forms of indebtedness exempt from the provisions of 12 U.S.C. 82, shall not exceed an amount equal to 100 percent of the bank's unimpaired paid-in capital stock plus 50 percent of the amount of its unimpaired surplus fund."

Code of Fed. Reg., T. 12, Sec. 14.5

This is merely a formula for limiting the amount of capital debentures which may be issued, but it is couched in language which would seem to classify capital debentures as part of the outstanding indebtedness rather than as a part of the capital stock. As we have mentioned above, the capital debentures are indebtedness so far as the stockholders are concerned although they serve the same purpose as capital so far as the depositors and creditors of the bank are concerned provided appropriate restrictions on their repayment are imposed.

4. The taxing authorities of the Federal Government have consistently taken the position that capitaldebentures are debt. In 1935 the Internal Revenue Service issued a ruling specifically on these securities, though it is limited to "income" debentures.

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"SECTION 23(b) -- DEDUCTIONS FROM GROSS INCOME: INTEREST.

Article 23(b)--1: Interest. (Also Section 115, Article 115--1.) XIV--14--7409 I. T. 2878

Revenue Act of 1934.

"The interest paid upon the income debentures issued by a bank to evidence indebtedness to the Reconstruction Finance Corporation is deductible for Federal income tax purposes.

"Distributions on preferred stock issued by a bank to that corporation constitute dividends and are not deductible for Federal income tax purposes."

Cum. Bul., Sec. 23(b), Art. 23(b)-1, 57

The Internal Revenue Service took the same position, i.e. that capital notes or debentures are creditor interests, with regard to the excess profits tax. However, in the only judicial construction of the federal legislation, it was held that capital notes or debentures constitute "equity" interest. In Mercantile Bank & Trust Co. v. United States, (Ct. Cl. 1957) 147 F. Supp. 956, 958-959, the court held in regard to income bonds:

"The plaintiff says that the RFC was originally authorized to purchase preferred stock; that the transaction quite certainly would have taken that form but for the impediment of the Constitution of Missouri; that the impediment was surmounted by legislation enacted by Congress and the State of Missouri; but that, in the end, the RFC wrote a document which, in most essential respects, put it in the position of a holder of preferred stock. The plaintiff offered, for comparison, and we have received in evidence, a certificate of preferred stock issued to the RFC by another bank in Kansas City which, because it was a national bank, was not restricted by the Missouri Constitution in its power to issue preferred stock.

"Comparison of the two documents does show that the RFC was in both cases making investments in the banks to restore their capital, putting its

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investments at the risk of the earning power of the banks, subordinating its rights to those of depositors and creditors having normal business dealings with the banks. Interest, in one case, and dividends, in the other, were payable only out of earnings accruing after the date of the capital note and of the issuance of the preferred stock. Both documents provide for the retirement or redemption of the obligations, by call, upon substantially identical terms. Both documents provide for the establishment by the banks of retirement funds or sinking funds for the liquidation of the respective obligations. Both documents provide that in case of liquidation of the banks, the rights of the holders shall be subordinate to the rights of depositors and all other creditors of the banks, except, in the case of the capital notes, other creditors, if any, who agreed, in extending credit, that their rights should be subordinate to those of the holders of the capital notes. Both documents provide that if the banks should be in default in the payment of dividends or interest on the obligations, or in payments into the retirement fund or sinking fund, the holders should have the right to remove directors or officers.

"The Government says that the capital note created a definite obligation to pay a fixed sum. It did name a fixed sum, but the obligation to pay it, hedged about as it was with conditions and grants of priorities to other creditors, was by no means definite. It had a definite maturity date, which is evidence of a debt, but that date, read in connection with the numerous subordinating conditions in the note, was the date on which the holder would be paid if the prescribed conditions did not prevent payment. It had a fixed rate of interest, but that rate was no more fixed than, and was identical with, the rate of dividends provided in the comparable certificate of preferred stock. Both were cumulative, were not currently payable except out of earnings, and were ultimately payable on the same conditions. The holder of the capital note had no voting rights, but it did have, as we have seen, the power under certain conditions to control the management of the bank. Voting rights are not a necessary attribute of preferred stock.

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"Our conclusion is that the predominant qualities of the capital note in question were those of preferred stock, and that it should be placed in that classification for legal purposes, including the application to it of the excess profits tax law. * * * "

Mercantile Bank & Trust Co. v. United States, 147 F. Supp. 956, 958-959

5. While Congress has never specifically authorized the issuance of capital debentures by national banks, it has recognized them by two statutes which specifically do not treat capital debentures as part of the bank's indebtedness.

(a) The first of these Congressional Acts treats the capital debentures as capital for the purpose of determining whether the capital is unimpaired. This Act reads as follows:

"If any part of the _capital_ of a _national bank_, State member bank, or bank applying for membership in the Federal Reserve System consists of preferred stock, the determination of whether or not the capital of such bank _is impaired_ and the amount of such impairment shall be based upon the par value of its stock even though the amount which the holders of such preferred stock shall be entitled to receive in the event of retirement or liquidation shall be in excess of the par value of such preferred stock. _If any such bank or trust company shall have outstanding any capital notes or debentures of the type which the Reconstruction Finance Corporation is authorized to purchase pursuant to the provisions of section 51d of this title, the capital of such bank may be deemed to be unimpaired if the sound value of its assets is not less than its total liabilities, including capital stock, but excluding such capital notes or debentures and any obligations of the bank expressly subordinated thereto._" (Emphasis added.)

49 Stat. 722 (1935), 12 U.S.C.A. Sec. 51b-1

There are several noteworthy aspects to this particular statute.

First, for determining impairment of capital the liability of capital debentures is ignored and to this extent the debentures are treated, not as debt, but as capital.

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Second, it should be noted that the exclusion of capital debentures from debt is not limited to capital debentures purchased by the Reconstruction Finance Corporation, but extends to all debentures "of the type" which the Reconstruction Finance Corporation could buy, regardless of who actually owns them.

Third, this section starts out with the term "capital". While not usually synonymous with "capital stock", the context indicates that Congress considered the two terms as the same for the purposes of this statute.

(b) In another Congressional Act dealing with state bank membership in the Federal Reserve System, Congress has specified that capital debentures are "capital stock" for the specific purpose of qualifying a state bank for such membership and determining the amount it must invest in stock of a Federal Reserve bank, 12 U.S.C.A. Sec. 329. It reads as follows:

> "Any bank incorporated by special law of any State, or organized under the general laws of any State or of the United States, including Morris Plan banks and other incorporated banking institutions engaged in similar business, desiring to become a member of the Federal reserve system, may make application to the Federal Reserve Board (Board of Governors of the Federal Reserve System), under such rules and regulations as it may prescribe, for the right to subscribe to the stock of the Federal reserve bank organized within the district in which the applying bank is located. Such application shall be for the same amount of stock that the applying bank would be required to subscribe to a national bank. For the purposes of membership of any such bank the terms 'capital' and 'capital stock' shall include the amount of outstanding capital notes and debentures legally issued by the applying bank and purchased by the Reconstruction Finance Corporation. * * *" (Emphasis Added.)

12 U.S.C.A. Sec. 329

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6. It is true that the Federal Reserve Board has taken the position, based on the last mentioned statute, that capital notes and debentures (other than those purchased by the Reconstruction Finance Corporation) may not be considered as capital or capital stock for the purpose of determining the loan limits of state member banks.

> "In a ruling issued under date of November 8, 1933, the board expressed the belief that it was the purpose of the Congress in authorizing the purchase by the Reconstruction Finance Corporation of debentures and capital notes from State banks to provide capital funds for such banks, and stated that it would consider the proceeds of such capital notes or debentures as capital funds of State banks and as part of the unimpaired capital required of such banks for admission of such banks to membership in the Federal Reserve System. By the act of June 16, 1934, section 9 of the Federal Reserve Act was amended to provide that, for the purposes of membership of any State bank, the terms capital and capital stock shall include the amount of outstanding capital notes and debentures legally issued by the applying bank and purchased by the Reconstruction Finance Corporation. In view of its previous ruling and of the subsequent amendment to said Section 9, the Board is of the opinion that capital notes and debentures legally issued by State member banks and purchased by the Reconstruction Finance Corporation should be considered as capital or capital stock in determining limitations under the aforesaid sections of the Federal Reserve Act and under section 210 of the Agricultural Credits Act of 1923. However, since the above-mentioned amendment to section 9 of the Federal Reserve Act does not refer to capital notes and debentures sold to other than the Reconstruction Finance Corporation, it is the view of the Board that any notes or debentures not sold to the Reconstruction Finance Corporation may not be included in determining the limitations under said provisions of law.

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"The foregoing ruling of the Board is applicable only to State member banks and is not intended to refer to limitations fixed by State statutes, as the construction of such statutes is within the jurisdiction of the appropriate State supervisory authorities rather than the jurisdiction of the Federal Reserve Board."

1934 Fed. Res. Bull. 749

The Federal Reserve Board, of course, based its ruling on the explicit language of the above statute that only capital debentures purchased by the Reconstruction Finance Corporation are to be considered as capital stock for determining whether a <u>state bank</u> meets the capital requirements for membership in the Federal Reserve System. There is no such limitation in regard to national banks. Of course, it can be argued that by limiting the circumstances under which capital debentures are "capital stock" for state banks Congress intended to limit the character of capital debentures for both state and national banks. Nevertheless there could be a good reason why Congress should specify and limit the treatment of capital debentures issued by state banks without extending a similar restriction to those issued by national banks. Congress has no other control over the capital structure of state banks, while it does have control over national banks.

7. The state treatment of capital debentures varies greatly.

(a) Banks are generally required to maintain a minimum capital structure. If a bank's net assets are insufficient to equal this required structure, its capital is to that extent impaired. In many states such impairment may be overcome by the issue of capital debentures. In the following 9 states it is provided that if the capital debentures are sufficient to make up the deficit, capital shall not be deemed to be impaired. Typically, such provision is coupled with a provision that the capital notes may not be retired until the impairment is rectified.

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Del. Code Anno. (1953) T. 5 Sec. 764 (b);
Md. Code Anno. (1957) Art. 11, Sec. 70;
Mo. Stat. Anno. (1952) Sec. 362.120
(See the sentence following this list);
N. Dak. Century Code (1959) Sec. 6-03-42;
S. C. Code (1962) Sec. 8-152;
Tex. Civ. Stat. (1959)Art. 342-607;
Wash. Rev. Code (1961) Sec. 30.36.030;
W. Va. Code (1961) Sec. 3128(2);
Wis. Stat. Anno. (1957) Sec. 221.046.

The Missouri statute permits only those capital notes sold to the Reconstruction Finance Corporation to be used in offsetting any impairment of capital.

(b) Six states expressly provide by statute that capital notes and debentures are generally to be considered as "capital".

Del. Code Anno. (1953) T. Sec. 764(b);
Ind. Stat. Anno. (1951) Sec. 18-103(p);
Md. Code Anno. (1957) Art. 11, Sec. 70;
Texas Civ. Stat. (1959) Art. 342-607;
Wash. Rev. Code Anno. (1961) Sec. 30.36.010.

In spite of these statutes, it was held, in Federal Dep. Ins. Corp. v. Department of Financial Inst. (Ind. App. 1942) 44 N.E. 2d 992, 995-996 and Reconstruction Finance Corporation v. Gossett (Tex. 1938) 111 S.W. 2d 1066, 1074-1075, that capital debentures in the hands of the Reconstruction Finance Corporation were debt, rather than equity, interests. These cases, however, were concerned only with the status of capital debentures in liquidation, and treated them precisely according to their standard terms, i.e. subordinate to debts and deposits, but senior to the stockholders.

(c) Four states expressly provide that capital debentures issued to the Reconstruction Finance Corporation shall be considered as capital.

Minn. Stat. Anno. (1948) Sec. 48.62;
N. D. Century Code (1959) Sec. 6-03-42;
S. C. Code (1962) Sec. 8-152;
W. Va. Code (1961) Sec. 3128(2).

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Minnesota provides that all capital debentures other than those issued to the Reconstruction Finance Corporation are "liabilities" of the bank. Minn. Stat. Anno. (1948) Sec. 48.62.

(d) OTHER STATE PROVISIONS.

Utah provides that capital debentures not maturing within a year shall be added to capital and surplus in determining the maximum amount which may be loaned. Utah Code Anno. (1953) Sec. 7-3-61.

Wisconsin provides that capital debentures "exclusive of Class 'B' capital notes and debentures as classified by the commissioner of banks" shall be considered "capital". Class B notes are not otherwise defined. Wis. Stat. Anno. (1957) Sec. 221.045.

Ohio and Oregon have no statutes, but classification of capital notes has been the subject of Attorney General opinions. In Ohio the Attorney General was asked to express an opinion on whether a bank could reduce its capital stock and paid in surplus below statutory levels, substituting capital notes for the deficit. It was his opinion that capital notes did not have the characteristics of equity interests, particularly assessability, and therefore could not be substituted for regular equity interests. 1933 Op. Ohio Atty. Gen. #1969. The Oregon Attorney General was asked to express an opinion whether capital notes should be shown on bank balance sheets as an equity or liability account. He opined that the Superintendent of Banks could direct either classification, depending on the terms of the securities. 1958-60 Ops. Ore. Atty. Gen. #116.

The Missouri statutes do not specify how capital debentures shall be treated in the capital structure. It is provided that the term of capital debentures shall not exceed 20 years and that certain assets may be set aside to fund them. Capital debentures issued pursuant to its laws have been twice litigated with inconsistent results. In Logrbrink v. Eugene State Bank (Mo. App. 1948) 209 S.W. 2d 265, it was held that a capital note holder was a "creditor" and required to file a claim against an insolvent bank. However, in

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Mercantile Bank & Trust Co. v. United States, (Ct. Cl. 1957) 147 F. Supp. 956, 958-959, without even a nod to Missouri law, it was held that capital notes were equity interests for the purpose of the Federal Excess Profits Tax. (See page 5 above.)

South Dakota, with no statutory provision for treatment of capital debentures, held that capital notes were not capital or surplus for the purpose of determining the deposit limits of a bank. See Security State Bank v. Breen (S. Dak. Code) (1960 Supp.) Sec. 6.0409.

Maryland and South Dakota make voting rights optional. Md. Code Anno. (1957) Art. 11, Sec. 70; S. Dak. Code (1960 Supp.) Sec. 6.0409.

New Jersey prohibits both voting rights and convertibility features. N. J. Stat. Anno. (1963) Sec. 17:9A-131.2(c), (d).

Utah limits the total issue of capital notes to "33-1/3 per cent" of the amount of capital stock and surplus at the date of issuance. It also prohibits use of the proceeds to retire outstanding capital stock or surplus. Utah Code Anno. (1953) Sec. 7-3-61.

(e) California has a statute authorizing capital debentures which expressly states that they shall not be deemed "paid up capital" or "paid in capital", but still makes them serve the purpose of capital to a greater or less extent according to how the section is interpreted. Section 662 of the California Financial Code provides as follows:

"Sec. 662. Issuance, sale, or hypothecation of capital notes and debentures. A bank with the prior approval of the superintendent and after obtaining the approval of shareholders holding a majority of the shares of the bank evidenced either in a writing signed by the shareholders or by vote at a shareholders' meeting, at any time, may issue, sell or hypothecate its capital notes or debentures which may be payable upon such terms and may bear such rate of interest, if any, as may be provided therein or which may be convertible into stock with

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the approval of the superintendent. Such capital notes and debentures shall be subordinate to the claims of creditors and depositors and it shall be provided in any such capital notes or debentures that in the event of liquidation all depositors and other creditors of the bank shall be entitled to be paid in full with such interest as may be provided by law before any payment shall be made on account of principal of or interest on said capital notes or debentures and may provide that after payment in full of all sums owing to such depositors and creditors the holders of such capital notes shall be entitled to be paid from the remaining assets of the bank the unpaid principal amount of the capital notes or debentures plus accrued and unpaid interest thereon before any payment or other distribution, whether in cash, property or otherwise, shall be made on account of any capital stock of the bank. <u>It shall be provided in such capital notes or debentures that no payment shall at any time be made on account of the principal thereof, unless following such payment the aggregate of the capital, surplus, undivided profits, and capital notes or debentures thereafter outstanding shall be the equal of such aggregate at the date of the original issue of such capital notes or debentures</u>, or as may be otherwise authorized by the superintendent.

"Such capital notes or debentures shall not be deemed 'paid up capital' or 'paid in capital', as said terms are used in this Banking Law. [Added by Stats 1953 ch 1438 Sec. 2.]"

Cal. Fin. Code Sec. 662

The underscored language provides that the principal of the capital debentures may not be paid unless the aggregate of capital, surplus and capital debentures outstanding <u>after their retirement</u> is at least equal to the aggregate of capital, surplus and capital debentures <u>at the date of the original issue</u> of the capital debentures being retired.

You will note that the starting point for the calculation is the date of the original issue, but it is ambiguous as to whether this is to be determined immediately before or immediately after the issuance of the

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capital debentures. Neither the courts nor the California Superintendent of Banks has as yet determined which interpretation should be adopted, and consequently purchasers of capital debentures issued in California have to assume for the time being the most restrictive of these interpretations.

One interpretation for determining the eligibility of capital debentures for retirement would be to use as a starting point the aggregate of capital, surplus and capital debentures outstanding <u>immediately before</u> the issuance of the debentures to be retired. In that event such retirement would not be permissible if there had been a drop in the combined capital, surplus and other capital debentures. The other and more restrictive interpretation would be to use as a starting point the aggregate of capital, surplus and capital debentures outstanding <u>immediately after</u> the issuance of the capital debentures being considered for retirement. In that event the debentures could not be retired unless they had been replaced subsequent to their issuance by additional capital, surplus, or other capital debentures. If the latter interpretation is placed on the statute, surely there is no economic reason why the amount of the capital debentures should not be included as a permanent addition to the equity of the bank.

8. From the foregoing, it is obvious that the statutory provisions with respect to capital debentures vary greatly from state to state. It further appears that California has the most stringent statutory restrictions on payment of capital debentures. While these apply only to the state banks of California, they can also be applied to national banks by contract. Whether they are applied automatically by statute or are applied voluntarily by contract, if the capital debentures expressly and unambiguously provide that they cannot be repaid unless the amount is replaced by stock, earnings, or similarly restricted debentures, such capital debentures are the economic equivalent of a preferred stock. It is submitted that capital debentures so restricted as to repayment should be treated as capital and surplus for most, if not all, of the purposes of the Federal Reserve Act. They constitute a permanent addition to equity.

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First, let us consider capital debentures as a part of the loan base. The loan limits for national banks are set by 34 Stats. 451, enacted in 1906, which provides, in pertinent part:

> "The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per centum of the amount of the capital stock of such association actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund."
>
> Rev. Stats. 5200 (1875) as amended
> 12 U.S.C.A. Sec. 84

This statute derives from the National Bank Act of 1864, 13 Stat. 99, 108, which provided, in pertinent part:

> "Sec. 29. And be it further enacted, that the total liabilities to any association, of any person, or of any company, corporation, or firm for money borrowed, including in the liabilities of a company or firm the liabilities of the several members thereof, shall at no time exceed one tenth part of the amount of the capital stock of such association actually paid in. * * * "
>
> 13 Stat. 108 (1864)

The terms "capital stock" and "unimpaired surplus fund" were not and are not further defined. Cf. 12 U.S.C.A. Sec. 51c which defines "capital stock" in a manner not pertinent here. However, the predecessor to 12 U.S.C.A. Sec. 52, 13 Stat. 102, was enacted at the same time and provided, in pertinent part:

> "Sec. 12. And be it further enacted, that the capital stock of any association formed under this act shall be divided into shares of one hundred dollars each, * * * "
>
> 13. Stat. 102 (1864)

Thus, when originally enacted, "capital stock" quite clearly meant the basic equity security. However, the legislative history can be analyzed to present quite a strong argument that capital debentures should be included in the loan limit

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base, either as capital stock or as unimpaired surplus.

Originally, loan limits were measured by capital stock alone. In 1906, in connection with the amendment to 12 U.S.C.A. Section 84, which increased individual loan limits by the additional factor of 10% of surplus, the reason for using capital stock as a measure was given. At that time, bank stockholders were generally subject to double liability based on par value. By tying loan limits to capital stock, banks were discouraged from setting an initial low par value and large paid-in surplus, effectively limiting their liability. See:

> H.R. Rep. No. 1835, 59th Cong. 1st sess. p. 2; 40 Cong. Rec. 5311

Since double liability is no longer a characteristic, strict limitation to capital stock terminology is not important.

Since the statutory language setting loan limits originated long before capital debentures were known, it is difficult to ascribe to Congress an intent to include or exclude them. Perhaps more significant is the intention indicated by Congress when legislating concerning capital debentures.

On the two occasions when Congress legislated with respect to capital debentures they treated them as part of the capital of the bank. (i) In 12 U.S.C.A. Sec. 51(b)-1 quoted under Point 5 above, Congress, for the purpose of deciding whether the capital of a national bank or a state bank was impaired when it applied for membership in the Federal Reserve System, stated that capital notes or capital debentures of the type which the Reconstruction Finance Corporation is authorized to purchase could be used to offset any impairment of capital which would otherwise exist. (ii) In 12 U.S.C.A. Sec. 329 quoted under Point 5 above, for the purpose of determining the amount of capital which a state bank must have to become a member of the Federal Reserve System, Congress provided that the terms "capital" and "capital stock" shall include the amount of outstanding capital notes and debentures legally issued by the applying bank and purchased by the Reconstruction Finance Corporation.

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If only those capital debentures which not only are subordinated to depositors and other creditors but which are also so restricted as to payment of principal that they cannot be retired unless replaced with other forms of "capital" (as would be the case under the subordination clause submitted herewith) were to be considered for inclusion in the loan base, the Board of Governors of the Federal Reserve System might very well be in a position to rule that such limited capital debentures constitute either "capital stock" or, possibly more appropriately, "unimpaired surplus funds" for the purpose of establishing the loan limits of a member bank.

Capital debentures so limited as above suggested would have all of the protective effect of capital and surplus insofar as the depositors and other creditors are involved. The protection of the depositors and creditors would appear to be the purpose of restricting the amount of loans to any one person to a stated percentage of the capital and surplus. Consequently those items which stand in the same relationship as depositors and creditors as traditionally recognized forms of capital and surplus could well be included in the loan base. The fact that, as to shareholders, the capital debentures would have a preferential position would be just as immaterial as is the fact that preferred shareholders take precedence over common shareholders.

<u>Second</u>, let us consider capital debentures as a part of the base for determining the maximum investment of a member bank in bank premises and the like. By 12 U.S.C. Sec. 371d banks are restricted to the amount of their capital stock in determining their maximum investment in bank premises, or in the securities of any corporation holding the bank premises, or in loans made to or upon the stock of such other corporation, unless they obtain certain approvals. For national banks the approval to exceed this limit must be obtained from the Comptroller of the Currency. For state member banks the approval to exceed this limit must be obtained from the Board of Governors of the Federal Reserve System.

For the purpose of determining the maximum permitted investment in bank premises, capital debentures restricted against repayment until replaced could be treated in either one of two ways. The Board of Governors and the Comptroller of the Currency could hold that they consti-

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tuted "capital stock" or they could give approval as permitted in Section 371d to investments in bank premises as described in that section up to the amount of the capital stock plus the amount of capital debentures frozen into the equity of the bank. The latter would probably be the more appropriate approach.

CONCLUSION

Some so-called capital notes and capital debentures are not truly such. They are often merely subordinated notes or subordinated debentures. The word "capital" in connection with notes or debentures should rightfully be reserved for those whose principal is restricted against payment until certain conditions are fulfilled with respect to the balance sheet items of capital and surplus.

Capital debentures were first issued to replace impaired capital and, as is noted above, in several states they could not be repaid until the impairment in capital had otherwise been restored. In the meantime, the capital debentures "stood in" for capital.

In some other instances, as pointed out in the Federal case cited above (Mercantile Bank & Trust Co. v. United States, (Ct. Cl. 1957) 147 F. Supp. 956, 958-959), the debentures could only be paid out of earnings. That would mean, in effect, that they were frozen in as capital or surplus until replaced by an increase in surplus through accumulated earnings. The 1935 Internal Revenue Service ruling, cited at the top of page 5 of this letter, declares that the interest paid upon such "income debentures" issued by a bank to evidence indebtedness to the Reconstruction Finance Corporation is deductible for federal income tax purposes although distributions on preferred stock issued by a bank to the Reconstruction Finance Corporation are not so deductible.

As mentioned at the beginning of this letter, we are enclosing herewith a proposed provision restricting the repayment of capital debentures until replaced. We are requesting that, with respect to capital debentures so limited, the Board of Governors make an exception to its general conclusion about capital debentures published in the January 1964 issue of the Federal Reserve Bulletin. We ask that you consider separately

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making such an exception (a) for loan base purposes and (b) for investment in bank premises. The exception should be limited to that part of the outstanding capital debentures which meet the following three tests:

1. The payment of the capital debentures must be expressly subordinated to the claims of depositors and other creditors, except those other creditors (usually purchasers of additional capital debentures) who by contract expressly agree in writing that payment of principal on the bank's debts to them shall be on an equal footing with or subordinated to payment of the capital debentures.

2. Payment of the principal of the capital debentures must be prohibited (except in a liquidation of the bank after the payment in full to depositors and other creditors not expressly on an equal footing with or subordinated to the capital debentures) until replaced by additional capital stock, additional earnings, or additional capital debentures similarly subordinated and limited as to payment of principal.

3. Only a portion of the principal amount of such outstanding capital debentures should be considered as part of the loan base or as a base for investment in bank premises, to wit, that part which is prohibited from being paid because not yet replaced by additional capital stock, additional surplus or additional capital debentures similarly limited as to payment. The reason for this third restriction is that, as capital is raised through the sale of capital stock, earnings accumulate in surplus or additional capital debentures similarly restricted are issued, thereby removing the restriction on payment of principal for a part of the outstanding capital debentures, there should not be included in the base both the proceeds from the additional capital stock, additional surplus and additional restricted debentures plus the total amount of the outstanding capital debentures. The new capital stock proceeds, earned surplus and additional restricted capital debentures should be included in the base but not that portion of the outstanding capital debentures which, by reason thereof, is freed for payment whether or not actually paid at that time.

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We would appreciate your reviewing the requested exceptions to your general rule at your early convenience. If there is any way in which I might be helpful, either by letter, telephone or personal appearance, please do not hesitate to call on me.

Respectfully yours,

Herbert F. Sturdy
of GIBSON, DUNN & CRUTCHER

HFS:mms
Enclosure

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EXHIBIT "A"

SUBORDINATION AND CONDITIONS ON REPAYMENT OF PRINCIPAL

The Capital Debentures shall be subordinate to the claims of depositors and other creditors of the Bank, except holders of other capital debentures or capital notes and those other creditors who by contract expressly agree in writing that payment of principal on the Bank's debts to them shall be on an equal footing with or subordinated to payment of the Capital Debentures, and in the event of liquidation of the Bank all depositors and other creditors of the Bank, subject to the same exceptions, shall be entitled to be paid in full with such interest as may be provided by law before any payment shall be made on account of principal of or interest or premium on the Capital Debentures; and after payment in full of all sums owing to such depositors and creditors, the holders of the Capital Debentures shall be entitled to be paid from the remaining assets of the Bank the unpaid principal amount of the Capital Debentures and unpaid interest thereon and premium, if any, before any payment or other distribution, whether in cash, property or otherwise, shall be made on account of any capital stock of the Bank. Except as above provided in the event of liquidation, no payment shall at any time be made on account of the principal of the Capital Debentures unless following such payment the aggregate of the capital, surplus, undivided profits, sinking fund for these Capital Debentures to the extent if any that the amount remaining in such sinking fund was debited against surplus or undivided profits, and the unpaid principal amount of these Capital Debentures and the unpaid principal amount of other capital debentures and capital notes thereafter outstanding which are subject to substantially the same or greater provisions on subordination

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and conditions on repayment of principal as are the Capital Debentures, shall be at least equal to such aggregate at the date of the original issue of the Capital Debentures, immediately after such original issue, unless otherwise authorized by the Comptroller of the Currency of the United States and by the Board of Governors of the Federal Reserve System.

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The Brookings Institution

1775 MASSACHUSETTS AVENUE, N. W., WASHINGTON 6, D. C.

February 3, 1965

Mr. Martin

This is the memorandum which we discussed. I hope it fits in with your ideas. Please destroy it when you have read it.

William R. Biggs

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To: The Vice President From: W. R. Biggs

As you know, I have been extremely interested in the Balance of Payments problem for several years and have made numerous trips to Europe and interviewed and know rather well some of the Central bankers of European countries, such as Switzerland, Germany, Holland and the Bank of England. You probably also know that I have lectured on the subject, both in 1963 and 1964, at the University of Virginia Business School. I merely mention this to indicate that this is a problem which holds major, long-term interest for me. It is my understanding that there is being prepared a Balance of Payments Message which the President will send to Congress.

The serious worsening of the Balance of Payments situation in the fourth quarter points up the necessity for specific measures of restraint on our part and it would, in my judgment, be a great mistake to have a Balance of Payments Message merely include exhortations and a discussion of the problem without (a) specific measures to improve the situation, which would apply to the private economy, and (b) also definite indications that the government, itself, intended to cut its own untied expenditures abroad, and be willing to take any necessary monetary action.

Some of the measures which would be most effective would be:

1. Extension of the interest equalization tax and a higher rate of tax on foreign borrowing of countries included under the tax. (The 15% tax on equity purchases is already effective and would not need to be raised.)

2. Immediate action to apply the tax at the present rate to bank loans and to include them in the extension of the law at the higher rates. Also, the new law should include a provision so that the renewal of bank loans beyond one year would be subject to tax.

3. "Direct" investment abroad has been most profitable and has and will in the future yield us substantial returns. However, it cannot be maintained at the present rate if we are to put our payments in balance. Furthermore, the Europeans, notably the French and Dutch, and now, more and more, the Germans, are becoming disturbed about the extent of U.S. "direct" investment in their industry. In a great many instances American industry has not wanted local partners or shareholders in their interests abroad because of technical and financial problems and loss of freedom in operating these subsidiaries. This has contributed to dissatisfaction in Europe with the extent of our investment. While American industry will strongly resist efforts to limit "direct" investment, it is, in my judgment, shortsighted on their part to so resist, since the countries involved could seriously hurt our investments by restrictive measures if they feel we are over-investing. Therefore, for reasons of our relationship with these countries, for reasons of protection to our present "direct" investment in these countries, and for the urgent reason of improving our Balance of Payments, it seems to me vital that we take some steps to:

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(a) Reduce "direct" investments abroad, and

(b) Encourage payment of dividends on the investments made.

As far as the latter is concerned, this could be accomplished by a tax incentive program which would encourage the payment of dividends from "direct" investments in Europe by remission of tax, especially if these payments are made within a certain time limit.

It will be extremely difficult to draw up the necessary regulations or restrictions. If such legislation or restrictions should be impossible, perhaps the next best thing would be a Committee to pass on "direct" investments.

4. I know that an export visa tax on travel to about the same countries as those covered by the interest equalization tax is being considered. Such a tax and a further limitation on duty-free purchases (especially including alcoholic beverages ~~and cigarettes~~) from these countries would bring home to our public and the countries involved our intent to solve the problem. It would also clearly indicate to the countries involved that correction of our problem could not be accomplished without some cost to them.

5. All the measures above apply to the private sector of the economy. The government should and could take two meaningful steps:

(a) It could indicate its willingness to face currently the penalty of somewhat higher short term interest rates. At this particular time with a strong economy and the stimuli provided for the maintenance of this strength through 1965, somewhat higher short term interest rates would be unlikely to have an adverse effect beyond keeping the economy from over-expansion. There are also some indications that monetary and credit measures might be a good thing for the domestic economy at this time, having in mind always that monetary policy can be reversed when necessary once we obtain freedom of action from our Balance of Payments problem.

(b) Is it not high time that the policy of maintaining such large numbers of troops in Europe be reviewed? We are told that there is an atomic mine belt stretching all along the Iron Curtain in Europe. If this is the case, the need for more than token troops stationed in Europe seems hard to understand. In the event of an attack one division would involve us as much as many more. Since the Europeans are so disturbed about our Balance of Payments and refer so often to its inflation effects on them, why not say that we will maintain our Air Force strength and one division, and more divisions if they will pay for them, but not otherwise. There certainly must be other places abroad where we can cut down our military expenses and I notice from the Budget that so far there has been very little decline in our military expenses abroad.

Conclusion

A combination of the measures noted above would indicate clearly that we mean business as far as eliminating our Balance of

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Payments deficit is concerned. The President's Message should emphasize that our objective is not to reduce our deficit but to eliminate it, even if only temporarily. Until dollars become scarcer and we show a will and ability to balance our payments we will continue to lose prestige and leadership in Western Europe, which is the heart of the Western World.

I am convinced that if we could eliminate our Balance of Payments deficit even for one year there would be a great change in psychology abroad, since, because of the dollar's role as a reserve currency and the constantly increasing need for reserves to finance trade, it will be generally recognized that it would be unfortunate for us to have a surplus, or even a balance in our payments, for very long. We must, however, show that we can achieve such a balance.

The great risk in not taking the necessary steps is that our freedom of action will be limited in the event that we have to take monetary steps in a future recession and the pressure on the dollar may come at just the wrong time. Furthermore, the recent moves of France indicate the kind of pressure that can be put on us and we should not be in a position where such pressure can be put on us.

While there will obviously be political handicaps to a program such as this, I am convinced that a program of this kind, if carried out with determination and success, would strengthen our position of leadership in the world, rather than weaken it, and would give us freedom of action in case we need it at a later date as far as the domestic economy is concerned. A Balance of Payments Message that exhorted and emphasized the problems but did not ask for specific measures might well create greater distrust of the dollar and particularly in our own country. The most serious threat to the dollar would be loss of confidence by the citizens of our country in their own currency.

The above memorandum is written on the assumption that as a minimum Congress will take action to eliminate the gold cover on the Federal Reserve deposits and thus give us freedom of maneuver from this technical point of view.

WRB/mr

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

OFFICE OF THE CHAIRMAN

February 8, 1965.

My dear Mr. President:

It is with deep regret that I herewith tender my resignation as Chairman of the Federal Reserve Board effective at your pleasure.

It has been a privilege to serve in the government for the past twenty years and you have my best wishes for continued success

Faithfully yours,

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date October 13, 1965

To Chairman Martin

Subject: Schweitzer Luncheon

From Robert Solomon

You might want to raise the following "tactical" questions with Mr. Schweitzer and his associates at lunch on Thursday.

Assume that the United States and like-minded countries in the Group of Ten, together with the Managing Director of the IMF, would like to see implementation of a scheme such as that outlined in my paper. What is the best tactical approach to assuring this outcome?

I can see two possibilities.

One possibility is that the Group of Ten negotiation turns out to be a stalemate. Suppose also that world monetary reserves continue to decline, as in the first half of 1965, or remain more or less unchanged. It is possible to imagine that, without fanfare and without a monetary conference, the Fund would simply go ahead and implement the proposal in order to provide for an increase in reserve assets.

Incidentally, the fact that we have this proposal in our back pockets ought to stiffen our negotiators in their substantive bargaining (a subject referred to in my October 4 memorandum to you).

The second possibility is that the Group of Ten itself would come together on a proposal of this sort. If that is to happen, the United States would, tactically, have to start from a position from which it could move in compromise to the desired scheme. In other words, if this is where we want to end up, what should be our initial position? Or, alternatively, to what extent would we be willing to modify this scheme in the direction of European positions?

Two possible answers to this last question occur to me. One is that the new reserve assets (in the form of claims on the Fund) would be used by deficit countries and acquired by surplus countries more or less in proportion to changes in their total reserves of gold and foreign exchange. Although this would not be a rigid link to gold as proposed by the French, it would be a gesture in that direction. We would want to think hard about this possibility before agreeing, but, it is worth considering.

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The second compromise would be to narrow participation in the scheme as indicated on page 8 of my paper. These more restrictive conditions for participation (the main one is that the country's currency has been used in Fund drawings in some significant way) could be applied under the present Articles of Agreement.

RS

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THE FIRST NATIONAL BANK OF CHICAGO
CHICAGO, ILLINOIS

HERBERT V. PROCHNOW
PRESIDENT

February 23, 1967

Mr. President
The White House
Washington, D. C.

My dear Mr. President:

With your very great responsibilities, it is perhaps wrong even to ask for the time required to read a letter. However, I believe the matter I should like to present is of major significance.

The term of office of the Chairman of the Board of Governors of the Federal Reserve System expires April 1. Having had contacts with the various chairmen and members of that Board over many years, I believe the present Chairman is one of the most distinguished in the history of the System. He has served several Presidents faithfully and conscientiously and is a man deeply dedicated, as you are, Mr. President, to the service of his fellow countrymen.

It has been my privilege to become acquainted with many of the leading central bankers and commercial bankers of the principal nations of the Western world. Mr. Martin not only has the complete confidence and respect of American bankers, but he is also the most highly esteemed and honored central banker in the world today. He is considered as a great tower of strength on monetary policy.

Although as a private citizen I may not know all the latest figures on the balance of payments and related problems, I have studied this problem carefully for a long period and know that it is extremely difficult. If it is not critical, it is at least serious. An experienced public servant held in the highest regard abroad may prove invaluable in the management of that problem.

In your recent message to the Congress regarding taxes, you also referred to the cooperation you would like on interest rates. I believe

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February 23, 1967

you spoke with the highest possible good intent on these matters. I am also completely confident that Mr. Martin would give you the finest cooperation in the attainment of those goals both of you so earnestly seek.

I trust that you may find it possible to reappoint Mr. Martin as Chairman so that he may serve his country and his President with his great talents.

With every good wish, I am,

Respectfully yours,

Herbert V. Prochnow

HVP:RML

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THE FIRST NATIONAL BANK OF CHICAGO
CHICAGO, ILLINOIS

HERBERT V. PROCHNOW
PRESIDENT

March 3, 1967

Dear Bill:

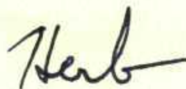
I was with Ben Heineman, President of the Chicago and North Western Railway, today at luncheon.

Mr. Heineman is very close to the White House. I had previously brought to his attention the matter in which he might be helpful. I told him again how important it was that the country have the benefit of your services as Chairman. He said, "I will bet you that Mr. Martin will be reappointed". He also feels sure the person who might fill the other vacancy on the Board will be satisfactory.

In addition, he told me what you undoubtedly know - a group of northern liberal Congressmen went to the President and urged him to reappoint you. He added, "knowing how politics work, I would not say that it was impossible that the President may not have asked these liberal members of Congress to come to him with this request." He thought it might even be unusual for a group of liberal Congressmen all of a sudden to decide themselves that they would go to the White House. He thought that it was just as likely that the President might have planted the idea that they should all come to him. At any rate, I did not take Ben's bet because I thought he seemed convinced as to what action would be taken.

No acknowledgment of this letter is expected.

Very sincerely yours,



Mr. William McC. Martin, Jr.
2861 Woodland Drive
Washington, D. C. 20008

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261 MADISON AVENUE, NEW YORK, N. Y. 10016 MUrray Hill 2-3190

December 6, 1967

Mr. William McC. Martin, Jr.
Chairman
Board of Governors of the Federal
  Reserve System
Washington, D.C. 20551

Dear Bill:

At the recent meeting at Tom Nichols' place, which you could not attend because of the British devaluation, Milton Eisenhower mentioned a paper of mine which attempts to evaluate the economic and social impact of our defense sector. I am enclosing a copy on the chance that you may find it of some interest. Before it is published, I shall want to revise the present rough draft. If you should feel that I have gone wrong at one point or another, I should appreciate your advice. However, I do not want this paper to become in any way a burden on you.

With kind regards,

Sincerely yours,

Arthur F. Burns

Enclosure

P.S. It was good to see you at the Fed meeting, but we hardly had a chance to talk. Will you be coming to New York soon? If so, do give me a ring. In any event, Helen and I are coming to Washington at the end of the month, and we hope to see you then. A.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 15, 1968

To Chairman Martin

Subject: Gold and Swaps Policy

From S. J. Maisel S.J.M.

(STRICTLY CONFIDENTIAL FR)

This memorandum explains somewhat more fully the background of my vote yesterday against expanding the Federal Reserve swap network and against employing it actively until we reach new agreements with our swap partners. These agreements should specify how over the intermediate period we are to share possible losses of gold to speculators as well as how to cover reserve gains by foreign banks as a result of the current over-valuation of the dollar. They should also cover longer term agreements looking toward the demonetization of gold and toward ways in which new methods of exchange and trade adjustments can be activated.

I am not optimistic that such agreements are possible. In effect, then, I am arguing that the present system cannot be maintained. Our bargaining power will be greater if we immediately refuse to fund through swaps, or gold sales, speculative attacks on the dollar. This weekend's negotiations should seek temporary standstill agreements on reserve movements while more basic changes are negotiated. These agreements should include methods of dealing with speculative reserve losses that would not require the United States to give exchange value guarantees on foreign reserve gains.

I. The United States faces three somewhat separate problems:

1. Gold speculation and the price of gold.
2. Speculation against the dollar in terms of other currencies.
3. The methods of adjustment of the price of the dollar relative to gold and other currencies.
   (a) In the short run (defined as: "end of Vietnam War plus three years").
   (b) In the long run.

The United States is in a true state of foreign exchange disequilibrium which will not be corrected under existing policies. As a result we cannot meet the immediate problems of speculation or the long-run adjustment problem without basic policy changes.

The required policies include new international agreements covering each of the above problems, i.e.,

1. Exchange rate adjustments.
2. Meeting currency speculation.
3. Gold policy.

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Unless new policies are agreed to and actively implemented by eight or nine of the Group of Ten countries, the present international monetary system will not be stabilized. We will only be throwing good money after bad. Until new policies are agreed to, the United States should embargo sales of gold and should give minimum support (simply enough to avoid extreme day-to-day fluctuations) to existing exchange rates.

II. There are three basic causes of the current situation:

1. The relative price of the dollar is too high in terms of our existing and potential international commitments.
2. The Bretton Woods international monetary system lacks a real method of adjustment for key currencies.
3. The reserve base lacks both a method of normal growth and is inherently unstable because of potential movements among its components.

The magnitude of the problems would be somewhat smaller if our international commitments were reduced or partially assumed by others. A relative decrease in the price of the dollar (an increase in the dollar price of foreign currencies but not necessarily gold) is also necessary. While such a relative shift could come about as a result of a less inflationary or more deflationary monetary-fiscal policy in the United States compared to our trading partners, I feel confident such relative shifts cannot solve the short-run problems and are extremely unlikely to solve the long-run problem.

III. To solve the short-run problem at existing exchange rates, we would need

1. More controls over foreign expenditures, both public and private.
2. More taxes on foreign expenditures.
3. A highly deflationary monetary-fiscal policy.
4. A method of insuring long-run adjustments.
5. The clear understanding on the part of our foreign partners of what the real problem is plus a firm commitment to cover almost the entire expected foreign exchange needs of a violent period of private speculation plus a considerable share of the needs brought about by our current disequilibrium.

Since I am pessimistic about the possibilities and effectiveness of cutting our short-term exchange needs much if at all by either monetary-fiscal policies (because short-run elasticities are too small) or by tax and control policies, this means we must have new adjustment policies. The adjustment policies will have to include methods of gradually changing the exchange rates among key currencies. In addition, they probably should include more flexible trade adjustment procedures than now seem possible under GATT. Finally, a better procedure for handling different types and growth rates of reserves may be necessary.

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In the intermediate period while these are being negotiated and made effective, we will need firm commitments by others as to the amount of their dollar gains they will fund over an intermediate period. Unless these commitments cover both their total possible reserve gains due to speculation plus some of the considerable gains that they will receive due to the fundamental disequilibrium in the current system, the existing system will collapse.

IV. The problem of gold speculation is separable to some extent from that of exchange requirements. It could probably be met by a massive infusion into the private markets from existing monetary gold stocks plus an embargo of three to five years by the major central banks of gold purchases. This would mean an immediate partial demonetization of gold with adjustments in reserves made through certificates, SDR's, or Fund drawings. It would look forward to a total demonetization when better systems of exchange rate and reserve adjustments come into effect.

Unless the other major countries agree to a partial demonetization of gold, we should probably embargo all gold sales. This would look forward to moving toward a new system of two or a few monetary blocs with special agreements on settling of accounts among and between them.

Obviously no solution is good. Since all are difficult, on the surface there may appear to be some major advantages of sticking with current policies and hoping for the best. This policy, however, has already been tried for too long. The British experience plus the failure of the Gold Pool operation since November lead me to believe that we cannot be optimistic. We should retain only minor hopes that we can reach equilibrium without a major change in the system. We risk great losses with only a small chance of gain if we continue to put off basic decisions on how policies should be changed.

cc: Other Members of the Board

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P.S.

March 28, 1968

Dear Bill:

I didn't want to clutter up the letter with which this note is enclosed. In your address in Detroit you said something to the effect that as long as the ratio of the Federal debt to GNP is declining you are really not concerned about the size of the debt. Those aren't the exact words but I think it is generally the idea and I'm pretty sure I have heard you make this statement on previous occasions.

It seems to me that the statement needs a qualification: namely, a great part of the Federal debt was created when the dollar was worth substantially more than at present; hence, if GNP is expressed in current dollars and the Federal debt largely in dollars of greater purchasing power, a declining ratio could be a cause for alarm, in that the decline in the ratio is materially affected by the declining purchasing power of the dollar.

I think your statement would have more validity if you said that you have never become too disturbed about the size of the debt provided its ratio to GNP in constant dollars is diminishing. While this would be a rather involved calculation I think it points up an important distinction. One way to approach the problem would be to restate the Federal debt in current dollars in determining the ratio of the amount of outstanding Federal debt to GNP in current dollars.

In any event, all of the above is meant to be a constructive observation on which some joker like me might try to trip you up someday.

Regards,

Harry

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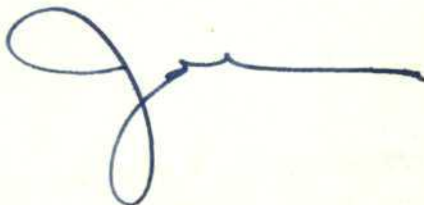
Date April 23, 1968

FROM THE DESK OF JOSEPH W. BARR

To: Bill Martin

Bill, I would like to send the attached letter to Bart Rowen -- not so much in your defense but to express my own conviction that men of responsibility must speak out when they think the nation is in danger.

What do you think?



The Under Secretary of the Treasury

Room 3326

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Dear Bart:

I have been in public life long enough to know that the press serves a very useful purpose in its critical efforts, and I also know that criticism can be lived with by the man who is being criticized. I am going to comment on your article of yesterday, not to defend Bill Martin -- he is perfectly capable of taking care of himself. I am commenting because I think Bill Martin is absolutely correct and I think he has an obligation to say what he did. He believes it; he has had many years of experience in the domestic and international affairs of this nation to back up his opinions; his opinion is widely shared by men of responsibility, and therefore I believe that he must speak out to the nation.

Bart, there has been too much talk about what this country can do if it only has the will. I agree that we are a great and a powerful nation and that we can meet our international and domestic responsibilities, within reason, if we are willing to pay the price. But if we are not willing to reduce or even to limit the increase in our standard of living while attempting to achieve our domestic and international objectives, then I can only conclude that we are running a grave danger of wrecking the international financial system with which we have lived for the past 23 years. If we wreck that system; if we are forced into a disorderly redeployment of our military forces for financial reasons; if we are forced into protectionist measures at home; then we can well be setting the stage for a world in which physical and financial order are in disarray. In other words, we could be facing a world not too different from the flow of history that began with 1931. Does a responsible man wait until we are knocked down by the third run on our reserves before warning his country of the dangers we face?

I would like to share with you one conclusion I have reached in my ten years of public service. The old term "political-economist" has fallen into disuse. We now have

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politicians, and we have economists. Bill Martin, in my opinion, qualifies as a political-economist. He is an uncanny judge of markets and the economic reaction of people to political decisions. I have learned, sometimes the hard way, that Bill Martin speaks with complete integrity, vast experience, and great judgment.

Perhaps all this makes me an "alarmist" also. If it does, so be it. I would prefer this title to sitting idly by and taking the chance that my country and the free world may blow apart without ever expressing my own convictions.

Sincerely,

Joseph W. Barr

Mr. Hobart Rowen
The Washington Post
1515 L Street, N. W.
Washington, D. C. 20005

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