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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 10, 1961.

To Chairman Martin

Subject:

From Mr. Sherman

Attached is a copy of a memorandum that Lewis Dembitz prepared for Governor Shepardson at the latter's request. This memorandum was not circulated to the Board, but you may wish to read it.

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Mr. Sherman

January 23, 1961

Governor Shepardson

Lewis N. Dembitz

Designation of Reserve Cities and Reserve City Banks

In accordance with your suggestion, I am setting forth below a possible plan for disposing of the problem of classification of reserve cities and reserve city banks. May I repeat that this represents only my personal ideas, not cleared with other members of the staff.

While the Board has devoted time to this subject, more consideration would be needed to arrive at any new set of principles to govern in this relatively unimportant field. Also, if the new principles called for designation of new reserve cities, political problems would arise (assuming that the cities don't want to be designated). In view of the important fields that the Board has to deal with, and the importance of obtaining maximum support for the Board's positions in these fields, we shouldn't waste any of our ammunition or strategic position in arguments over the designation of new reserve cities.

The suggested plan and further reasons for it, given below in condensed form, could be elaborated in future discussion.

The plan is as follows:

1. Re designation of reserve cities:

Decide that the Board will continue the 1947 rule on this subject; this would not call for any public announcement beyond a routine note (like that which appeared in the February 1960 Bulletin), discussed further in Appendix A to this note.

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2. Re <u>exemption of individual banks in reserve cities</u>:

(a) Decide on standards for such exemption, along lines previously circulated to the Reserve Banks, as discussed further in Appendix B to this note. This would <u>not</u> require any public announcement.

(b) Pass upon the pending applications by individual banks on which decision has heretofore been deferred.

(c) Then, indicate to each Federal Reserve Bank that, with respect to each member bank in its district that seems likely to qualify, the reserve bank should call this fact to the attention of the member bank and should indicate the kinds of information that the bank should initially submit if it wishes to apply for exemption. (This would be in the interest of uniformity and fairness among member banks.)

* * * * *

This suggestion for continuing the 1947 rule, notwithstanding its shortcomings, is based on my view that any new plan would not be so much better, nor so clearly better in principle, as to warrant the political problems that would arise in defending it. If there is any significant matter of principle involved, it is not so clear or well-defined as to make it a good subject for the Board to get involved in public argument on.

The only pressure for the Board to take any action at all in this field, I believe, is from those reserve city banks on whose applications for exemption the Board has deferred any decision. On most or all of the applications that have been filed, the Board would probably have been

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willing to grant them (before now) except for one thing: since the rules to govern the designation of reserve cities and reserve city banks in the future were still undecided, it seemed undesirable to grant exemptions to any reserve city banks which might again be reserve city banks under future rules.

Since the 1947 rule is still in effect (only the 1960 triennial review having been suspended), its continuation would not call for any Board statement setting forth or defending its principles, and the Board would be quite free to change to some other rule in some future year if it wished to do so. I personally agree that the system of designations would seem fairer if Hartford and a few other financial centers were made reserve cities, but I do not believe that the accomplishment of this would be worth its probable cost.

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Appendix A

1947 Rule: Resumption of Triennial Reviews

The note that appeared in February 1960 in the Federal Register and in the Federal Reserve Bulletin (page 151) was as follows:

"Title 12--Banks and Banking...
Part 204. Reserves of Member Banks

"Classification of Central Reserve and Reserve Cities

"In view of the recent changes in the provisions of law with respect to bank reserves (Section 19 of the Federal Reserve Act; 12 U.S.C. 462), the Board of Governors of the Federal Reserve System has suspended until further notice subparagraph (4) of paragraph (b) of Sec. 204.51 Classification of central reserve and reserve cities, which contemplates a triennial review."

(The Board's rule that is referred to, which was subsequently numbered 204.51, appears in the Bulletin for January 1948, pages 40-42.)

I think that the note to be published now could simply say that henceforth the dating of the triennial reviews, instead of being "as of March 1 of every third year after March 1, 1948," will be as of March 1, 1962 and every third year thereafter.

Re selection of March 1, 1962 for the date of the next review, it may be noted that (1) by sticking to March 1 rather than some other day of the year, the other dates in the rule (which were selected in relation to March 1) can be left unchanged; and (2) March 1, 1961 might allow too little time for the necessary preparatory work.

Under this rule, the terminations of Wichita, Topeka and Kansas City, Kansas as reserve cities -- already requested by most of the banks

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in those cities -- would automatically take place March 1, 1962. The one reserve city bank in Pueblo would presumably ask to continue as such. The banks in Toledo would have time to consider what they want to do. All these cities are now reserve cities because their banks voluntarily elected that status in 1957. The only other prospective reclassification would be Jackson, Miss., which would probably go into the reserve city class because the banks there have expanded their interbank balances considerably further during recent years; the effective date of any such designation would be March 1, 1963.

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Appendix B

Exemption of Individual Banks in Reserve Cities

In the memo of August 10, 1960 which the Board circulated to the Reserve Banks, estimating the effects of a plan for reserve city classification, it was assumed that a bank in a reserve city would be exempted if it had less than $100 million of gross demand deposits <u>and</u> less than $10 million of interbank deposits <u>and</u> met a third test relating to character of business. This third test was assumed (for purposes of statistical analysis) to be based entirely on deposit turnover; but a later draft rule (dated December 8) specified that "all factors relating to the character of such bank's business" should be considered, including the nature of its depositors and borrowers, amount and frequency of borrowings from Reserve Bank or other lenders, its geographical location within the city, and its competitive position with relation to other banks in the city.

I would now suggest that the Board adopt a standard along the foregoing lines (to be used internally as a guide to decisions, not to be published). As to the figures to be filled in, I think there might be a choice between:

(a) the figures $100 million and $10 million respectively (as above); or

(b) lower figures such as $70 million (instead of $100 million) of gross demand deposits and $5 million (instead of $10 million) of interbank deposits.

In either case, there would also be considered the "character of business" of each bank that falls within the given size limits.

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Under alternative (a), using the figures $100 million and $10 million, the total number of banks shifted to the country bank classification might be around 80, with total net demand deposits of about $3 billion, so that the shifts would reduce total required reserves by about $130 million.

Under the plans discussed in 1960, this reduction would have been offset by the shifting of a number of other banks from the country to the reserve city classification. Without such offsets, a net reduction as large as $130 million might now seem undesirable. If so, the Board could instead follow alternative (b), under which the number of banks shifted to the country bank classification would be about 60 instead of 80, with total net demand deposits of only about $1.8 billion, leading to a net reduction of about $80 million instead of $130 million in total required reserves. If alternative (b) is followed now, a change to alternative (a) could be considered in some future year if that should ever seem desirable.

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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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April 10, 1961

To: Board of Governors Subject: Reserve city classification

From: John R. Farrell

Since the announcement on March 1, 1961, of the proposed amendments to Regulation D, Reserves of Member Banks, a number of protests have been received concerning various aspects of the proposed rules. Copies of the material submitted by the protesting banks have already been distributed to the Board.

The most serious protests received were from two banks in Hartford, three banks in Albany and the Albany Clearing House Association, three banks in Newark, and two banks in Phoenix arguing against the classification of these cities as reserve cities. These protests are commented on in the next section of this memorandum.

The protest received from one of the Newark banks (National State Bank) contains the following request:

> "No attempt has been made herein to present a formal brief but for the reasons set forth in this letter, we feel that Newark should not be classified as a Reserve City and we ask that the Board of Governors give us an opportunity to discuss the matter in more detail before the proposed amendments are adopted."

Protests have also been received from one bank in Charleston, South Carolina, three banks in San Francisco, and two in Los Angeles about the long-standing provision which includes deposits held by out-of-town branches among the deposits of the bank subject to reserve city requirements. These banks argue that it is inappropriate to subject out-of-town branch deposits to reserve city requirements because these branches are like country banks.

> The Legal Division feels that it is extremely doubtful that the Board has the power to prescribe differing reserve requirements for segments of a bank's demand deposits--e.g., 16-1/2 per cent against demand deposits held by the head office and 12 per cent against demand deposits held by out-of-town branches.

In addition, the Federal Reserve Bank of New York and the City National Bank and Trust Company of Columbus, Ohio, submitted suggested revisions of the paragraph in the proposed regulations concerning permission to carry reduced reserves.

> The New York Reserve Bank suggested that the phrase "the amount and frequency of its borrowings from its Federal Reserve Bank or other lenders" be eliminated from the list of factors which the Board may take into account in considering requests for permission to carry reduced reserves.

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As the list in the proposed regulation is indicated as not being all-inclusive and since there is no objection by the Board's staff to the elimination of the phrase in question, it is suggested that the recommendation of the New York Bank be adopted.

The Columbus bank suggested[1/] that the paragraph in question be completely rewritten to provide in effect that any member bank located in a reserve city would have automatic permission to carry reduced reserves in any case where the daily average amount of total demand deposits of such a bank during the preceding calendar year was below a similar figure for any "country" bank in the same Federal Reserve district. This proposal would seem undesirable because its mandatory nature would ignore local competitive factors. The Board should have the flexibility necessary to consider each request for reduced reserves in the light of all the relevant factors pertaining to the particular case.

There is one other suggested change in the proposed revision of Regulation D which the Board may want to consider. It will be recalled that, at a recent Board meeting when Chairman Martin reported his conversation with Mr. Biggers of the Toledo Trust Company, there was some sentiment in favor of permitting banks in cities which were voluntarily retained as reserve cities under the "grandfather clause" to have their status reviewed more frequently than once every three years. In this connection the Legal Division has suggested that this purpose could be accomplished by inserting on page 6 of the March 1, 1961 mimeographed draft the following new paragraph (d):

(d) In any case in which the reserve city classification of any city is continued effective as of June 1, 1961, or as of June 1 of any third year thereafter, solely by reason of the provisions of subparagraph (5) of paragraph (a), the reserve city classification of such city may be terminated at any time after one year following the effective date of its continuance as a reserve city if a written request for such termination is

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1/ The Columbus bank also proposed that member banks located in reserve cities in which there is no Federal Reserve Bank or branch be given permission to compute availability of credit for cash items from the time such items are dispatched by the member bank rather than from the time the items are received by a Federal Reserve Bank or branch. The bank feels that such a change would minimize the discrimination which it says now exists in favor of member banks in Federal Reserve Bank or branch cities. This suggestion, which has nothing to do with the proposed revision of Regulation D, would seem to be completely undesirable because it could result in substantial operating difficulties and would significantly increase float.

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received by the Federal Reserve Bank of the district in which the city is located from one or more member banks with head offices in such city and if such request is granted by the Board of Governors.

New Reserve Cities

The banks in Hartford, Albany, Newark and Phoenix argue that the cities in which they are located should not be made reserve cities because--

1. Curtailment of lending power, due to higher reserves, would have a detrimental effect on area economy. (Albany, Hartford, and Phoenix)

2. Deposits held by branches outside of the head office cities account for a large proportion of total demand deposits. (Albany, Hartford, and Phoenix)

3. Fully secured public funds account for a large proportion of total demand deposits. (Albany)

4. The ruling is arbitrary, discriminatory, unreasonable, and out of harmony with the intent of Congress. (Newark)

The counter-arguments to those presented by the protesting banks are:

1. The law requires that banks be divided into two groups and the only question is whether banks with similar characteristics, from the standpoint of function of reserve requirements, are treated alike. Many, perhaps most, existing reserve cities might contend that their ability to meet loan demands in their communities is being hampered by the reserve requirements applicable to them. It may be noted that in some cases this argument is used on the grounds that the area is depressed, whereas in Phoenix lower requirements are said to be needed to meet the demands of a growing community. Current Federal Reserve policies with respect to the over-all availability of reserves are designed to provide for the credit needs of the economy in general; the distribution of these resources among areas and banks is determined by the working of a variety of market and other economic forces beyond the control of the Federal Reserve.

2. It is true that a large portion of deposits in branches--particularly those located in small communities--are more nearly similar to country bank deposits than to reserve city bank deposits, but large branch banks are in position to, and in most cases do, engage in activities and hold

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substantial amounts of deposits of a nature similar to those in large unit banks. Moreover, in branch banking, the relationship between a head office and its own branches serves as a substitute for correspondent banking and the function of interbank deposits is effectively served, even though there is no substantial volume of deposits carried for other banks.

Branch deposits are subject to the over-all lending and investment policies of the head office management. Furthermore, any attempt to separate branch deposits from those attributed to the head office would involve administrative and regulatory difficulties of an insurmountable nature.

3. From the standpoint of the function of reserve requirements, namely limitation on credit expansion, there is no basis for distinguishing between public funds and other deposits. They are all a part of the process of multiple credit expansion. With respect to their effect upon the volume of spending in the economy, it has long been recognized that public funds have a higher rate of turnover than other demand deposits. The material furnished by the Albany banks indicates the velocity of public funds is double that of the other deposits. Higher reserve requirements would tend to minimize the erratic effect of these deposits on the money market.

4. The present alignment is discriminatory and unreasonable because it permits country bank status for some cities that have significant characteristics essentially similar to existing reserve cities. The Board's objective was to remove as many of these inequities as was possible with a minimum disturbance. Recent Congressional action would seem to support criteria which take into account general character of business. Tests of various possible criteria indicate that total demand deposits provide a simple standard that gives about the same results as other more complex formulas. The cities that have been added to the list of reserve cities have characteristics that are similar to many cities now so classified. It would not be feasible to evolve and apply equitably a standard that would leave out these cities, without eliminating a number of existing reserve cities.

Need for Guidance

Ordinarily in a project of this nature the relevant material would be submitted to interested members of the Board's staff for consideration and suggestions concerning recommendations to be made to the Board. In view of the time element in this case, however, we are taking the liberty

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of submitting the following suggestions (which illustrate one position the Board might take) without having had the usual benefit of full staff consideration. While the Board may wish to take some other position, our thought was that whatever it decides with regard to these suggestions will give the staff guidance in the preparation of such material as may be appropriate for final action. For instance, the staff could begin working on appropriate drafts if the Board should decide to inform the Reserve Banks that--

1. It has considered the protests to its proposed procedure for classifying reserve cities and has adopted the original proposal with the minor changes suggested herein.

2. It is sending a reply to each of the protesting banks and copies of these replies to each of the Reserve Banks concerned.

Other alternatives to the procedure proposed in Item 2 above would be, in lieu of replies to the individual banks, to make only a short announcement along the lines indicated in Item 1 above, or to issue a general statement giving some of the reasons for the Board's action. The suggestion for individual replies is based on a belief that the protesting banks would feel better if they had some indication that their points had been carefully considered rather than summarily dismissed. Individual replies seem better suited for this purpose than a general statement because of differing points raised by the various banks. For instance, the question of public funds was raised only by the Albany banks and the charge of capricious action was made only by the Newark banks. Accordingly, it would seem undesirable to refer to these points in a general statement.

Related Matters

In addition to protesting against the proposals to designate their cities as reserve cities, the following banks have requested permission to carry reduced reserves if the proposed reserve city classification standards are adopted:

National Commercial Bank and Trust Co., Albany, N. Y.
First Trust Company, Albany, N. Y.
Savannah Bank and Trust Co., Savannah, Ga.
Valley National Bank, Phoenix, Ariz.

Of these four banks, the Savannah Bank and Trust Company is clearly eligible,[1] but the First Trust Company of Albany request would

1/ Demand deposits of this bank total about $27 million. Although the bank indicated a strenuous objection to the designation of Savannah as a reserve city, this protest appears to be based on a misunderstanding of the Board's intention to permit it to carry reduced reserves. In this light, the protest was not included among the earlier comments in this memorandum concerning banks objecting to the designation of new reserve cities.

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seem to require more information regarding the character of its business before further consideration. There would appear to be no basis for granting the requests of the National Commercial Bank and Trust Company and the Valley National Bank becuase they are the largest banks in their respective cities.

Under the Board's proposed rule banks in present reserve cities which would lose this status under the new plan have until May 15, 1961, to request continuation of their reserve city status. In this connection requests have been received from the First National Bank of Pueblo, Colorado (the only reserve city bank in Pueblo), and from two Toledo banks (The National Bank of Toledo and the Ohio Citizens Trust Company). It is understood that The Toledo Trust Company, which has about $200 million of demand deposits and is the largest bank in the city, will submit a similar request.

It is suggested that the Board will want to defer action on the requests for permission to carry reduced reserves and for continuation of reserve city classifications at least until it has taken final action on the standards for classifying cities.

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BOARD OF GOVERNORS
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Office Correspondence

Date August 25, 1961

To Chairman Martin

Subject:

From Ralph A. Young

Attached is the draft memorandum re Federal Reserve membership on the BIS directorate that we mentioned in conversation before I went on vacation. After ruminating at length on this matter, I think my view is positively in favor, whether or not as part of a package involving Federal Reserve operations in and holdings of foreign currencies.

As pointed out in the memo, a special general meeting of the BIS shareholders has been called on October 9 to consider changes in the BIS statutes. It would be desirable to have a Board determination in sufficient time to enable a revision of Article 58, which pertains to the definitation of central bank of the United States, to be adopted at that meeting.

RAY

Attachment

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revised DRAFT
8-24-61
JHF/RAY:ajm

TO: Board of Governors

FROM: Ralph A. Young.

SUBJECT: Federal Reserve membership on the board of directors of the Bank for International Settlements

In view of the present stress on cooperation among the central banks of Europe and North America, it appears appropriate to consider again the problem of closer ties between the Federal Reserve and the Bank for International Settlements, of which all major European central banks are members.

Accordingly, this memorandum briefly reviews the development of relations between the Federal Reserve and the BIS since 1929 and the main legal questions that present themselves on the question of Federal Reserve membership in the Bank's board of directors. It then considers the advantages under present conditions to the Federal Reserve of such membership, and in the light of these advantages recommends Board action to authorize System membership.

Development of relations since 1929

The Bank's statutes provide for the participation of U.S. banks as shareholders (Articles 6, 9, 15) and state that the "Governor" of the "central bank" of the United States is to be an *ex-officio* member

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of the board of directors, with the right of appointing a second member as well as substitute and alternate members (Article 28, paras. 1 and 2).

Nevertheless, on May 16, 1929, Secretary of State Stimson declared that the U. S. Government would "not permit any official of the Federal Reserve System either to themselves serve or to select American representatives as members of the proposed International Bank." He based this decision on the intimate relation between the proposed bank and the problem of German reparations.

In 1933, Mr. Harrison, Governor of the Federal Reserve Bank of New York, was offered an appointment as a director of the BIS. On November 28, 1933, the Board of Governors decided that he "should not accept the appointment."

In 1936-37, the Board of Governors gave consideration to a proposed amendment of the Federal Reserve Act, under which a member of the Board of Governors, with the approval of the President of the United States, might have served as a director of the BIS. The Board, however, took no action recommending this amendment.

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Since the end of the second world war, the Bank has no longer been concerned with the problem of German reparations. Instead, it was selected to function as the fiscal agent of the Organization for European Economic Cooperation and later of the European Payments Union and its successor, the European Monetary Agreement. This fiscal agency activity has lost most of its importance since the re-establishment of convertibility by the major European countries.

In view of postwar changes in the international situation, Mr. Thomas and Mr. Marget, on May 5, 1950, recommended that the Board again consider the representation of the Federal Reserve on the board of directors of the BIS. Their tentative conclusion was as follows:

a. The Chairman of the Federal Reserve Board could be the U.S. ex-officio director on the board of the BIS.

b. The Chairman of the Federal Reserve Board could appoint, as the second permanent U.S. member of the Board of the BIS, either the President or the Chairman of the Board of the Federal Reserve Bank of New York.

c. The Chairman of the Federal Reserve Board could designate as his substitute Nominee the member of the Board who normally serves as his Alternate on the N.A.C.

d. The Alternate to the substitute Nominee, likewise to be appointed by the Chairman of the Federal Reserve Board, could be, not only a member of the Board of Governors, but also, with the concurrence of the Board, any other person whom the Chairman of the Board might designate.

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The matter was discussed with Mr. Sproul, President of the Federal Reserve Bank of New York, as well as with Mr. Martin, then Assistant Secretary of the Treasury, and Mr. Southard, U.S. Executive Director of the International Monetary Fund. Neither Mr. Martin nor Mr. Southard raised any objection on principle but Mr. Martin did raise the question of timing and the matter was not pressed further.

On May 2, 1955, Mr. Marget informed the Board of Governors that Mr. Sproul, in a letter dated April 25, 1955, had once more raised the question of Federal Reserve representation on the board of directors of the BIS. Chairman Martin, in a letter of May 9, 1955, brought the matter to the attention of Mr. Burgess, Under Secretary of the Treasury. In his answer, dated July 28, 1955, Mr. Burgess referred to the "informal arrangements" under which "personnel" of the Treasury and the Federal Reserve "attend as observers at the meetings of the BIS" and commented on the "European character of the Bank" and the continued membership "of some of the Eastern European countries." The concluding paragraph of the letter read as follows:

> "On the whole, there would appear to be some advantage at the present time in the informal arrangement which facilitates the participation as informal observers of representatives of several U.S. agencies in the meetings of the BIS. It seems to me that we might well carry on this arrangement for the time being and defer consideration of formal membership until a later date."

Since that time, the Board has given no further consideration to the matter.

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Present relations between Federal Reserve and BIS

The BIS has a dollar and a gold account with the Federal Reserve Bank of New York and frequently draws from the FRBNY short-term loans on gold collateral.

The Federal Reserve opened a dollar account with the BIS in 1931; this account was liquidated when the Federal Reserve credits to foreign central banks were repaid in the middle 'thirties.

The BIS has repeatedly offered gold "swaps" to the Federal Reserve but these offers have not been accepted.

Conforming to Article 20 of the BIS statutes, the BIS informs the Federal Reserve (through the FRBNY, which relays the information to the staff of the Board of Governors) of all planned operations involving U. S. dollars or operations in U. S. money, capital, or exchange markets. In a few instances, the Federal Reserve has used its statutory right of objecting to specific transactions or to certain types of transactions, such as dollar loans to unfriendly countries or payment of interest on dollar deposits in excess of the rates permitted under Regulation Q.

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Members of the Board of Governors and senior officials of the Board of Governors and of Federal Reserve Banks participate as observers in directors' meetings of the BIS from time to time, including usually the annual general meeting and some of the monthly meetings.

Legal problems of formal representation

In the BIS statutes, the terms "central bank" and "Governor" are so defined that they apply, in the United States, to the Federal Reserve Bank of New York and its President (Article 58, paras. 1 and 2).

It has always been understood that the Board of Governors would consider Federal Reserve representation on the board of directors of the BIS only if Article 58 was changed so as to substitute the Board of Governors and its Chairman for the FRBNY and its President and thus to make the Board Chairman the U. S. ex-officio member of the BIS board. Article 58 can be amended by simple majority of the general meeting of the BIS, if proposed by a two-thirds majority of its board of directors, so that no difficulties would be expected to arise on this score.

The BIS has called an extraordinary general meeting for October 9, 1961, to consider some amendments of the statutes. It

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might be possible to have the amendment of Article 58 added to the agenda of that meeting.

Some question has been raised as to the interpretation of the provisions of the Federal Reserve Act (Section 10, paras. 1 and 4), according to which the members of the Board of Governors have to devote "their entire time to the business of the Board" and must not be directors of "any bank /or/ banking institution." In a memorandum of February 2, 1950, Mr. Hackley has expressed his opinion that neither of these provisions would bar the appointment of a member of the Board of Governors as a director of the BIS, since such service would help the Board to discharge its responsibilities in the foreign field and since the BIS should not be considered a "banking institution" as defined in the Federal Reserve Act.

Advantages of Federal Reserve representation on the BIS board

Membership in the BIS board of directors would give the Federal Reserve more influence over BIS operations than it can exert by its veto power under Article 20 and its participation in informal

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discussion at occasional BIS meetings. These operations are substantial: BIS assets are at present in excess of $1.5 billion, as is shown in the attached condensed balance sheet. However, the Federal Reserve is presumably less concerned with these operations than with the wider problem of central bank cooperation.

From this more important point of view, membership in the BIS board of directors would be a symbol of the cooperative relations between the Federal Reserve and the major European central banks. It would evidence Federal Reserve willingness to cooperate in solving problems of international monetary policy, and thereby to contribute to a greater degree of mutual financial confidence.

The importance of giving such evidence at this time is underscored by general U. S. foreign economic policy, which is to foster as close a knitting together as possible of the economies within Europe and of the European and North American economies. As regards the European community, U. S. participation in OECD is one phase of this policy and formal Federal Reserve membership on the BIS directorate might well be another. In any case, foreign economic policy at this time provides

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a basis for fresh consideration of the role of the BIS as an instrument of closer cooperation at the central banking level between the U. S. and European countries.

Finally, assumption of formal membership would involve an obligation to have a member of the Board of Governors or his alternate and the President of the Federal Reserve Bank of New York or his alternate attend every year the ten meetings of the BIS board. Assumption of this obligation would strengthen the personal contacts of System officials with officials of European central banks and thus help to make for a firmer basis of cooperative activity and understanding.

Recommendation

The above reasons for Federal Reserve membership on the BIS board of directors would appear to provide ample justification for assumption now by the Board of Governors of such membership. Accordingly, it is recommended that the Board, after consulting with the Secretary of State and the Secretary of the Treasury, act to approve this membership as proposed by Messrs. Thomas and Marget in their memorandum of

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May 5, 1950, quoted above, and to authorize the Secretary to undertake the necessary negotiations to accomplish System representation on the BIS board of directors.

Attachment

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BANK FOR INTERNATIONAL SETTLEMENTS

Condensed Balance Sheet, June 30, 1961
(In millions of U. S. dollars 1/)

Assets		Liabilities	
Cash	34.7	Deposits:	
		Gold	672.7
Gold coins & bars	618.5	Others	743.2
Time deposits, bills & advances:		Others	14.7
Gold	37.3		
Others	827.9	Capital, surplus, reserves 2/	88.2
Others	0.4		
Total 3/	1,518.8	Total 3/	1,518.8

1/ Converted from gold francs at the rate of 32.67 cents per franc.

2/ Excludes that part of the bank's own funds which is invested in frozen German assets in consequence of the Hague Agreement of 1930 on German reparations ($22.2 million).

3/ Excludes assets held by the bank as agent for the OEEC under the European Monetary Agreement, as depositary for the European Coal and Steel Community and as trustee for international loans, as well as frozen assets and liabilities under the Hague Agreement of 1930 ($97 million).

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Asst Secy Int'l Aff Secy Under Secy Gen Counsel

C. Currency

Asst Secy Tax Policy

Asst Secy Commerce
Econ affairs Davis Schmidt

Ex. Pres. [illegible]
U.S. Director Int'l Bk
Ex-Import Bk
U.S. Tariff Com

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 9, 1962.

To Chairman Martin

From James L. Knipe

Subject: Paper on public criticism of the Federal Reserve System.

This is a re-do, amplification, and updating of my earlier outlines of the Staff Report of the Joint Economic Committee and the Monetary Commission's Report.

Very little analysis or rebuttal has been attempted, and not much comment has been made on the material reviewed. Essentially, it is just a job of codification and summary.

I see no particular reason to distribute the paper, because it is meant mainly to refresh your mind on some of the problems. However, after you have had an opportunity to read it, please let me know if you wish to have it distributed.

Attachment

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A SUMMARY OF THE PUBLIC CRITICISM

OF THE

FEDERAL RESERVE SYSTEM,

1959-1961.

February 9, 1962.

J.L.K.

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A SUMMARY OF THE PUBLIC CRITICISM

OF THE

FEDERAL RESERVE SYSTEM,

*

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CRITICISM OF THE FEDERAL RESERVE SYSTEM, 1959-'61

During the first forty years of the System's existence, from 1913 until 1953, it faced occasional outbursts of rather severe criticism but came through them apparently unscathed. During most of the later years of the period, 1940-1951, it avoided large-scale attacks by subordinating itself to Treasury dominance. During those forty years before 1953 the System had moved slowly, haltingly, toward the exercise of its function as a principal credit and monetary controller of the commercial banks of the United States. As it settled, after 1951, into this key role, the chances that it would be the target for strongly-expressed disparagement increased rapidly. An agency charged with recognizing the cyclical facts of life, and with attempting to maintain the integrity of the dollar, must be prepared to have its views and its actions challenged by many people and on many grounds.

In the postwar period, the first organized outburst on Capitol Hill was encountered in 1953, in connection with a small rise in Government security yields from the artificial levels which had been maintained during World War II and in the immediately following years. Political leaders belonging to the Democratic Party led the chorus of disapproval. In the next big debate, which took place just three years afterwards, in the spring of 1956, the more vocal critics were mainly political and business leaders belonging to the Republican Party. Their difference of opinion with the Federal Reserve revolved around the twin questions of whether or not the economy was going to remain on its high plateau, and what financial restraints, if any, should be placed on financial institutions by the

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monetary managers, as a part of their efforts to stop the continued deterioration of the purchasing power of the dollar.

Both of the forays, in 1953 and 1956, appeared to produce important short-run reactions in System policy, although this cannot be proven. The effects, if they really were effects, seemed to wear off each time within about half a year. As the System came into the summer of 1959, beginning of the latest series of turmoils, it showed no evidence of having had either its courage or its self-confidence weakened by the events of the preceding six years.

The most recent strife has covered a span of a little more than two years, from the spring of 1959 through the summer of 1961. First events of interest were the Hearings before the Joint Economic Committee, March-October 1959, and the last was Senator Paul H. Douglas' speech on the floor of the Senate, July 12, 1961. In between were other Hearings and other speeches. More important, two large books were produced, two books which will unquestionably stand as milestones of a sort in Federal Reserve history--the Staff Report of the Joint Economic Committee, and the Report of the Commission on Money and Credit.

The two years in question embraced the last part of the thrust and the entire plateau of the fourth postwar business cycle, the downswing of that cycle, and the beginning of the thrust of the fifth postwar cycle.

THE STAFF REPORT--JOINT ECONOMIC COMMITTEE--DECEMBER 1959

In the last week of 1959, the Joint Economic Committee published a document which received a great deal of attention, and which will be

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referred to, favorably and unfavorably, for years to come. The Staff Report of the Joint Economic Committee (Senator Douglas, Chairman; Representative Patman, Vice Chairman) was the outgrowth of Hearings which began on March 20, 1959, and concluded October 30, 1959. During the seven months of Hearings, one hundred witnesses were heard. Concurrently, more than twenty special study papers were written. These, added to the 488-page Staff Report, make an impressive shelf of evidence, analysis, and opinion.

It was only natural that the minority members of the Committee were something less than enthusiastic about the assemblage of material: 1/

> "In undertaking this study of employment, growth, and price levels, the Joint Economic Committee had a magnificent opportunity--a $200,000 opportunity--to define the issues, to identify gaps in our knowledge, to recommend agreed-on changes in public policy, to focus attention on the sources of disagreement, and to improve congressional and public understanding of the various goals of economic policy.
>
> "On the whole, the study itself was conducted in a competent and objective manner. The hearings were well balanced and at a high level. Many of the top economists of the profession contributed freely of their time, talents, and wisdom. A literature was assembled, both in the hearings and in the special studies, which reflects credit on the Committee, on its special staff, and on the economics profession. . . . .
>
> "These standards were not, unfortunately, maintained in the Committee's staff report . . . . We regret to say that, in our opinion, this report does not meet high professional

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standards. While there is much valuable material in it, it is marred by partisanship, by opinions and assertions not supported by the evidence, and by significant inconsistencies and serious omissions. We know from working with the special study staff that the report does not do justice to their individual and collective capacities. . . .

" . . . We deeply regret that the majority are presenting a report that is partisan, cavalier about simple rules of logic and evidence, and disrespectful of legitimate differences of values, opinions, and judgments. . . .

"Why should the time periods and terminal dates used in both staff and committee reports be invariably and obviously juggled to put the worst possible light on the record of the present administration, and exalt the record of previous Democratic administrations? . . .

"How can a whole new set of selective controls, a theme which runs through the report, be reconciled with recommendations to make the economy more flexible and responsive to consumer demands? How can the report find market power to be a cause of inflation, requiring more vigorous antitrust enforcement for business, and yet fail to meet squarely the question of market power in the hands of unions?"

The tone for the Hearings, and for the Staff Report, was set by Professor Sumner Slichter of Harvard, first witness on the first day. He scoffed at the worries about the loss of the dollar's purchasing power in the preceding years, and pointed out what seemed to him to be the virtue of inflation: 2/

"Creeping inflation is said to discourage saving. The opposite is true--inflation encourages saving. The reason is that the volume of saving is in the main determined by the volume of investment--not investment by the volume of saving. . . .

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> "I don't think that slow creeping inflation is an encouragement to speculation so much as an encouragement to enterprise. One good thing about creeping inflation to be set over against the problems it causes is that it is a tax, and it is a tax that falls on everyone. It is not a bad kind of tax in many respects. One thing I like about it is that there are no exemptions. . . . Fortunately under inflation they pay a little tax on everything."

The third witness also assisted in setting a tone which was scarcely reassuring for those who worried about such things as the injustice already done by inflation, and the dangers of large Federal deficits in the future. Mr. Leon H. Keyserling blasted at those who let themselves be bothered in this fashion and then went on to give what was probably the simplest answer in history to the question of how proposed great public-benefit programs would be financed: 3/

> "The Chairman: . . . How would you have the expenditures met, by taxation or by financing out of a deficit?
>
> "Mr. Keyserling: Here I would distinguish between short range and long range. In the long range, the tableau of economic growth which I have presented, and the policies which I blend into it . . . point the answer to your question . . . I finance it out of economic growth."

Representative Curtis, one of the members of the Committee, was not impressed and had difficulty in following the reasoning: 4/

> "Representative Curtis: . . . Your syllogisms are advanced by so many begged questions and based upon the debris of so many straw-men you have created and then demolished that it is hard to separate the ideas out."

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CRITICISM OF THE FEDERAL RESERVE SYSTEM, 1959-'61

While the general tone of the Staff Report may not be conducive to the development of great confidence in the financial wisdom of the authors, and many of the ideas put forward may seem unrealistic, naive, and politically slanted, the fact remains that a great deal of the writing is stimulative. The massive book is a must for those who would understand how some of the young economists were looking at the problems of the day. The top man was Dr. Otto Eckstein, 5/32, of Princeton (A.B., 1951; A.M., 1952) and Harvard (Ph.D., 1955). His doctoral dissertation had been on "Benefits and costs: studies in economics of public works evaluation," and his continuing research interest was listed as "Investment criteria for economic development; economics of water resource development."

Since the Report will be mentioned frequently in the pages to follow, it will be referred to as the "J.E.C. Staff Report," or, simply, "Staff Report." Also mentioned often, and related to the J.E.C. Staff Report, are the two reports published soon afterwards by the Committee. The first one, 6/ published on January 26, 1960, will be referred to as "Committee Report #1," and the second, 7/ published February 29, 1960, as "Committee Report #2."

REPORT OF THE MONETARY COMMISSION--JULY 1961

Second of the two books of criticism, albeit somewhat more realistic and constructive criticism in this case, was the report prepared by the Commission on Money and Credit.

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CRITICISM OF THE FEDERAL RESERVE SYSTEM, 1959-'61

The Commission was set up in 1958, apparently as a voluntary effort on the part of the Committee for Economic Development to compromise a behind-scenes debate in Washington between the Administration (Republican) and the Congress (Democratic) as to whether the financial system should be investigated by a private group or by a Government group. The C.E.D. separated the Commission from the C.E.D. (1) by having an intervening Selection Committee to choose the Commission, (2) by asking the Selection Committee to see that the Commission contained representation of the agricultural and labor viewpoints as well as of the business and financial, and (3) by using foundations as the main source of funds.

Mr. Frazar B. Wilde, of the Connecticut General Life Insurance Company, was Chairman of the twenty-seven man Commission. Every member of the Commission was a distinguished man in his field. Included were people like Marriner S. Eccles, Adolph A. Berle, Jr., Emil Rieve, David Rockefeller, Charles B. Shuman, J. Cameron Thompson, and Theodore O. Yntema. First announcement of the appointment of the Commission was dated May 1958, and the report was published in mid 1961. Three years and, it is said, well over a million dollars went into the work. Although the report itself contains less than three hundred pages, plans are said to be on foot to publish supporting material--largely papers from academic authors--which may run up to twenty or thirty volumes.

Professor Bertrand Fox, of Harvard's Graduate School of Business Administration, was Research Director, and Professor Eli Shapiro, of M.I.T.'s School of Industrial Management, was Deputy Research Director.

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Both worked only part-time at the jobs, commuting between Boston and New York. A small full-time staff was in the New York office. Professors Lester V. Chandler, of Princeton University, Paul A. Samuelson, of M.I.T., and Sumner H. Slichter, of Harvard, were three out of thirteen members of an Advisory Board. This Advisory Board cooperated closely with the Commission as a whole, as well as with the so-called Task Forces, six in number, into which the Commission divided itself.

From the beginning, it seemed likely that the Commission's contributions would be of a negative character, that is, agreement among the members would be reached more easily in connection with refusals to criticize than in connection with constructive proposals to change. This sort of thing is not to be despised, even though one would like to have more positive contributions from such an array of talent. Reasons behind a forecast of limited accomplishment were (1) the Selection Committee had leaned over so far in its anxiety to get a cross-section of viewpoints that it had made agreement on many things quite impossible, and (2) the top research people (part-time) and the advisers (part-time) would find it very difficult to condense the vast paper flow from the universities into constructive proposals which could be "sold" to the busy members when they assembled from time to time for meetings. It was clear, then, that the principal value of the final report might appear negatively, in the form of failure to condemn.

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Economists all over the United States were the beneficiaries of the contracts given to them for papers. It is possible that some of these papers may turn out to be useful, when and if they are published. Undoubtedly some, or perhaps many, of the authors resisted the temptation to polish up old papers and actually wrote new ones on their special fields of interest. It is also possible that some of the material furnished by organizations like the Treasury, the Board of Governors, the American Bankers Association, and the Life Insurance Association of America, may be of interest and value when it is made available to the public.

The report of the Commission will be cited often in the pages ahead, and it will be referred to as the "Monetary Commission Report." One should keep in mind that it was not published until a year and a half after the J.E.C. Staff Report, although preparations were organized nearly a year before the preparation began on the J.E.C. Staff Report. The J.E.C. Staff Report was in process only about nine months (March-December 1959), while the Monetary Commission Report was in process more than three years (early 1958-mid 1961). The Monetary Commission, therefore, had time to absorb everything that was in the J.E.C. Staff Report, in Committee Reports #1 and #2, and in all the other material of all kinds which appeared in 1958, 1959, 1960, and the first half of 1961.

It was generally understood that the issuance of the Monetary Commission Report was postponed until mid-1961 in order that it might

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appear at a decent interval after the inauguration of a new President. A careful reading of the book does not reveal anything which might not have appeared at any time, before or after an election, without creating any stir at all. Many hard, basic questions are either ignored or skimmed over with platitudes or with unrealistic assumptions. Recommendations are, generally speaking, neither new nor exciting.

Depending upon the reader's personal expectations for such studies, one might feel a sense of disappointment, and wonder how so much time and money could have produced results so meager. On the other hand, one can emphasize the usefulness of the negative accomplishment. Perhaps the failure to condemn most aspects of recent monetary policy is, in itself, a remarkable testimonial to the worthwhileness of the efforts of all the people who direct the financial activities of the country.

*

The two years of criticism of the Federal Reserve System, or rather of criticism related to the functioning of the System, may be grouped under eight headings. In every case, in the eight sections to follow, an attempt is made to give the central portion of the argument, along with some supporting references or quotations. The J.E.C. Staff Report and the Monetary Commission Report will, of course, be the most frequently-cited sources.

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CRITICISM OF THE FEDERAL RESERVE SYSTEM, 1959-'61

#1 - MONETARY POLICY IS NOT VERY EFFECTIVE IN THREE AREAS

An allegation relative to the ineffectiveness of monetary policy may be directed either toward monetary policy in general, any policy, or toward monetary policy in particular, as administered by the Federal Reserve. The group of allegations which are commented on just below are mostly aimed at monetary policy in general; they do not seem to be aimed directly at the Federal Reserve. However, they have to be examined, because they are nearly always encountered somewhere in every assault made on the System.

First, there is the matter of business inventories. The upward and downward movements in the levels of inventories are so large that they exert a significant pro-cyclical influence, it is contended in the J.E.C. Staff Report:8/

> "Changes in the rate of inventory accumulation and decumulation have been an important factor in business fluctuations in the United States during the postwar period. Inventory runups in boom times have set the stage for inventory disinvestment during periods of decline, and rapid inventory disinvestment has been an important factor in the recessions of 1949, 1953-54, and 1957-58. In the last recession, a decline in nonfarm business inventory investment (seasonally adjusted annual rate) from positive $1.7 billion to negative $8.1 billion--a drop of $9.8 billion--accounted for 58 per cent of the drop in gross national product from the peak in the third quarter of 1957 to the trough in the first quarter of 1958."

The statement is then flatly made that monetary policy does not, and apparently could not in the view of the J.E.C. staff, offer much in the way of a remedy:9/

> "In any case, there is certainly no evidence that monetary policy has had any appreciable effect

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"on inventory investment and its fluctuations
in the last few years."

Some of the reasons mentioned[10] for the inadequacy of monetary policy in this respect are that (1) interest is ordinarily not an important element of cost in holding inventories, (2) since this is a favorite type of loan in the eyes of most commercial bankers, it would be hard to restrain them from granting such loans, and (3) even if the commercial banks were restrained, the industrial companies could probably finance inventory investment by liquidating cash balances or by selling Government securities or by borrowing elsewhere.

As to remedies outside of general monetary policy, the J.E.C. staff reaches back,[11] half heartedly, for two old ideas. One is a variable secondary reserve requirement, which would permit governmental locking up or releasing of certain categories of banking assets. The other is the basing of reserve requirements of commercial banks on different types of assets, rather than on liabilities, thereby affording a new type of governmental control over the shifting of commercial banks' assets. Both proposals are beset with practical problems of administration which are great enough to give any practical banker the shakes.

It would seem that the Joint Economic Committee may have realized that its staff had been spending some time in a rarified, Utopian atmosphere, because in Committee Reports #1 and #2 inventories are not even mentioned.

When the Monetary Commission got around to contemplating the inventory matter, it commented on the nature of the problem for one-half page and then skittered away with:[12] "It may well be that more effective

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controls of such expenditures than general credit measures will be necessary to achieve our major economic objectives, and the Commission suggests that possible methods of influencing inventory and business equipment expenditures on a selective basis be investigated by the Government." The Commission evidently felt that the time, money, and talent at its disposal were not adequate to tackle the subject of how to control business expenditures on inventory through the use of financial mechanisms.

*

A similar situation presents itself in the case of business spending for plant and equipment. Businessmen and their bankers are eternally surprised when they discover every three or four years that there is a business cycle and that they have, by bunching their spending at the top and by unduly reducing it at the bottom, been the principal contributors to making the cycle. Sheep-like behavior of this sort is, in part, an inevitable result of a system of highly-capitalized production. If the country is to have the benefit of goods manufactured with complex machinery, it would seem that it must put up with the consequences of the guesswork involved in trying to estimate volumes in consumers' goods markets several years in advance. Not all of the imitative behavior of the industrial executives can be explained away in this fashion. Part of it comes from close contacts through trade associations and other group activities, plus their traditional competitive conformity. Whatever the origins of the unfortunate habits, the habits seem to be inextricably tied up with the magnificent dynamism of the American economy. Industrialists

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would unquestionably be less happy in the aggressive management of their plants if they were ever to lose the right to be wrong.

The J.E.C. staff finds, as it found in the matter of inventories, that general monetary policy is not very effective in exercising influence over the total volume of corporate expenditures for capital equipment:[13/]

> "It seems fair to conclude that while changes in interest rates and credit availability brought about by monetary policy have some marginal influence over business investment expenditures, these effects are so weak that they are commonly swamped by the dynamic forces of innovation, surging business activity, and rising profits . . . it is very doubtful whether restrictive monetary policy did more than touch the fringes of the private investment boom of 1955-57."

Evidence[14/] is marshalled by the staff to support the widely-recognized fact that the spending on plant and equipment is either not influenced much by interest rates or is actually influenced perversely, i.e., the spending increases as the cost of money goes up. Reasons are listed[15/] as follows: (1) a large percentage of the funds spent for plant and equipment are obtained internally, (2) the prospective returns from capital profits are ordinarily so high relative to returns on safe financial assets that the comparison is practically meaningless, (3) management does not have time, anyway, to familiarize itself with outside financial investments, and[16/] (4) "The existence of unexploited monopolistic profit opportunities permits such companies to raise prices to their customers in order to pass along any increased interest costs they may incur."

As to additional steps which might be taken, beyond the usual monetary actions, the staff does not come up[17/] with anything which seemed even to be satisfying to itself. After mentioning briefly the possibilities

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of reducing the deductibility of interest under the corporate income tax (to increase the influence of changes in the interest rate), and of re-imposing the tax on undistributed profits, they proceed to the thought that the Federal Reserve might take a more positive attitude toward influencing the long-term rate of interest through purchases and sales for the System portfolio.

In view of the severe criticism of so-called high interest rates throughout the entire Staff Report, the implications of this proposal would appear to be inconsistent with the rest of the Report in that the Federal Reserve would presumably be expected to try to run long-term interest rates up considerably higher than they have been at the tops of recent cycles. Evidently these considerations came to mind very quickly, because on the next page the writers back away from the proposal--mentioning the effects of such higher interest rates on State and local government financing, and concluding "On the whole, the institutional changes required, together with the problems which would arise and the fact it is by no means certain that the controls, even under the best circumstances, would be effective, make the feasibility of this approach seem rather doubtful."

Here is a classic example of the difficulty of finding soft answers to hard problems, in the staff's attempt to discover at least one way to restrain excesses in expenditures on plant and equipment. Higher interest rates, they point out, might help to restrain certain expenditures of which they (the writers) disapprove, but these rates might also help to restrain certain other expenditures of which they approve. How much simpler life would be for them if this great roaring beast of an

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economy would only lie still so that some of them could give it a stimulative hypodermic in one part of its body while colleagues simultaneously wrapped a tight elastic bandage around some other part.

Other suggestions which are mentioned[18] are a selective control over investment holdings of all financial institutions, a selective control over capital expenditures by a system of variable depreciation allowances, and a selective control over corporations through adjustments in their tax rates.

At the end of all of this meditation, the reader senses acute unhappiness on the part of the staff. This is an area which plays a vital role in the expanding American economy and it is an area in which clearly, to analysts of the staff, there is too much exercise of the prerogatives of freedom. And yet, they must admit that no centralized, specific control appears practicable:

> "We may conclude that, while the proposals referred to above and others as well are worthy of study, it is by no means clear that it would be either desirable or feasible to apply selective controls on plant and equipment. Some instability may be the price we have to pay for a generally high rate of capital development; moreover, it is by no means certain that controls would be effective in preventing instability."

The Joint Economic Committee again, as in the case of inventories, apparently came to the conclusion that its staff had been playing around with ideas which may have looked fine on paper but which might do more harm than good if tried out in the real world. Plant and equipment expenditures were barely mentioned in Committee Report #1, and were ignored completely in Committee Report #2.

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It has already been noted above that the Monetary Commission dismissed the whole subject with the suggestion that it ought to be investigated by the Government.

*

Last of the three areas in which monetary policy is labelled as ineffective is the field of consumer credit. As the total outstanding credit to consumers has soared to previously unbelievable heights, and as borrowing has become indispensable to so many millions of people in maintaining what they believe to be their proper standard of expenditure, it has clearly become an economic phenomenon of great importance. Growth of this practice of "spend now, save later" has made it possible for consumers to exercise some of the spending discretion formerly reserved for business executives, and so to engage in similar herd behavior. Mob action of any kind is always disruptive--whether it be on a ship, or on a street, or in the economy of a powerful industrial nation. The staff of the J.E.C. speaks bluntly:[19] "Consumer durable goods, particularly automobiles, have contributed significantly to economic instability during the postwar period." Two pages later: "Thus, it appears that it is the instability--the rapid accelerations and decelerations--in the growth of consumer credit rather than the high average rate of growth per se that constitutes the problems. Consumer credit has contributed to most of the fluctuations in economic activity since 1929."

The bad effects of too-rapid movements in consumer credit are emphasized with respect to the sequence of events in the years 1955

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through 1957: "A boom in consumer durable goods, especially automobiles, powered by a rapid growth of consumer credit, in 1955 seems clearly to have been a factor in the inflationary expansion of 1956 and 1957, both through its effect on profits and on the three-year wage settlement negotiated on the basis of them, and through its effect on other industries. Moreover, the excessive expansion in the automobile industry in that year set the stage for the unemployment and stagnation in that industry in the ensuing years . . . And, finally, the automobile expansion of 1955 undoubtedly helped to power the boom in plant and equipment in 1956 and 1957, which eventually resulted in overcapacity and unemployment."

As to the remedy, most economists in the United States are aware of the disillusionment of the Federal Reserve people in connection with enforcement of retail-type Regulation "W". They are also aware that the Federal Reserve has chosen not to take any leadership in working out plans for an entirely different, wholesale-type regulation. Very few economic thinkers would ever again advocate a retail-type regulation but probably a majority would go along with the J.E.C. Staff Report in proposing that consideration be given to a new approach to an important problem:[20]

> "For example, controls applied to the supply of funds to sales finance companies by limiting their borrowings might be more satisfactory if combined with similar controls over the ability of commercial banks to make consumer loans."

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In sharp contrast to the reticence shown by the Joint Economic Committee in following up its staff's ideas with regard to business inventories and capital expenditures, it spoke vigorously in Committee Report #1 on the subject of consumer credit:[21]

> "We recommend that legislation for standby regulation of the downpayment and of the maturity terms of consumer loans be enacted . . . sudden surges of consumer credit have from time to time been an important source of instability . . . . Further, the rapid rate of expansion of consumer loans in some periods has contributed to inflation through its effect both on prices and wages."

The Monetary Commission did not choose to take any stand on this vital subject. In its Report it was almost as casual and inconclusive as in the matter of business inventories and capital expenditures. After a rambling, one-page[22] discussion, the whole thing was dismissed:

> "The Commission is almost evenly divided as to the desirability of granting standby authority to the Federal Reserve Board for consumer credit controls. In the absence of a consensus, no recommendation is made except to urge an investigation of better forms of such controls which could be administered more effectively if they should be needed."

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A selective control over consumer credit, even if it were of a wholesale-type, and skillfully designed, is something which would likely

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be extremely unpopular unless the country were engaged in a major war. Even a prestigious, self-confident group like the Monetary Commission shied away from making any recommendation. On the Joint Economic Committee there were dissenting views expressed by Mr. Patman[23/], disagreeing with his own majority's recommendation. It would seem, therefore, as though the Federal Reserve will not have to face up to a strong demand for consumer credit controls within the very near future. If the System does not take it on itself to design an improved set of controls, however, it will be just as unprepared as everyone else when, and if, the controls become a necessity.

So far as the criticisms relative to business inventories and capital expenditures are concerned, it also seems obvious that no organized attack will develop within the predictable future. So, again, if the Federal Reserve wishes to procrastinate in its planning and testing until it faces an aroused public demand, or a national emergency, it can do so without any imminent danger of public embarrassment. If, on the contrary, the System wants to anticipate the problems of the coming years, it could assign some analysts' time to a thorough study of selective controls in the three areas where general monetary policy is alleged to be ineffective.

#2 - MONETARY POLICY IS TOO EFFECTIVE IN THREE OTHER AREAS

Some critics of monetary policy find that it is not very useful anywhere; they think it is always either too weak or too

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strong. The staff of the Joint Economic Committee was of that school. Apparently they felt that no matter how brilliantly monetary and credit controls might be managed, they are not up to the job in a modern economy:24/

> "It is quite plain that if general credit controls affected all sectors equally (in some sense), they would still be quite unsatisfactory as a stabilization device, because we do not want equal effects everywhere at all times. If we want to improve the performance of stabilization policy significantly, it is necessary to move in the direction of greater selectivity. This has been apparent for some time, but the other findings of this study should increase our awareness of it. General controls are a mirage and a delusion. It is perhaps just as well that monetary controls have not been very effective; if they had been, they might have been disastrous." (underlining supplied)

One of the fields in which the J.E.C. staff sees general monetary policy as having been too effective around the top of the business cycle is residential housing. They do not come by the opinion easily, because a look at the evidence leads one to judge that monetary policy has been successful in recent years in producing countercyclical movements in housing volumes:25/ "The interesting thing about these fluctuations is that they have been distinctly anticyclical, with residential construction rising when the rest of the economy was declining and declining when the rest of the economy was rising . . . residential construction has behaved in a contracyclical fashion and, in the aggregate at least, has contributed to economic stability."

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Having said these good words about monetary policy, the J.E.C. staff hastens to point out that this performance, satisfactory as it might look, was not good enough. Something nearer perfection might have been attained, they think:26/

> "What we know about the behavior of prices and wages in the construction industry suggests, however, that the cutback in housing construction in 1956 and 1957 may not have contributed much directly to the prevention of inflation. And the high level of unemployment in the construction industry during this period seems to indicate that much of the labor released from housing construction failed to find employment in other branches of the industry. These considerations suggest that if mortgage credit had been more liberally available, we might have been able to have somewhat more residential construction without very much more inflation. To be sure, there would probably have been somewhat more pressure on the prices of certain building materials that were in short supply and there would have been some additional inflationary pressure from the respending of the additional income generated in residential construction, but there is little reason to suppose that these effects would have been large."

Probably the main reason why housing volumes moved as they did in those years--a useful movement, it seemed to many analysts, but not useful enough in the eyes of the J.E.C. staff--was that the Federal Government sets interest rate ceilings on guaranteed loans:27/

> "The pronounced impact on housing since 1953 is chiefly due to the existence of a rather peculiar but very simple mechanism. Due to ceilings on the interest rates that may be charged on mortgages insured by the Federal Housing Administration and guaranteed by the Veterans' Administration, a rise in yields on other competitive types of investments, such as corporate and Government

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> securities, has tended to attract the supply of investment funds away from these mortgages. On the other hand, when credit conditions have eased and yields on competitive investments have fallen, the supply of investment funds has tended to flow back into the Government-supported mortgage programs."

Having developed this point that residential construction had responded satisfactorily, or perhaps too satisfactorily in the view of the writers, to general monetary policy, they then start to theorize as to what might happen (1) if the trend toward use of conventional mortgages were to speed up, and (2) if the ceilings on interest rates charged under Government-supported programs were to be removed. In such case, they contend,28/ "It does appear . . . residential construction would continue to show significant fluctuations. But instead of behaving in a contra-cyclical fashion, as has been the case in the last few years, it seems likely that the income effect would dominate and the fluctuations would be procyclical, thus contributing to over-all instability."

Postulating these altered conditions, the writers move over to the other side of the debate and, instead of implying that monetary policy has exercised too great a restraint on housing, they contend that a selective control is needed because,29/ ". . . housing construction is capable of powering an inflationary boom which would affect other sectors of the economy, and there should be some way of preventing this." After considering whether it would be better, if this situation were to be encountered, to ". . . keep the present interest rate limitations, recognizing them frankly as a selective credit control, and manipulating them accordingly, or to adopt another kind of selective regulation . . .",

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they come to the conclusion that ". . . it would probably be preferable to eliminate the interest rate ceilings and adopt the other form of controls. . . ."

Perhaps the Joint Economic Committee was able to follow the reasoning of its staff, which may be summarized as follows:

(a) General monetary controls have worked quite well,

(b) Really too well, but if interest rate ceilings on mortgages were removed,

(c) Monetary controls would not work so well, so

(d) A new system of controls must be devised to replace the "interest rate ceiling cum monetary controls" of the present.

On the other hand, possibly the Committee was not able to follow the reasoning. At any rate, the whole subject was accorded only the briefest mention in Committee Report #1:[30] "Present general tools primarily affect residential construction, as well as small business and State and local governments. Credit for consumers and the supply of funds for most business investment are very little affected by monetary policy. Therefore, the effect of the general policies has in fact been selective, penalizing the investment for housing, for schools, and for small business. . . ." The Committee's stance, therefore, is that monetary policy has been too effective with respect to housing, whereas the staff had labored principally to develop the thesis that it would not be effective enough after certain institutional changes which might possibly take place

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sometime in the future. The Committee does not mention the matter at all in Committee Report #2.

The Monetary Commission is equally brief and equally unclear in its treatment of residential construction. There is a weak statement on page 59, and a vague implication, on page 75, that the countercyclical movements of housing volumes in the last few years have been deemed to be satisfactory. There is another sentence on the same page which implies the desirability of some new kind of a selective control if interest rate ceilings are ever removed. On page 208, the Commission recommends the abolition of ceiling rates. However, on page 204, the Commission recommends "that the FHA and VA underwriting programs be used to aid in implementing the countercyclical and price-stabilizing policies of the government by variations in the terms of the underwritten loans . . . ."

It would appear as though the Federal Reserve will not be confronted by any well-organized, well-planned program of critical comment, from any source, in support of an allegation that general credit and monetary policy is too effective in the field of residential construction. If the ceiling rates are removed, though, at some time in the future, there would be need at that time for a Federal Reserve study of whether or not it would be wise to supplement monetary policy with additional control devices, in the field of housing.

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Another place where the J.E.C. staff finds monetary policy too effective in its restraint phase is with small business concerns. Obviously, insofar as smallness is associated with marginality of credit

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risk, smaller businesses will find it is somewhat harder for them to raise money at the top of the cycle than it is for their larger competitors. The same thing is true at the bottom of the cycle. Until the world is remade into one of perfect equality among all men and all corporations, this is not a startling discovery. Unless some great and manifest injustice is done in the process, the phenomenon is not one which justifies criticism of the central bank or of anyone else.

Even though one's common sense tells him that small businesses must always find money a bit harder to raise than do their larger competitors, the remarkable dispersion and penetration of banking services of the United States has gone a long way toward reducing the differential. As a result, evidence to sustain the thesis of abused small business--even if attention is directed only toward conventional banking facilities and the Federal Government's special programs are ignored--is not easy to assemble. As stated in the Staff Report:31/

> "However, as to whether there has in fact been such discrimination in the last few years, the evidence is mixed, difficult to interpret, and highly unsatisfactory."

An example of how hard the staff was straining to support its thesis of economic injustice worked on small business is this quotation from the Staff Report relative to interest rates:32/

> "It does appear that during this period interest rates on loans to large businesses rose substantially more than interest rates on loans to small businesses. In a sense, this was favorable to small businesses, but basically it probably hurt them by making loans to small business less attractive than loans to larger concerns."

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If the evidence had shown that the interest rates on loans to small business had risen more, rather than less, it seems likely that the same answer would have been found, i.e., that small business had been injured unfairly. When a group of analysts has decided on the way something should look, it is usually possible to move around until one sees it that way.

The conclusion drawn by the J.E.C. staff was not justified by the evidence adduced. It is simply an unsupported personal opinion:[33/] "That is, if monetary policy works chiefly through availability and if availability is not a problem for large firms, it follows that when monetary policy is effective in curtailing business spending, its impact must fall mainly on small business."

The Joint Economic Committee itself made only the scantiest reference to the matter, as quoted above in connection with residential construction.

The Monetary Commission Report discusses the matter briefly and on page 58 makes the fairly flat statement: "Bank credit rationing did occur and was not uniform. But the criticism for rationing did not appear to be size of firm."

The Federal Reserve should presumably always be alert to "discrimination," using the word in a reasonable way and without any suggestion of an attempt to impose an obligation for making noneconomic judgments on the private loaning institutions, but there seems to be no

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justification for expecting the System to undertake vast new studies in this area of the economy.

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The third area which bothers the J.E.C. staff is that of State and local public projects, schools, hospitals, and other public buildings. Here again, the staff[34] seems to be struggling with facts which either point in a direction which seems to them wrong, or else do not point at all. To cite one example: "Expenditures on new construction by State and local governments increased steadily during the period of tight credit in 1955-57--from $7.8 billion in 1954 to $9.7 billion in 1957." And another: "A study by the Investment Bankers Association, covering the 9-month period July 1956 to March 1957, indicated that about $0.5 billion of bonds were not sold as scheduled, but a substantial portion of these were reoffered and sold at a later date during the period." And still another: "There are signs that in some instances State and local governments . . . are becoming more sensitive to interest costs, but there are also a great many instances where interest rates do not influence decisions at all. In some cases, there are legal ceilings on interest rates that can be paid by governmental units, but apparently these ceilings are commonly set at 5 or 6 per cent and are thus high enough so that they do not interfere with the raising of funds."

Faced with these stubborn facts, it is necessary for them to look elsewhere to find some kind of backing for the thesis that general monetary policy had been too restrictive. An unfinished study is said to find evidence ". . . of systematic contracyclical behavior on the part of

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State and local government construction expenditures in recent years. This study . . . concludes that monetary policy has a contracyclical effect on State and local expenditures which is approximately one-third to one-fourth as great as the effect on residential construction." Clearly not satisfied with that scarcely damning indictment, a paragraph on school needs was inserted, concluding with this expression of opinion: "Thus, in a period in which school facilities were generally recognized as inadequate to begin with, in which there have been increasing increments to the school-age population, and in which construction costs have been rising sharply, we find an apparent decline in expenditures on school construction. One might surmise that the tight money that has prevailed during most of this period has had something to do with it."

If monetary policy had been unduly restrictive on State and local expenditures, the contention could not be proven by the evidence cited. It was surely prudent for the writers to insert a hedge clause at the end of their conclusion: "Aside from this sector (residential construction), the effects of monetary policy have probably been greatest on State and local government expenditures . . . although the evidence . . . is far from definitive."

It has already been mentioned that the Joint Economic Committee, in its Report #1, referred to this class of expenditures in only one sentence.

The Monetary Commission Report does not treat the subject at all.

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One must conclude that, on the basis of the evidence reviewed by the J.E.C. staff, there is no reason for the Federal Reserve to feel that general monetary policy has imposed, or is likely to impose, any unfair or unwarranted restrictions on State and local public projects.

#3 - THE FEDERAL RESERVE SYSTEM IS NOT EFFICIENTLY INTEGRATED INTO THE ADMINISTRATION.

The J.E.C. Staff Report did not take up for consideration the relationships between the Federal Reserve System and the Executive Branch of the Government. Neither did the Joint Economic Committee itself, in its two Reports. Congressman Wright Patman, however, never seems to tire of the theme and he periodically makes speeches, or issues statements, with regard to the situation as he sees it, regardless of whether or not the rest of the Committee majority expresses interest. A typical comment is contained in an appendix to Committee Report #1,[35] "The Supplemental Views of Representative Wright Patman":

> "The Federal Reserve System should be brought back into the Government from whence it has seceded, so that its economic policies may be coordinated with economic policies arrived at by constitutional means and so, too, that some branch of the Government--the executive or the Congress--will have political responsibility for its political decisions."

Mr. Patman touched on the same relationship when, on June 2, 1961, he was questioning[36] Mr. Alfred Hayes, president of the Federal Reserve Bank of New York:

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> Chairman Patman. . . . I think that the President of the United States, under the Constitution, is dutybound to take care that the laws are faithfully executed. The Federal Reserve Act is a law just like any other law, and since the President of the United States has asked you gentlemen, this is what I consider a direct statement to the Federal Reserve System, the Federal Reserve Board and the Open Market Committee, in particular, to, "Not choke off recovery . . ."
>
> Mr. Hayes. Let me say this, Mr. Patman, I have the utmost respect for the President and the utmost respect for anything he says. But I would also like to point out that in the wisdom of Congress they set up the system in such a way that the system is not under the instructions of the executive branch of the Government.
>
> Chairman Patman. Listen, you are seceding more than you have ever seceded. I thought you seceded pretty well on March 4, 1951, but you are going further, I think, than you did then.

The Monetary Commission, in its long deliberations, devoted a great deal of attention to the problem and brought forward some rather drastic proposals for changes. To say that the Monetary Commission had accepted the Patman view of what ought to be done would be an exaggeration, but to say that the Commission, apparently for quite different reasons, produced some comparable recommendations, would seem to be a fair statement. Certainly the Commission's recommendations, if followed, would move the relationships a long way toward making the System a directly-reporting department in the Presidential hierarchy.

A reader of the Monetary Commission Report gets the feeling that the Commission did a lot of soul-searching before it came to such a

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decision. For example, it pointed[37] out that: "A strong advocate for the claims of monetary stability is needed within the government, and the central bank is the natural home of such advocacy. A measure of independence from the Treasury with respect to support of the Treasury securities market is a requisite too, if the central bank is to exercise effective monetary control."

However, after looking at arguments on both sides of the question, the Commission concludes:[38]

> "No doubt there are occasions and types of pressure that need to be guarded against . . . The need for coordination, however, is very important. Isolation may mean weakness, and presidential support can be very helpful at times. The real ability of the System to influence national economic policy might well be increased rather than diminished if its ties to the President were closer. The Commission believes that somewhat closer ties are advisable."

Recommendations made by the Commission to bring about "somewhat closer ties" are six in number. It is impossible to know which, if any, may turn out as most likely to receive serious consideration by Congress or which would, if put into operation, bring about the most significant alteration in System practices. The order and grouping, below, represent the writer's effort to re-arrange the recommendations of the Commission somewhat more meaningfully than the way they are presented in the Report.

First, it is recommended[39] that ". . . the Employment Act be amended to provide that whenever in the President's judgment the current economic situation, as revealed over a span of time in the indicators

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issued from his Executive Office or on the basis of other information, shows a tendency significantly counter to the objectives set forth in the Employment Act as amended, and at least quarterly thereafter for so long as the unfavorable tendency prevails, the President shall supplement his annual Economic Report with a statement setting forth: 1. His understanding and assessment of the factors in the economy contributing to the unfavorable tendency. 2. The steps being taken by him and by government agencies, including the Federal Reserve System, to use existing instruments and resources available for better achieving the goals of the Employment Act as amended. 3. Explanations for any seemingly inconsistent use being made of any of these instruments . . ." This item #3, particularly, appears to be aimed directly at the Federal Reserve in connection with the allegation that the System is sometimes out of step with the rest of the Government.

Second, the Commission proposes[40/] that an Advisory Board be created by the President, perhaps with the Chairman of the Council of Economic Advisers as Chairman. Included in the membership would be the Chairman of the Board of Governors, and the Secretary of the Treasury. Since the meetings would be attended frequently by the President himself, the heads of the various agencies would feel obligated to put in personal appearances at each meeting. The Commission says: "This would make the CEA Chairman less than a cabinet member but more than an executive secretary . . ." Many people might feel that it would do even more toward enhancing the power and prestige of the CEA Chairman, largely at the expense

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of the power and prestige of the Secretary of the Treasury and the Chairman of the Board of Governors.

The third proposal[41] is regarded by some observers as the most important of the six. It is: "The FRB Chairman and Vice-Chairman should be designated by the President from among the Board's membership, to serve for four-year terms coterminous with the President's." Persons not familiar with a board's (Federal Reserve or any other Government board) functioning might doubt that this would be a vital change. They could cite the facts (1) that the Reserve Board Chairman's statutory powers are not great now, (2) that he is simply an equal among his peers in voting, and (3) that a new President might ordinarily choose from among members already on the Board. All of these are valid points, but several other points are missing. A new chairman of any board can always, even if he is lacking in ability and forcefulness, exercise a great deal of subtle control through such devices as (1) preparation of the agenda of meetings, (2) timing and duration of the meetings, (3) postponement or advancement of issues to be considered, (4) encouragement or discouragement of minority viewpoints, (5) delivering of speeches, granting of interviews, and carrying on of conversations outside, and (6) general supervision of staff material presented for consideration to his board. Therefore, the appointment of a chairman by an incoming President could conceivably, under circumstances easily visualized, be an important factor in changing the philosophy, policies, and practices of the Board of Governors of the Federal Reserve System.

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As a fourth recommendation, presumably related to the possibility of the Board's becoming more directly under the control of the President, the Commission suggests[42] a large increase in the Board's powers: "The determination of open market policies should be vested in the Board. . . The determination of the rediscount rate (the same for all Reserve banks) should be vested with the Board." In cutting down the power (or perhaps snuffing out the life) of the Open Market Committee, the Commission writes[43] with dogmatic confidence on a subject which is not that simple: ". . . the distinction between the Board and the Federal Open Market Committee has outlived its usefulness. The exercise of the System's three main powers should be complementary and governed by the same considerations, that is, by the same people in the same forum . . . the decisions of the Board are exercises of public regulatory authority, and there should be no ambiguity about where the responsibility for them lies: it belongs exclusively in the hands of public officials." The Report does not comment on the relative economic competence likely to be expected of the men in the two groups, Presidents and Board, or on whether or not there is an advantage in having some votes cast by men whose base of operations is outside of Washington.

The fifth proposal[44] would, among other things, make it easier for the President to name appointees to the Board as he pleased: "Occupational and geographical qualifications for Board members should be eliminated. Instead the statute should stipulate that members shall be positively qualified by experience or education, competence, independence, and objectivity commensurate with the increased responsibilities recommended for

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them in the achievement of low levels of unemployment, an adequate rate of economic growth, and reasonable stability of price levels . . ."

As the sixth recommendation:[45] "The FRB should consist of five members, with overlapping ten-year terms, one expiring each odd-numbered year; members should be eligible for reappointment. This would assure the President of one vacancy to be filled shortly after his inauguration . . ."

There could not be much doubt that these six recommendations, if accepted by Congress, would bring about "somewhat closer ties." It is clear that, in the Commission's opinion, this is a good thing. The Commission rejected[46] some of the counter-arguments, with what reads like scorn: "Some arguments for independence are more or less frankly anti-democratic in their premises. For example, it is said that anti-inflationary measures are unpopular though necessary, and therefore the best assurance of being taken is by 'endowing the Board of Governors with a considerable degree of independence,' or that 'hard' decisions are more acceptable to the public 'if they are decided by public officials who, like the members of the judiciary, are removed from immediate pressure.'" Other students of the art of practical politics may see more to such arguments than was visible to the Commission.

The six recommendations put forward by the Monetary Commission might be taken more lightly if they had come from a group within which there was known to exist a pro-inflation, anti-sound-money bias. A group of that sort would be expected to want to change the Federal Reserve

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structure in drastic fashion. Coming from a group which seems to have approved, in general, the System's economic policies of recent years, and which would appear to be anything but anti-sound-money, the suggestions must be regarded as deserving of close study. Surely it has to be assumed that the Commission felt that the System could function more smoothly and could continue to do its job with unimpaired efficiency only if it were thus brought more closely under the immediate direction and "protection" of the President of the United States.

#4 - THE FEDERAL RESERVE SYSTEM IS NOT ORGANIZED TO FUNCTION EFFICIENTLY.

As sketched in the preceding section, the criticisms and suggestions as to the System's place within the governmental scheme of things have largely originated with the Monetary Commission and with Mr. Patman, rather than with the Joint Economic Committee or its staff. As one moves down into the internal organization of the System, and into its day-to-day operations, the ideas about weaknesses, and needed changes, are furnished both by the staff of the Committee and by the Monetary Commission.

The distribution of powers within the System, as well as the functioning of the Federal Open Market Committee, are not considered entirely satisfactory by the Joint Economic Committee's staff:[47] "The present administrative arrangements within the Federal Reserve seem to be unduly cumbersome. Primary responsibility with respect to the discount rate lies with the individual Federal Reserve banks; changes in reserve requirements are made by the Board of Governors; and open market policy is administered by the Federal Open Market Committee. . ." No words are

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wasted in the Report's flat recommendation: ". . . it would be desirable to put the administration of all the credit control weapons in the hands of the same agency."

Another organizational feature which the staff does not like is the way in which the Open Market Committee functions. How a commentator can write with such confidence about something with which he could have had no direct experience is an interesting question.

> "A body of 12 members is a rather cumbersome administrative organ, and the clumsiness is greatly increased by the presence of numerous other persons. Some streamlining of this complex machinery would seem to be in order. It seems possible that some of the self-imposed limitations on the System's freedom of action, such as the bills-only policy, are the result of arriving at decisions on complex matters under such conditions. Perhaps a reduction of the size of the Board of Governors and the concentration of authority with respect to all of the policy weapons in the hands of this group, with representatives of the Reserve banks serving only in an unofficial advisory capacity (if at all) would be desirable. Some reform along these lines is vitally necessary if a more complex policy involving the use of selective controls is to be put into operation."

In item #4 of the section just preceding this one, a quotation[48/] from the Monetary Commission Report showed that the Commission essentially accepted the J.E.C. staff's viewpoint on the Federal Open Market Committee, the distribution of powers, and what ought to be done about these things.

The Monetary Commission, though, goes far beyond the area covered by the J.E.C. staff, into the operations of the Board. Here the Commission speaks with the authority of men who are chief executive officers of large and profitable business enterprises:[49/]

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". . . the Board has suffered from a malady that has plagued the other independent regulatory commissions, a congestion of detailed business at the top, to the detriment of the time and energy Board members can devote to the broad issues of monetary policy.

"The FRB Chairman should be the chief executive officer of the Board, empowered to handle administrative matters. The law should be clarified to authorize the Board to delegate to Board committees, or to Board members individually, or to senior staff officers of the Board, any of its functions in the administration of its powers in regard to the supervision of the banking structure, such as the Bank Holding Company Act, the anti-trust laws in regard to mergers, and applications for charters and branches . . ."

Another matter of operational efficiency is the reporting which the Federal Open Market Committee and the Board do, to the Congress and to the public. Although neither the J.E.C. staff nor the Committee dealt with this subject, Mr. Patman has done so, as has the Monetary Commission. In the Hearings[50] before the Joint Economic Committee, June 1, 1961, Mr. Patman was questioning Mr. Martin:

Chairman Patman. . . . I do not see how the ordinary, average person could possibly interpret what the language means. It is really, and I say this respectfully, it is gobbledygook.

The Monetary Commission stresses the necessity for timeliness and completeness, and by implication clarity, in the reports issued by the System:[51]

"The case for more complete and timely disclosure is partly that accurate information would perhaps be less dangerous than the rumors that are continuously circulating about what the Federal Reserve policy is today or is likely to

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be next week. In the absence of adequate knowledge, those interested in such matters have a tendency to seize upon even the most outlandish rumors as significant . . . Another argument for more complete disclosure is that monetary policy represents one facet of national economic policy, and in a democratic society public policies should be subject to current debate.

"Although there is no easy solution to this issue, the Commission believes that the Federal Reserve should follow the general rule that the public should be kept informed with reasonable promptness and with reasonable detail of the reasons for its major policy decisions and actions in order to avoid misunderstanding and misinterpretation."

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When it comes to consideration of the way in which the System functions, it can be seen that there is a large amount of agreement between the economists on the Joint Economic Committee's staff and the business and professional leaders on the Monetary Commission. Both groups question certain organizational patterns and operating practices, although the Monetary Commission probes much deeper. The Monetary Commission also takes a strong stand with respect to the desirability of more and better reporting.

#5 - FEDERAL RESERVE OPERATIONAL RESULTS ARE HANDICAPPED BY SLIPPAGES, TIME LAGS, INADEQUACIES, AND AMBIGUITIES.

The criticisms noted in this section under "slippages," "time lags," and "ambiguities" are, generally speaking, ones which might apply to any central bank's operations and so tend to be arguments either for greater use of selective controls or for the wider use of automatic or semi-automatic devices. Under "inadequacies," the Federal Reserve's so-called "Bills Only" policy is examined.

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First, the matter of "slippages."[52] One line of thought which intrigues some critics of the Federal Reserve is to the effect that the financial community is so clever that it can often successfully nullify or delay the effects of policy action taken by the Board or by the Federal Open Market Committee. Sometimes the same commentators will be heard five minutes later declaiming on the unholy power of the Federal Reserve, with no apparent comprehension of their inconsistency.

In the Staff Report, these so-called "slippages" are commented on at some length, with understanding, and without any accompanying proposals to try to do away with them or to attempt anything impractical in the way of counteracting them. One gets the impression that the staff is realistic in contemplating the "slippages"--aware that even so gentle and general a control as that exercised through a gradually-tightened reserve position would probably be disturbing if the financial community were not able to counteract its application to some degree. The most obvious of these actions which can be taken is the borrowing by member banks from the Federal Reserve, thereby temporarily maintaining a level of total reserves at a time when the System is lowering the level of non-borrowed reserves. This is not mentioned among the "slippages" in the Report, because the writers are addressing themselves to the various ways by which the business community itself steps up the efficiency with which it employs its cash, i.e., increases the velocity of the available money supply and thereby counterbalances the effect of a reduced or unchanged supply of money. The principal actions which result in more efficient use

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of money are shifts in portfolio composition between various investing groups in such a way as to produce maximum turnover of cash balances. The most meaningful of the shifts is probably that made by the commercial banks when they sell large quantities of Government securities in order to add to their loan totals.

The Staff Report concludes:[53]

> "There is not much that can be done about this propensity of the financial system to be ingenious. It is a matter of numerous small adjustments, frequently quantitatively unimportant individually, but cumulatively constituting a significant 'slippage' in our monetary controls. Moreover, it would probably be unwise to interfere with these developments even if it were possible to do so, since they have served to increase the mobility of funds, reduced interest rate differentials, and caused the market mechanism to perform more efficiently . . ."

The Monetary Commission Report does not give much space to this matter. In the discussion of whether or not the Federal Reserve should be given control over nonbank financial institutions, it is stated:[54] "The evidence, for either the cyclical or the secular periods, does not support a case for an extension of the direct monetary controls over nonbank financial intermediaries. Their contribution to cyclical changes in velocity appears to be too small to warrant such an extension. Their effect on velocity over the long run can easily be taken into account in regulating the long-run monetary supply."

"Time lags" are, of course, related to "slippages," but a number of other aspects of the problem also have to be pondered. The

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first, and perhaps the most important, time lag is that between the true beginning of a new cyclical direction and the time when the Federal Reserve System recognizes the new direction. In the Report this is not mentioned, perhaps out of courteous sympathy for the extremely difficult task which the Federal Reserve must constantly undertake in its effort to keep abreast of economic direction changes in their earliest stages. The time lags which are listed[55/] are those (1) between the action of the Federal Reserve and the action's influence on the effective money supply, remembering the "slippages," and (2) in the various industries, between the time when credit availability or interest rate changes occur and when they finally begin to have a bearing on production and employment.

As in the case of "slippages," the Staff Report does not appear to regard these phenomena as anything to criticize, but, rather, as facts of life which must be taken into consideration in any evaluation of the merits of general monetary policy. In view of the writers' dim view of these merits, it may be assumed that, without specifically saying so, they regard the slippages and time lags as just two more groups of operational shortcomings in a machine of doubtful utility.

In the Monetary Commission Report, a very brief passage[56/] on time lags serves as an introduction to what the Commission regards as an inadequacy--the Federal Reserve's refusal (at least up until February 1961) to admit that it wished to influence the pattern of interest rates:[57/] ". . . a more direct and immediate pressure on long rates can be brought to bear by both Treasury and Federal Reserve sales of the long-term

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securities . . . the effectiveness of monetary policy on the downswing will be increased if the Treasury and the Federal Reserve take direct action to reduce long-term as well as short-term interest rates."

A specific recommendation is made by the Commission: 58/ "Instead of relying on a 'bills-only' policy, the Federal Reserve should be willing, when domestic or international conditions warrant, to influence directly the structure as well as the level of interest rates in pursuit of countercyclical monetary policies and should deal in securities of varied maturities. This recommendation does not mean a return to a pegged structure of prices and yields for government securities. And the normal use of open market operations in bills to carry out technical and seasonal changes in bank reserves is appropriate."

In taking the stand, the Monetary Commission is in line with others who have, over the years, suggested that the System modify its so-called "bills only" or "bills preferably" philosophy. The J.E.C. Staff Report did not give much space to its analysis, but wound up with a firm recommendation: 59/ "The bills-only policy should be abandoned in the interest of eliminating meaningless fluctuations of the prices of Government securities, as well as to increase the effectiveness of monetary policy."

The Joint Economic Committee, in its Report #1, went far beyond anything which its staff had proposed. 60/ "We are advocating that the Federal Reserve System assume responsibility for the orderly behavior of our credit markets." Moving still farther along the same path, and only

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two paragraphs later: "In 1951, the Federal Reserve held almost $5 billion in long-term bonds which was 21.5 percent of its total portfolio holdings of $22.7 billion. As of the end of October 1959, the Federal Reserve held only $1.5 billion in long-term bonds which was only 5.7 percent of its total portfolio of $26.3 billion. There is no reason why the present ratio should not be improved."

Apparently fascinated by the thought of all those prospective billions of long-term bonds vanishing from the market into the portfolio of the Federal Reserve, the Committee made one more suggestion: 61/ "Another concept is that of expanding the Federal Reserve System portfolio, upon which the fractional reserve system operates, by 3 percent per year. As the Federal Reserve now holds slightly more than $25 billion in Government securities, such an expansion would require the purchase of about $750 million of Government securities in the first year . . . it would appear that the purchase of long-term securities for this purpose would be warranted. This would help to lengthen the debt structure, increase the price of bonds, and have the effect of lowering the long-term interest rate." Adding emphasis to this point, the Joint Economic Committee, in its Report #2, listed as its first major recommendation: 62/ "The Federal Reserve should . . . abandon its discredited 'bills only' policy."

The System may have taken the sting out of these attacks by doing what the critics have been demanding for so long, i.e., dropping the "bills only" policy. Since February 1961, purchases for the portfolio have included a substantial volume of short maturities other than bills,

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as well as some longer securities. However, no one outside the System knows whether this is a permanent or a temporary practice. Neither does anyone outside know whether or not the System plans to sell part or all of these securities at some point in some cycle. For that matter, no one on the outside knows whether the System has had, or now has, any specific plan or philosophy of any kind for the whole operation.

*

As an ambiguity in Federal Reserve use of its tools, the J.E.C. Staff Report mentions the discount rate: 63/ "Sometimes discount-rate changes are apparently meant to serve as signals of the System's intentions, while at other times the rate is changed merely to keep it in alinement with prior changes in market rates of interest. It is not always clear when a change in the rate is meant to be a signal and when it merely represents a passive adjustment to the market."

Two alternatives are proposed by the J.E.C. staff: 64/ "Since 1956 the Bank of Canada has kept its discount rate linked to open market interest rates by setting the rate each week one-quarter percent above the average issue rate at the most recent Treasury bill auction. This arrangement avoids the ambiguities that arise in connection with the interpretation of the significance of discretionary changes in the discount rate and automatically preserves a consistent relationship with other interest rates. It appears to have much to recommend it in the United States. An alternative that might be considered would be to get rid of rediscounting altogether and rely on interbank borrowing to perform the safety valve function now performed by borrowing from the Federal Reserve."

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One more suggestion is broached, two pages later: ". . . there seems to be no sensible reason for leaving the initiative with respect to the discount rate in the hands of the individual Reserve banks, assuming that discretionary discount rate changes continue to be employed."

The Joint Economic Committee clearly approved of its staff's work in this area, and spoke strongly on the matter in Committee Report #1. 65/ "Rediscounting should be eliminated as a general practice . . . in the postwar period it has been demonstrated again that rediscount arrangements are a source of trouble. They provide a way by which banks can offset monetary restraint . . . If rediscounting is not eliminated entirely, at least the use of the rediscount rate as an influence on interest rates should be. The rediscount rate should be made a penalty rate, and only adjusted for the purpose of keeping it so."

The Monetary Commission rejects the thought that rediscounting should be eliminated: 66/ "The argument for retaining the privilege is that it provides a smoother means of adjustment to temporary and local situations than would be available otherwise, and that any slippage in the process of general monetary restraint can be easily offset by open market operations."

Meditating on the use of the discount rate, and on the way in which it is set, the Commission finds that: 67/ ". . . because market rates move continuously whereas changes in the discount rate are made infrequently, the relationship between the discount rate and market rates varies. Changes in this differential often have effects that tend to counter those pursued by open market operations." (underlining supplied)

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One would think that a comment to the effect that the discount rate had been so used that it often opposed, rather than complemented, open market policy, would lead the Monetary Commission to a strong conclusion, perhaps similar to that of the Joint Economic Committee. This does not happen, though, and the Commission lamely concludes: 68/ "If the Federal Reserve chooses to do so, it can now change the rates weekly, and it can inform the public directly whenever a given change represents a basic shift in policy rather than a technical readjustment. The Commission favors the fully discretionary system and urges that it be administered to avoid effects counter to those sought by open market operations." All that is then added to this hopeful admonition is a suggestion that the discount rate be nationally the same.

*

Out of this group of subjects for criticism, it is possible to guess that the Federal Reserve will not experience any severe challenges unless it fails to establish clearly that it has thrown overboard the so-called "Bills Only" philosophy. As to the use of the discount rate, the System will not, it would seem, ever be forced by outside pressures to institute a change--however badly the change might be needed. Political leaders probably will not apply the pressure, because the issue is a "hard" one, rather than an attractive "soft" one. Business, professional, and labor groups, like the Monetary Commission, will not exert severe pressures either, possibly for more or less similar reasons, or perhaps because they hesitate to object to a practice so long sanctioned in the financial folklore.

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#6 - THE FEDERAL RESERVE IS UNDULY, AND WRONGLY, INFLUENCED BY PRIVATE BANKING INTERESTS

When an organization has gone through forty-eight years of financial leadership without a hint of scandal, it is surprising to find that a thread of criticism based on suspicion or anticipation of skullduggery should appear. Principal weaver of the thread is Congressman Wright Patman, but he occasionally finds support among other figures on the Hill. The place where the suspicions take their most definite form is in the matter of the way the Board has made use of its power to alter reserve requirements during the last eight years.

The tone which is encountered in this thread of criticism is illustrated in a colloquy between Chairman Patman and a witness, Mr. Robert G. Rouse, of the New York Reserve Bank, at the Hearings before the Joint Economic Committee, June 1, 1961.[69/] Mr. Patman is referring to the five presidents of the Reserve Banks who serve as members of the Federal Open Market Committee, as well as to the other seven presidents who sit in the meetings as guests:

> Chairman Patman. . . . the five presidents have more of a private, profitmaking, almost a selfish interest, as compared to the public members. The public is, therefore, required to accept the judgment of people who have an ax to grind . . . I think Congress made a terrible mistake when it allowed representatives of private banks to be on these policy-making boards that fix the interest rates and the supply of money and things like that . . . it (the will of Congress) is disregarded when they bring in all 12 of the presidents, each one of them having an ax to grind . . .

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A year and a half earlier, in January 1960, Mr. Patman had introduced a bill (H.R. 9511, January 11, 1960) which showed how distrustful he was of Federal Reserve motivations. The bill provided for the transfer to the Secretary of the Treasury of $15 billion of Government securities held by the Federal Reserve Banks, in return for a nontransferable, non-interest-bearing demand note of the United States in the same amount. After going over his reasons for introducing the bill, he said:[70/] ". . . the present Federal Reserve authorities have a way of taking the bit into their own teeth and doing what they please to do, notwithstanding laws and expressions of congressional intent. They have come to believe that the Federal Reserve System is a fourth branch of the Government which stands over and above the three constitutional branches of Government . . . they feel that they are not subject to the laws that govern mortal men. So, just in case the Federal Reserve authorities get it into their heads to reduce their holdings of Federal securities despite the recent and clear congressional mandate to the contrary, having $15 billion less of marketable Government debt obligations would make such an idea much less tempting. At least there would be $15 billion less of Government securities which could be given away."

The same attitude is displayed in the keen enjoyment he seems to take in getting officials of the System to deny that the stock of the Federal Reserve Banks is really a stock at all, and to affirm that the Reserve Banks are not, therefore, really owned by their stockholders. Mr. Patman had Mr. Carl Allen, president of the Federal Reserve Bank of

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Chicago, on the stand on June 6, 1960, and quoted to him a statement by Mr. Fred Wilson, former assistant vice president of the Chicago Bank, to the effect that Federal Reserve Banks are owned by the member banks:71/

> Mr. Patman. . . . So there is a newspaper quotation from your very first assistant, Mr. Allen, saying that the Federal Reserve Bank is owned lock, stock, and barrel by the member banks. Now you don't agree with that, do you?
>
> Mr. Allen. I do not.

On June 10, Representative Oliver, of the same subcommittee, embarked on a series of similar questions with Mr. Alfred Hayes, president of the Federal Reserve Bank of New York. Oliver quoted72/ several standard economics textbooks, one after another, all stating, of course, that the Federal Reserve System is privately owned by the member banks. In each case Hayes said that he did not agree with the quoted passage, or words to that effect. The series of repudiations ended with:

> Mr. Oliver. Another one . . . is entitled "Money and Banking" by Weldom Wefling, American Institute of Banking, American Bankers Association, published in 1958, and here the statement is categoric: The member banks own the 12 Federal Reserve banks.
>
> Mr. Hayes. That I would disagree with entirely.

It would appear that the general lack of confidence as to motives, which Mr. Patman has expressed so frequently, and in so many different ways, lies behind the criticism leveled at the System for the manner in which it has employed the reserve-requirement tool in carrying out monetary policy during the last eight years.

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CRITICISM OF THE FEDERAL RESERVE SYSTEM, 1959-'61

The Federal Reserve System always has a choice of two methods when it wishes to ease or restrain the credit situation, i.e., it can work the desired effects either through the use of open market transactions (ordered by the Open Market Committee) or through altering reserve requirements (ordered by the Board of Governors). Essentially similar end-results are brought about in either case, although endless debates are carried on among economists as to speed of accomplishment, side effects, and so forth. When easing is done through reducing reserve requirements, the commercial banks do not initially sell any securities to the Federal Reserve and so retain earning power from these securities, earning power which would otherwise go to the Federal Reserve and eventually back to the Treasury. On the other hand, when restraint is imposed through raising reserve requirements, the commercial banks do not initially purchase any securities from the Federal Reserve and so do not benefit by obtaining earning power from the securities. Instead, the System continues to enjoy the earning power from the securities.

Obviously, the commercial banks would like for the System to ease by reducing reserve requirements and to firm by engaging in open market selling. Conversely, those who feel that the commercial banks need no largesse of this sort would ordinarily prefer that the System ease by engaging in open market purchasing and firm by raising reserve requirements. Arithmetical illustrations, simplified, will make clear the sort of sums involved.

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Assume that it was decided to try to ease by expanding commercial banks' liabilities (deposits) by $6 billion, over a period of several months. If the Board were to order reserve requirements lowered by $1 billion, the commercial banks would presumably then go out and add loans and investments in the amount of about $6 billion, thereby also increasing liabilities (almost entirely in deposits) by the same $6 billion. Assume that it was decided, a year later, to try to impose restraint by contracting commercial banks' liabilities (deposits) by $6 billion, over a period of several months. If the Open Market Committee were to order the sale of $1 billion of securities to the commercial banks, their reserves would be reduced by $1 billion, and they would presumably contract their total of loans and investments by a gross amount of $6 billion, making a net reduction of $5 billion, considering the purchases just made from the Federal Reserve. Back at the same deposit level from which they had started, the commercial banks would have gained by the substitution of $1 billion of Government securities, purchased from the Federal Reserve, for an equal amount of non-interest-bearing reserve balances. This is an attractive sequence of events for commercial bankers.

Reversing the order of use of the two monetary tools, assume that the easing had been carried out through open market operations, the purchase of $1 billion of securities by the Federal Reserve from the commercial banks. The earning power of the $1 billion of securities would, from then on, flow to the Federal Reserve, and thence on to the Treasury,

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instead of to the former owners, the commercial banks. The banks would presumably go out and add loans and investments in the amount of $6 billion. Deducting the $1 billion of securities previously sold to the Federal Reserve, their portfolio increase would amount to $5 billion, but their total assets would be up $6 billion when their added reserves were included. Their total liabilities (almost entirely in deposits) would have grown by the same $6 billion. Assume that it was decided, a year later, to try to impose restraint by contracting commercial banks' liabilities (deposits) by $6 billion, over a period of several months. If the Federal Reserve Board were to order reserve requirements increased by $1 billion, the commercial banks would presumably contract their total of loans and investments by about $6 billion. Back at the same deposit level from which they had started, the commercial banks would have lost earning assets in the amount of $1 billion of Government securities sold to the Federal Reserve. This reversed sequence of events would not be one to gladden the hearts of commercial bankers.

If both easing and firming were carried on with the same tool--either open market operations or changed reserve requirements--the commercial banks would neither gain nor lose over the cycle in the manner illustrated above.

Anyone who feels that the commercial banks are earning an adequate return on their capital funds would tend, other things being equal, to favor a practice of the System's using open market operations to ease and reserve requirement increases to firm. This sequence brings

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in some revenue to the Government and takes away some revenue from the commercial banks. Those who feel, on the contrary, that the commercial banks are needful and deserving of special favors would tend, other things being equal, to vote for the practice of using reserve requirement reductions to ease and open market operations to firm. This is what the Federal Reserve has done in recent years, explaining its actions by saying that, in its opinion, 73/ there are certain advantages of diffusion, flexibility, effectiveness, etc. in following the course it has followed. A skeptic who might question these unproven expressions of opinion would find it equally impossible to support his argument with facts. He, too, would have to rely on opinion, and his opinion might be founded on less experience than that of the System's executives.

As one more item of factual information to serve as background for a brief sketch of the critical comments, member bank earning rates in recent years are listed below: 74/

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MEMBER BANK EARNINGS

Net after taxes and
after all charges

As a percentage of average total capital accounts,
and in millions of dollars

	Percentage on Capital	In millions of dollars
1949	7.6%	686
1950	8.3%	781
1951	7.6%	756
1952	7.9%	829
1953	7.8%	865
1954	9.3%	1,096
1955	7.9%	985
1956	7.7%	1,027
1957	8.3%	1,169
1958	9.7%	1,457
1959	7.9%	1,257
1960	10.0%	1,689

One may start the sketch with the concluding portion of an extended colloquy[75] between Chairman Douglas of the Joint Economic Committee and Chairman Martin of the Board of Governors of the Federal Reserve System, on July 30, 1959, at a hearing before the Joint Economic Committee. The two distinguished gentlemen were not able to get together in the questioning and answering:[76]

> The Chairman. Mr. Martin, to come back to this original point, which I think is very important, if the two methods give the same ultimate result which you admit, but one of them in the process yields a gain to the Federal Reserve and to the Government of an average of $500,000 a year, and added interest earnings which accumulate as

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additional amounts, why not take the method which, giving the same ultimate result, yields large capital gains and large increases in net revenue to the Government.

Mr. Martin. Because, Senator, we are not dealing with ultimate results. We are not dealing with a mathematical equation that comes out at a certain point. We are dealing with a flow of money of a continuous nature. It just is not, in my judgment, an easy matter, nor is it correct to say that you can regulate that flow just as effectively by something that will come out with an end result in terms of benefit to the Treasury or benefit to the banks.

Six months later, on February 2, 1960, before the same Committee, the same two had the same difficulty in making any progress toward an area of mutual understanding:77/

The Chairman. Now, is it not true that you can get the same result in expansion of the monetary medium by open market operations as you can by lowering reserve ratios?

Mr. Martin. At a time of recession; no, sir.

The Chairman. But I mean over the long run. In normal periods.

Mr. Martin. Leaving out recession or boom--but that is what we are usually dealing with, one of the two. If you want to put it in long-run mathematical terms, I would say the answer is "yes."

The Chairman. In a normal period?

Mr. Martin. In a normal period. But I merely point out that we have had practically no normal periods.

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The Chairman. Well, there must be some normal period.

Mr. Martin. Well, I must say my job would be a lot easier if I could get a few.

The Chairman. It is either abnormal up or abnormal down? There is no abnormal down?

Mr. Martin. That has been the experience. And I think it would be a lot easier for me if we had more normal periods.

The Chairman. Mr. Martin, I want to suggest that I think you are obscuring fundamentally the intellectual issue. Is it not true that you can get substantially the same increase by open market operations, which will increase member bank reserves, as you can by lowering reserve ratios . . . ?

In the J.E.C. Staff Report, it would seem as though the writers had brushed aside the opinions expressed by Federal Reserve spokesmen relative to the advantages of using reduced reserve requirements for easing. The conclusion[78] is brusque:

> "The use of open market purchases of Government securities to supply reserves to the banking system has an advantage, from the standpoint of the Treasury, over reductions in reserve requirements, since open market purchases absorb securities in the Federal Reserve System's portfolio and since most of the interest on that portfolio is returned to the Treasury at the end of the year. There are, of course, other differences between open market purchases and lowering of reserve requirements. Lower reserve requirements clearly tend to result in larger profits for the commercial banking system. . . . Aside from these factors, it is difficult to see that there are any significant observable differences in the impact of these two credit control weapons. . ."

The members of the Joint Economic Committee followed the lead of their staff, and made this a major issue. In Committee Report #1[79] they said:

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> "The ultimate effect of either weapon is the same. There is very little to choose between them on the final effect which will come about. Furthermore, at best, there are only very minor differences in the effects of the process. . . the Federal Reserve has not raised member bank reserve requirements since 1951 and has lowered them several times, particularly in the two periods of recession since 1953. It appears to be aiming at a general reserve requirement level of about 10 per cent which, in the opinion of this committee, is not necessary nor in the public interest."

As might be expected, Mr. Patman goes far beyond his own majority on this subject:[80]

> "It seems to me, however, that the Committee's recommendation does not go far enough. It would not restore to the public the Government securities which the Federal Reserve has given away from the vaults of the Federal Reserve Banks in the course of its successive reductions in reserve requirements since 1951. There should be a restoration of reserve requirements and a return of these assets to the Federal Reserve System."

The issue was kept alive by the Joint Economic Committee in Committee Report #2, in the form of a major recommendation[81] that "The Federal Reserve should . . . use open market operations rather than lowering reserve requirements as the means of bringing about the secular expansion of credit which the Federal Reserve and the banks desire."

The Monetary Commission Report is so brief and vague on this controversial question that it is difficult to tell how deeply they considered the problem, or, for that matter, to what conclusion they came. If one were to hazard a guess, based on their three short paragraphs of treatment, it would be that the Monetary Commission was nearer to the

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Joint Economic Committee than to the Federal Reserve in its thinking. The conclusion in the Monetary Commission Report:[82]

> "There is little clear evidence to indicate that the effects of open market operations are slower than those following reserve requirement changes. Nor is it clear, in view of the other lags involved in monetary policy, that any difference in timing is large enough to be important.
>
> "The Commission believes that the power to change reserve requirements should be used only sparingly and favors major reliance on the use of open market operations for countercyclical adjustments."

*

The use of reserve requirements could scarcely be envisioned as a problem likely to be very annoying to the Federal Reserve System over the next few years, on straight economic grounds. However, it has obvious appeal for any political leader who wishes to challenge the motivations of the System's officials while, simultaneously, alleging that large sums are being handed to commercial bankers instead of being returned to the Treasury via the Federal Reserve. As the Joint Economic Committee wrote[83] in Report #1:

> "In fact, if instead of the policy of lowering reserve requirements, the expansion of credit which was created by this means since 1953 had instead been created by open-market operations, the net increase of revenue to the Treasury at the bond rate would have amounted to a total of almost $500 million and at a present annual rate of some $112.7 million."

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#7 - THE FEDERAL RESERVE PROMOTES HIGH INTEREST RATES, TO MAKE MORE PROFITS FOR LENDERS

A contention of the kind described in the section heading above is quite different from one which says, for example, that the System has been unwise with respect to the influence which it has exercised on interest rates in some cycle. This broad contention is often not based on economic reasoning so much as on political or emotional considerations. It frequently involves, as in the debate on reserve requirements, at least an implied mistrust of the motives of central bank authorities. In some cases, it appears that the critics wish to assume away the free market mechanism and to substitute some sort of Utopian magic for the hard rules of the real world.

There are, no doubt, many times when this essentially noneconomic criticism becomes entangled with economic analysis. The same individual who may be demanding, say, a permanently low, economically impossible interest rate on home mortgages, might also deliver a carefully-reasoned critique of the Federal Reserve's firming steps as taken during the thrust phase of the most recent business cycle. However, the two lines of criticism are ordinarily identifiable as quite different things, and deserve to be looked at separately.

It is important to the Federal Reserve that the two lines be kept separate, because the noneconomic attacks cannot be answered in economic terms. They either must be ignored, or must be answered with arguments which are not founded on the facts of life as known in the world around us. Usually, if an answer were attempted, it would be necessary to try to talk to the point of what could or should be done in a controlled economy from

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which the free practices of a free people had been removed.

This statement, though, may not be wholly fair to some of the critics in the school which is being labelled here as "noneconomic" or "emotional" or "nonfree enterprise." A critic belonging to the school can insist that these rather disparaging names are not justified, because he is actually trying to restore some freedom to financial markets which he thinks have been twisted out of shape by a central bank devoted to the profitmaking wishes of financial institutions. Undoubtedly, some of the critics truly believe that this is the situation to which they are addressing themselves.

Fortunately for the System, this form of criticism is not encountered too often. Neither does it seem to be well-organized nor well-publicized. Perhaps it is of no real significance, in that it is probably overwhelmingly outweighed by a high public regard for the integrity and patriotism of the men who have managed the Federal Reserve over the years. Quotations from two people, cited below, constitute a warning, though, that it must not be completely neglected.

One of the strongest general statements was made by Congressman Wright Patman, in an Appendix[84/] to Committee Report #1, issued January 26, 1960:

> "On the facts, I cannot avoid the conclusion that the tight-money and high-interest policies have been a principal cause both of increasing prices over the past 7 years as well as a cause of the Nation's substandard rate of economic growth in those years. In other words, these policies do not give us a choice between two evils but an abundance of both evils . . .

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> "This diversion of income through high interest benefits the few at the expense of the many . . .
>
> ". . . Federal Reserve spokesmen have been less than candid with Congress and with the general public, disclaiming at times that they have anything to do with matters about which they have all to do . . .
>
> "The persistent and pronounced bias of the present Federal Reserve authorities has been in favor of the financial elite, in favor of high interest for the sake of high interest, in favor of the banking business it is supposed to regulate . . ."

Professor James Tobin, Sterling Professor of Economics in Yale University, wrote a magazine article[85/] which was published in January 1961, just before he was appointed by President Kennedy to be a member of the Council of Economic Advisers. In the article, he roundly criticized the Federal Reserve on a number of grounds. Some of his sharper remarks were:

> "The Federal Reserve has tended to take the view . . . that there is a single correct monetary policy--namely the course which, within the limits of human error, the Fed pursues. Federal Reserve spokesmen contend the inevitable consequence of a deviation from their course of monetary restraint would be an eventual collapse which would more than offset temporary gains in employment and output.
>
> "The economic logic of this prediction is, to say the least, obscure . . . Whatever its logic, it is expounded and believed with ideological fervor inside and outside the Federal Reserve System.
>
> "This conviction may lead the Board of Governors to resist and to frustrate any effort by the Kennedy Administration to gear the federal budget and other instruments of economic policy to higher levels of employment and production."

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A few paragraphs further along:

> ". . . 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."

It is obvious that spokesmen for the System cannot reply in kind to attacks of this type, because what would ensue would not be a debate, it would be a name-calling contest. What can be done is to publish studies on such subjects as how the flows of funds in the economy affect interest rates, or compilations of interest rates in other countries, or outlines of the history of interest rates in the United States. Facts and figures will do something toward disproving the hostile allegations.

#8 - THE FEDERAL RESERVE SHORTENS ECONOMIC UPSWINGS AND STUNTS NATIONAL ECONOMIC GROWTH

This is the wrap-up category of critical comment. Those who are sufficiently annoyed with the Federal Reserve System, on enough counts, sum up by claiming that it has stunted cyclical and secular economic growth in the United States. The people who level these grave charges range all the way from fully qualified to completely unqualified. Very often, their motives are showing, and the motives run the gamut from thoroughly patriotic to entirely selfish.

Despite the enormous complexity of the debates which have taken place, and will continue to take place, probably on a much larger scale, the basic issues can be described quite simply. The question is: how should the nation's financial "managers" (insofar as

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management is possible in a relatively free economy) define the terms, and rate the relative importance of (1) high-level production and employment, (2) an adequate rate of economic growth, and (3) reasonable price stability.

Anyone who is familiar with the attacks of recent years must realize, therefore, that these issues go straight to the heart of the national philosophy. No wonder the discussions sometimes sound as though theological dogma were involved, because the matters being argued back and forth are often just about that important. If it is true, as frequently contended, that decisions have to be made between millions of jobs, on the one hand, and the continued destruction of the savings of millions of savers, on the other hand, then it is hard to visualize a problem more fundamental to the welfare of the American people.

In a debate of this sort, both sides may be expected to hesitate about revealing admiration for either horn of a cruel dilemma. One way to weasel out of such a situation is to deny that there is a dilemma, and perhaps that _is_ true when the issues are phrased in certain ways and definitions are expediently framed. The other way to weasel out is to ignore the dilemma, sometimes even more effective and disarming than to deny its existence. Part of the evasive strategy, in either case, is to shift the attack, or the defense, to some specific practice of monetary management and so focus attention on a detail instead of on the true, big issue.

The quotations to be cited below are not analyzed. They are meant only to show something of the nature of this most comprehensive set of criticisms. They suggest the necessity for a largely expanded, and improved

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program of explanation on the part of the Federal Reserve.

Aside from Representative Patman, the man who has spoken most often against the Federal Reserve, to the most people, and at the greatest length, must be Mr. Leon H. Keyserling, former Chairman (under President Truman) of the Council of Economic Advisers. His statement[86] to the Joint Economic Committee, meeting in March 1959, reflects views which he has put forward many times:

> "Monetary policy, in recent years, has been used contrary to all of the three great purposes of our economic life . . . an excessively restrictive monetary policy contributed to a severely contracting rate of economic growth during the period 1955-57 . . . the tight money policy in early 1957 based upon a fundamental misreading of the economic situation, repressed the kind of investment which was already too low, repressed consumption which was already too low, and did nothing to restrain the boom in plant and equipment . . .
>
> ". . . the Federal Reserve System is now again tightening up on money further, when there is still a tremendous slack in the economy; when unemployment is actually rising . . .
>
> ". . . the blunderbuss methods of the Federal Reserve System are again aggravating the distortions in the credit and investment and income structure . . . and again in the overall are repressing production and employment . . ."

The Joint Economic Committee, in its Report #2 (February 1960), said about the same thing, in fewer words:[87]

> ". . . the monetary authorities have limited their actions almost exclusively to only one aspect of the problem, i.e., stabilizing the price levels, while they have largely ignored the problems of economic growth and excessive unemployment."

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Representative Henry S. Reuss, at a Hearing of the Joint Economic Committee held on June 2, 1961, remarked:88/

> ". . . What I am suggesting, Governor, is that the overtightening of credit by the Federal Reserve has contributed to the fact that we have had two recessions in the last 3 years . . .
>
> ". . . Mr. Arthur Burns, who was Chairman of the Council of Economic Advisers under the Eisenhower Administration, in a statement put into the Record . . . said that many factors undoubtedly contributed to the unsatisfactory character of the business cycle expansion from 1958 to 1960, but three of them were preeminent and, as his second cause, he cites the fact that the Federal Reserve pushed its credit tightening with undue vigor."

A little more than a month later, on July 12, 1961, on the floor of the Senate, Senator Paul H. Douglas, former president of the American Economic Association, aired his views:89/

> "The immediate danger is not demand and monetary inflation. Any threatened price increase is more likely to come from administered prices and wages. The basic problem we face is that of idle men and idle capital and a restricted output.
>
> "The choice is therefore squarely up to the Federal Reserve Board. If, as output increases slightly, the Reserve Board again takes fright, as it did in 1958-59, and again restricts the credit supply so as to raise interest rates, it will once more help to choke off a revival and keep unemployment at an unduly high level, as it has done before. I believe the conscience of the country is aroused and cannot again permit the Reserve Board and the financial world to use an abnormally high ratio of unemployment and idle capital as a built-in stabilizer . . .
>
> "The issue is therefore directly up to the Federal Reserve Board and the financial authorities in Government and business. Let us hope that they have the wisdom to act wisely and effectively. May Congress and the public encourage them to realize the gravity of the situation in which we are placed and help them

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to cast aside their old errors which have already
cost us so much . . ."

IN SUMMARY

The institutional structure of the American economy in 1961 is one in which, as a result of the increased strength of highly-organized power blocs--labor, industry, agriculture--prices will have a tendency to rise whenever men and machines are operating at anywhere near to capacity. The purchasing power of the dollar is, therefore, subject to possible further deterioration within the next few years. As an important agency especially interested in the integrity of the dollar, the Federal Reserve will find itself again in the unenviable position of having to decide whether or not to restrain what it looks on as "inflationary excesses," at times when its critics may regard the economy's performance as unsatisfactory, and not even near to "inflationary excesses."

If the System continues to act with courage, it will inevitably face a continuing barrage of criticism. The criticisms will be, as in the past, general and specific, fair and unfair, but they may become more powerfully voiced as time goes on. In order to defend itself with sufficient skill and energy to maintain its effectiveness, the Federal Reserve will need to put forth much greater efforts than in the past to gain public support for the policy formulations which will come nearest to meeting all the needs of all the people.

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FOOTNOTES

1/ Report of the Joint Economic Committee, 86th Congress, 2nd Session, entitled "Employment, Growth, and Price Levels," January 26, 1960, pp. 73-75. Referred to hereafter as "Committee Report #1."

2/ Hearings before the Joint Economic Committee, 86th Congress, 2nd Session, March 20, 23, 24, and 25, 1959; Part 1- "The American Economy: Problems and Prospects"; p. 12 and p. 47. Referred to hereafter as "J.E.C. Hearings, 1959, Pt. 1."

3/ Ibid, P. 165.

4/ Ibid, P. 166.

5/ American Economic Association Handbook, 1956, p. 80.

6/ See note #1, above.

7/ Report of the Joint Economic Committee, 86th Congress, 2nd Session, entitled "Report on the January 1960 Economic Report of the President," February 29, 1960, No. 1152. Referred to hereafter as "Committee Report #2."

8/ "Staff Report on Employment, Growth, and Price Levels," Joint Economic Committee, 86th Congress, 1st Session, December 24, 1959, p. 390. Referred to as "J.E.C. Staff Report" or simply "Staff Report."

9/ Ibid, p. 392.

10/ Ibid, p. 391.

11/ Ibid, pp. 399-400.

12/ "Money and Credit," the Report of the Commission on Money and Credit, 1961, Prentice-Hall, Inc., pp. 75 and 76. Referred to hereafter as the "Monetary Commission Report."

13/ J.E.C. Staff Report, p. 375.

14/ Ibid, p. 368 et seq.

15/ Ibid.

16/ Ibid, p. 372.

17/ Ibid, pp. 396-398.

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18/ Ibid, p. 398.

19/ Ibid, pp. 385, 387, 398-399.

20/ Ibid, p. 399.

21/ Committee Report #1, p. 33.

22/ Monetary Commission Report, pp. 73 and 74, the quotation from p. 74.

23/ Committee Report #1, pp. 67-68.

24/ J.E.C. Staff Report, p. 401.

25/ Ibid, p. 365 and, after the three dots, p. 400.

26/ Ibid, p. 400.

27/ Ibid, p. 365.

28/ Ibid, p. 368.

29/ Ibid, pp. 400-401.

30/ Page 32.

31/ J.E.C. Staff Report, p. 378.

32/ Ibid, p. 380.

33/ Ibid, p. 381.

34/ Ibid, pp. 381-383, and p. 393.

35/ Page 65.

36/ Hearings before the Joint Economic Committee, 87th Congress, 1st Session, June 1 and 2, 1961, pp. 82-83. Referred to hereafter as "J.E.C. Hearings, June 1961."

37/ Monetary Commission Report, p. 85.

38/ Ibid, p. 86.

39/ Ibid, pp. 272-273.

40/ Ibid, pp. 276-277.

41/ Ibid, p. 87.

42/ Ibid, p. 90.

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43/ Ibid

44/ Ibid, p. 88.

45/ Ibid, p. 87.

46/ Ibid, pp. 85-86.

47/ J.E.C. Staff Report, p. 407.

48/ See note #43. Monetary Commission Report, p. 90.

49/ Ibid, pp. 87-88.

50/ J.E.C. Hearings, June 1961, p. 105.

51/ Monetary Commission Report, pp. 92, 93.

52/ J.E.C. Staff Report, pp. 344-360.

53/ Ibid, p. 359.

54/ Monetary Commission Report, pp. 80-81.

55/ J.E.C. Staff Report, pp. 392-393.

56/ Monetary Commission Report, pp. 56-57.

57/ Ibid, p. 57.

58/ Ibid, p. 64.

59/ J.E.C. Staff Report, p. 426.

60/ Committee Report #1, p. 42.

61/ Ibid, p. 46.

62/ Committee Report #2, p. 16.

63/ J.E.C. Staff Report, p. 405.

64/ Ibid.

65/ Committee Report #1, p. 32.

66/ Monetary Commission Report, pp. 64-65.

67/ Ibid, p. 65.

68/ Ibid.

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69/ J.E.C. Hearings, June 1961, pp. 35-36.

70/ Congressional Record, January 11, 1960, p. 229.

71/ Hearings before subcommittee No. 3 of the Committee on Banking and Currency, House of Representatives, 86th Congress, 2nd Session, June 6, 7, 10, 17 and 25, 1960, pp. 18-19.

72/ Ibid, p. 177 et seq.

73/ See the System's memorandum, Hearings before the Joint Economic Committee, 86th Congress, 1st Session, June 24, 27, 28, 29, and 30, 1959, Part 6A, pp. 1462-1465. Referred to hereafter as "J.E.C. Hearings, 1959, Pt. 6A."

74/ Federal Reserve Bulletin, May 1961, p. 521.

75/ J.E.C. Hearings, 1959, pt. 6A, p. 1455 et seq.

76/ Ibid, pp. 1459-1460.

77/ Hearings before the Joint Economic Committee, "January 1960 Economic Report of the President," 86th Congress, 2nd Session, February 1, 2, 3, 4, 5, and 16, 1960, pp. 172 and 173.

78/ J.E.C. Staff Report, pp. 423-424.

79/ Committee Report #1, p. 43.

80/ Ibid, p. 72.

81/ Committee Report #2, p. 16.

82/ Monetary Commission Report, p. 67.

83/ Committee Report #1, p. 44. The supporting table is on p. 45.

84/ Ibid, pp. 63,64,65.

85/ "Challenge," January 1961, p. 24 et seq.

86/ J.E.C. Hearings, 1959, Pt. 1, pp. 102 and 103.

87/ Committee Report #2, p. 3.

88/ J.E.C. Hearings, June 1961, p. 99.

89/ Congressional Record, July 12, 1961, p. 1519.

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BOARD OF GOVERNORS
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WASHINGTON

October 15, 1962.

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TO: Federal Open Market Committee

FROM: Mr. Young

There is enclosed a copy of a memorandum written by Mr. Koch on "Government Deposits Part of the Money Supply?" This memorandum was written in response to Mr. Sternlight's recent memorandum entitled "Comments on Recent Behavior of Required Reserves in Relation to Growth Guidelines."

Ralph A. Young

Ralph A. Young, Secretary,
Federal Open Market Committee.

Enclosure

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MEMORANDUM October 15, 1962

To: Federal Open Market Committee Subject: Government Deposits

From: Albert R. Koch Part of the Money Supply?

Peter Sternlight has recently written a thought-provoking memorandum entitled "Comments on Recent Behavior of Required Reserves in Relation to Growth Guidelines." In it he concludes that about half of the recent increase in Government deposits should, in effect, be considered as part of the money supply, and that the reserves made available to support such deposit expansion should be counted toward meeting a required or total reserve target.

Sternlight has made a helpful point when he suggests that we should look at the source of the change in the Government balance rather than just the end result. To put it somewhat differently, it is the effect of the size of the Government balance on the liquidity and incomes of the private economy that is important for monetary policy formulation. Here liquidity should be defined broadly, including not only liquid assets but also short-term liabilities (which are a negative part of liquidity) and the cost of borrowed funds. The relevance of this last point will appear shortly.

One may agree with Sternlight when he suggests that, in periods like the present at least, if the Government balance is increased by borrowing from the banks, generally speaking the reserves underlying such a deposit increase should be supplied to the banking system to permit bank acquisitions of Government securities without decreasing the ability of banks to make loans and acquire other securities. Private liquidity and incomes would not be reduced in these circumstances.

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Reserves are in fact supplied to support the bank acquisitions of Government securities and the resulting Government deposits if the guidelines to monetary policy are free reserves, money supply, the tone and feel of the money market and/or interest rates. They are not likely to be supplied if bank credit, total deposits, total reserves, or nonborrowed reserves are the dominant guides to policy.

Private liquidity and/or incomes are certainly reduced, however, when the Treasury's cash balance is built up through tax collections or by borrowing from nonbank sources. In the tax collection case, private incomes <u>and</u> the money supply are reduced and Sternlight suggests (1) that the income drain is largely planned for and therefore doesn't depress spending significantly, and (2) that the reduction in the money supply overstates the total effective drain in the nation's liquidity.

In the case in point, one may wonder if Sternlight doesn't overlook an important phase of the operation. Doesn't one have to consider the spending side as well as the receipt side? Thus, Government collects taxes from some and dispenses funds to others. If it collects taxes normally but doesn't dispense the funds normally, the accumulation of a larger balance is surely a factor on the deflationary side. To some extent at least, this certainly occurred in the second quarter of this year when the fiscal position of the cash budget, seasonally adjusted, shifted from a significant deficit to near balance.

Another point of possible disagreement with the Sternlight memorandum stems from his discussion of the significance of a Government balance built up through borrowing from the private nonbank sectors of the economy. Here he suggests that if this nonbank borrowing is done through

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short-term securities, the deflationary effect on the economy is minimal. But even here there is surely some dampening liquidity effect merely from the fact that the public has traded very liquid cash for less liquid securities, unless one assumes that if the securities had not been purchased, the money would have been held as idle cash balances.

Moreover, one must be very careful here to avoid double counting. If it is relevant to take into account the effects of the increase in Government balances in building up the nonbank public's holdings of short-term Government securities, should we at the same time add into the money supply (or the reserves available to support it) any part of the idle Treasury balances generated in the process of putting these securities in the hands of the public?

It is generally accepted, moreover, that in order to get the community to hold more short-term Government securities rather than cash, higher interest rates have to be paid. These higher rates on short-term Government issues necessarily get reflected in higher short-term private rates. In addition, they make lenders somewhat more willing to hold short-term rather than longer term securities. As a result, longer term interest rates and presumably capital investment are also affected adversely to some extent.

As for the relevance of all this to the present situation, one can only say that <u>part</u> of the Government's current large balance has been built up as a result of borrowing from the nonbank public. The rest apparently came mainly from tax receipts in excess of expenditures, for bank holdings of Government securities were virtually unchanged on balance over the period of the buildup. From the end of April to the end of August

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(latest data available for nonbank holdings of Governments), the Government's cash balance rose almost $3 billion whereas nonbank holdings of Government securities rose about $1-1/4 billion. Nonbank holdings of Governments with maturities of a year or less, however, rose about $2-1/2 billion, indicating some shortening on balance of Government portfolios. In September, Government deposits rose another half billion or so, and nonbank holdings of short-term Governments must have decreased appreciably as a result of the advance refunding, even allowing for the fact that most of the longer issues offered in the refunding were taken by commercial banks.

A fact not to be overlooked is that the current larger Government balance was built up <u>in order to maintain higher short-term interest rates</u>, at least at levels higher than market flows of funds would have produced recently. One danger in the attempt to maintain short rates through debt management policy is that the effort will contribute to an undesirable circular process wherein a sluggish economy generates liquidity, which tends to depress short rates, which in turn requires more Government borrowing and higher cash balances to offset. If, under these circumstances, the Federal Reserve authorities were to consider Government deposits as part of the money supply, it would mean a further dampener to private deposit expansion.

This is not to deny that a larger question is involved here, namely, assuming the desirability of firm short-term interest rates, what are the relative roles of debt management policy and monetary policy in helping to achieve such an objective? What, for example, would have been the posture of monetary policy in recent months if it had provided the

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added firming influence on short rates that was in fact provided by Treasury advance borrowing and the resultant larger than normal cash balances?

My conclusion is that the recent buildup of the Government balances has been a deflationary influence. At the same time I do not argue that it has necessarily been a powerful one--judgments will differ on that. If some part of the recent increase in Government deposits should be counted as an effective increase in the money supply, Sternlight's estimate is probably too high. While it may be a mistake not to count some of it as money supply, it would be a mistake to count that much. My own view is that no adjustment gives a closer approximation than one as large, or nearly as large, as 50 per cent, if one is trying to assess (1) the effect of the increased Government balances on private liquidity and incomes, and (2) the influence of recent monetary policy on total economic activity.

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BOARD OF GOVERNORS
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Office Correspondence

Date October 31, 1963

To Chairman Martin

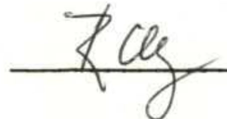
Subject:

From Mr. Young

The enclosed memorandum is intended to be along the lines of your request. It tries to be fair and at the same time critical. But you may want it retailored in some respects. Since the "news" was in circulation via press sources yesterday, Jack helped in its preparation. He will be glad to take over any redesigning that you might want.

The only copies in existence are the two enclosed.

I will call you on Monday or Tuesday following the WP-3 discussion, or if anything of importance comes up which should be passed along promptly.



Attachments 2

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Professor Harris is 66 years old. He was born in New York City. He did both his undergraduate and graduate work at Harvard University and has been connected with that institution with minor interruptions all of his life. He is retiring this year, after many years of service, which include long terms as Professor of Economics (since 1945, including several years as Chairman of the Economics Department), editor (since 1943) of the "Review of Economic and Statistics," and associate editor (since 1947) of the "Quarterly Journal of Economics." Professor Harris has displayed a strong institutional loyalty to Harvard and has worked energetically to maintain the distinction and quality of its Economics Department--to hold good men in teaching, to improve academic pay, and to promote opportunities for publication of the results of economic research.

He is generally regarded with affection and obligation by the graduate students who have worked under his direction. Despite his varied outside and publication interests, he has always had the reputation of making time in his schedule to confer with graduate students assigned to him--reading the drafts of papers they submitted and giving them the benefit of such criticisms and suggestions as he might have. This high regard appears to extend to students who have not been generally in agreement with him, as well as those who have subscribed to the lines of economic thinking he has advocated. One would have to be very biased indeed not to conclude that Harvard University has benefited tremendously from his devotion, loyalty and energy over the term of his service at that institution.

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Professor Harris's reputation as an original scholar is not so clear. He is not associated with any major advance in economic thinking or analysis. While he is a facile writer and has been a prolific contributor to the literature, there is no particular development in professional thought that is identified with his name. Despite the impressive documentation and attention to detail, it is interesting that his "Twenty Years of Federal Reserve Policy" did not add much either to understanding of or subsequent restructuring of the Federal Reserve System or its policy processes.

In many of his publication efforts he has served more as an editor, collector and publicist of the ideas and contributions of other economic writers, than an original author or contributor to books with which his name is associated. A number of his own books are directed to current issues of national economic policy and so are of transient rather than lasting professional interest.

Throughout most of his career he has been outspoken on public issues, and is an eager writer of "Letters to the Editor." This has led him down some strange paths on occasion. For example, in his zeal to be helpful to his adopted New England, he associated himself for a time with a group which advocated higher protective tariffs--a position that reflected very adversely for a time on his prestige among academic economists. He has also associated himself rather enthusiastically with the group of economists sometimes called the neo-Keynesians, who have argued that deficit spending by Government can be used to correct almost any short-fall in aggregate demand and

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that, therefore, unemployment and underutilization of resources can always be corrected by "enlightened" fiscal policy. Like many of his colleagues in this camp, he has argued for some time that monetary policy was relatively unimportant and impotent.

In more recent years he has shifted his position somewhat and has emphasized the strong negative role that monetary policy can play in holding the economy below optimum levels of output and employment. Like most of his compatriots he has tended, over the years, to belittle the importance of inflation as a threat to the American economy and has argued that "some" inflation is tolerable and perhaps even necessary to achieve socially acceptable levels of employment. Thus, he has been critical of, at least unsympathetic to, Federal Reserve policies that were directed toward limiting inflationary pressures and arresting the long-term inflationary trends. This applies particularly to the policies pursued by the Federal Reserve in the latter fifties.

While not closely identified with politics in the narrow sense, Professor Harris has made no secret of his strong preference for the Democratic Party and he was, and is, highly critical of the Eisenhower administration and almost gushing in his praise of the present administration. In fact, both in his role as Chairman of the Treasury consultants' group and in his writings and speeches, he has often appeared to be a sort of "official" apologist to the

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academic fraternity for the administration, undertaking to explain why political obstacles have prevented the use of a more active fiscal policy and even, on occasion, defending the moves toward lesser ease taken by the Federal Reserve, with the approval of the administration. On some occasions he has pressed his defense of administration policies to such extremes that it would appear more of an embarrassment than a help to policy objectives.

Certainly, one would have to conclude that Professor Harris's record of participation in public affairs does not match his really distinguished career as an educator. His positions on issues have sometimes been contradictory, and sometimes doctrinaire. His record suggests strong loyalties to ideas, individuals and institutions with which he regards himself as being associated. There seems little question but that these loyalties currently run to the group of public policy advisers who would emphasize the role of stimulative fiscal policy, and who are skeptical of flexible monetary policy, for stabilization objectives.

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Professor Harris is 66 years old. He was born in New York City. He did both his undergraduate and graduate work at Harvard University and has been connected with that institution with minor interruptions all of his life. He is retiring this year, after many years of service, which include long terms as Professor of Economics (since 1945, including several years as Chairman of the Economics Department), editor (since 1943) of the "Review of Economic and Statistics," and associate editor (since 1947) of the "Quarterly Journal of Economics." Professor Harris has displayed a strong institutional loyalty to Harvard and has worked energetically to maintain the distinction and quality of its Economics Department--to hold good men in teaching, to improve academic pay, and to promote opportunities for publication of the results of economic research.

He is generally regarded with affection and obligation by the graduate students who have worked under his direction. Despite his varied outside and publication interests, he has always had the reputation of making time in his schedule to confer with graduate students assigned to him--reading the drafts of papers they submitted and giving them the benefit of such criticisms and suggestions as he might have. This high regard appears to extend to students who have not been generally in agreement with him, as well as those who have subscribed to the lines of economic thinking he has advocated. One would have to be very biased indeed not to conclude that Harvard University has benefited tremendously from his devotion, loyalty and energy over the term of his service at that institution.

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Professor Harris's reputation as an original scholar is not so clear. He is not associated with any major advance in economic thinking or analysis. While he is a facile writer and has been a prolific contributor to the literature, there is no particular development in professional thought that is identified with his name. Despite the impressive documentation and attention to detail, it is interesting that his "Twenty Years of Federal Reserve Policy" did not add much either to understanding of or subsequent restructuring of the Federal Reserve System or its policy processes.

In many of his publication efforts he has served more as an editor, collector and publicist of the ideas and contributions of other economic writers, than an original author or contributor to books with which his name is associated. A number of his own books are directed to current issues of national economic policy and so are of transient rather than lasting professional interest.

Throughout most of his career he has been outspoken on public issues, and is an eager writer of "Letters to the Editor." This has led him down some strange paths on occasion. For example, in his zeal to be helpful to his adopted New England, he associated himself for a time with a group which advocated higher protective tariffs--a position that reflected very adversely for a time on his prestige among academic economists. He has also associated himself rather enthusiastically with the group of economists sometimes called the neo-Keynesians, who have argued that deficit spending by Government can be used to correct almost any short-fall in aggregate demand and

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that, therefore, unemployment and underutilization of resources can always be corrected by "enlightened" fiscal policy. Like many of his colleagues in this camp, he has argued for some time that monetary policy was relatively unimportant and impotent.

In more recent years he has shifted his position somewhat and has emphasized the strong negative role that monetary policy can play in holding the economy below optimum levels of output and employment. Like most of his compatriots he has tended, over the years, to belittle the importance of inflation as a threat to the American economy and has argued that "some" inflation is tolerable and perhaps even necessary to achieve socially acceptable levels of employment. Thus, he has been critical of, at least unsympathetic to, Federal Reserve policies that were directed toward limiting inflationary pressures and arresting the long-term inflationary trends. This applies particularly to the policies pursued by the Federal Reserve in the latter fifties.

While not closely identified with politics in the narrow sense, Professor Harris has made no secret of his strong preference for the Democratic Party and he was, and is, highly critical of the Eisenhower administration and almost gushing in his praise of the present administration. In fact, both in his role as Chairman of the Treasury consultants' group and in his writings and speeches, he has often appeared to be a sort of "official" apologist to the

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academic fraternity for the administration, undertaking to explain why political obstacles have prevented the use of a more active fiscal policy and even, on occasion, defending the moves toward lesser ease taken by the Federal Reserve, with the approval of the administration. On some occasions he has pressed his defense of administration policies to such extremes that it would appear more of an embarrassment than a help to policy objectives.

Certainly, one would have to conclude that Professor Harris's record of participation in public affairs does not match his really distinguished career as an educator. His positions on issues have sometimes been contradictory, and sometimes doctrinaire. His record suggests strong loyalties to ideas, individuals and institutions with which he regards himself as being associated. There seems little question but that these loyalties currently run to the group of public policy advisers who would emphasize the role of stimulative fiscal policy, and who are skeptical of flexible monetary policy, for stabilization objectives.

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December 17, 1962

In the question and answer period following his speech to the Economic Club of New York, on December 14, 1962, President Kennedy twice made reference to the Federal Reserve.

The questions and answers in which these references occurred appeared in text form as follows, in the Wall Street Journal of December 17:

Stimulate Economy Without Inflation

Q. Mr. President, in view of the prospect for a deficit in any event, and a fairly large one if taxes are reduced, is it part of the Administration's plan to finance a major part of that deficit outside the banking system in order to reduce the threat of monetary inflation?

The President: That will be a judgment which is primarily that of Mr. Martin (chairman of the Federal Reserve Board) and the Federal Reserve. He has commented on that to a degree before the Joint Committee (House-Senate Joint Economic Committee) this year; he is concerned about the prospect of inflation, because of course it affects us adversely, and also because it affects the balance of payments. I would hope, however, and I am sure that he will agree, that he will--any deficit which has to be financed will be financed in a way which will be the maximum degree possible to stimulate the economy without increasing the prospect of another inflationary or speculative spiral. So it is a fine adjustment which Mr. Martin will make, but I'm sure he will be as concerned as all of us are to get the benefit such as it may be out of the deficit, and also at the same time keep and use our monetary tools wisely enough to keep matters in control. His judgment will be, because of the Federal Reserve law, final.

* * * * *

Easy Money Stimulation

Q. Mr. President, will it be possible and desirable to use a little easy money stimulation as well as tax reduction?

The President: Well, I think there is a good supply of credit. I think the Federal Reserve Board has attempted to keep credit as free as it could, and the supply of money has been increased with the growth of the economy. I think it would be very difficult to keep it easier than it now is, without having the short-term funds pour out at a higher rate than they are. After all, we

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have seen when Canada put its interest rates up, I think as high as 7%, though it has dropped them now, it affected the flow of capital here. In October, we had several cases of major investments using our markets because of our interest rates. The fact of the matter is that I am not sure that we would get much stimulation out of the economy, but I don't see how we could possibly afford easier money than we now have, and still not have a hemorrhage at our balance of payments.

I think we have a major problem to balance off the use of monetary policy here at home affecting our balance of payments abroad, and also that is one of the good arguments, and as a matter of fact I think that we can make the case which is almost unanimously made in Europe, that the United States monetary policy in some ways is too loose, while our fiscal policy is too tight. And it is for that reason that the international banks in Europe and others have suggested that the reverse would be more appropriate. I think we should attempt to keep monetary policy about where it is, try to liberalize fiscal policy, for the reasons that I have given tonight, but I don't see how we could possibly go any further in the direction of easier credit, while we have a balance of payments which is against us by over $2.5 billion a year.

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January 13, 1964

MEMORANDUM FOR THE PRESIDENT

1. Appointment of a Governor of the Federal Reserve Board will be due before January 31.

   On that date, the present term expires for James L. Robertson, 56, career Government official, appointed from the Kansas City District.

   The vacancy will be for a 14-year term, as one of seven Governors, at an annual salary of $20,000. Appointments have customarily been non-partisan rather than bi-partisan. There are no specific Governorships identified with a particular party.

   There cannot be more than one Governor from any one of the twelve Federal Reserve Districts. The open districts, in addition to Kansas City, will be Boston, Atlanta, Cleveland, St. Louis, and Minneapolis. A map showing the States in each District, and the identifying number of each District (e.g., Boston is also known as the First District; New York, as the Second District; and so on) is attached.

2. The need is for a comparatively young man of broad practical experience preferably with a knowledge of bank operations.

   The statute directs the President to "have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country."

   The six other present members include three who are 65 years of age or older; another about 60; one, 57; and the most recent appointee, 46. A list of the present Governors is attached, indicating the State from which each was appointed, the President by whom appointed and the year, the expiration date of the Governor's term, and his age.

   Governor Robertson, as an attorney with long previous Government service in bank supervision, has met the practical need to have at least one Board member fully acquainted with banking operations, bank examination, and questions of mergers and competition. No other present Governor can fully provide the special competence that is desirable in these areas.

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Comparable special areas of competence of the other Governors are:
Chairman Martin: securities markets, international finance
Vice Chairman Balderston: business and industry
Governor Shepardson: agricultural conditions
Governor Mills: commercial loans
Governor Mitchell: fiscal policy, research and analysis
Governor Daane: debt management; foreign exchange and gold.

3. The most promising possibility seems to be Frederick L. Deming, 51, President of the Federal Reserve Bank of Minneapolis (Minneapolis District) and formerly Vice President of the Federal Reserve Bank of St. Louis (St. Louis District). He is widely known and highly respected throughout business and financial circles in the United States. A good banker and a good Democrat.

Brief biographies are attached of Mr. Deming and of three other men from three other open Districts who deserve consideration:

George H. Ellis, 44, President of the Federal Reserve Bank of Boston (Boston District)

Rex J. Morthland, 51, President of the Bank of Selma, Selma, Alabama (Atlanta District)

Walter Lingle, 56, Deputy Associate Administrator for Industry Affairs, NASA, now located in Washington, but actually from Cincinnati, Ohio (Cleveland District).

Governor Robertson would also be eligible for reappointment, since he was originally appointed in 1952 to complete an unexpired term. He would appear to be the best qualified candidate from the Tenth District. His biography is also attached.

Douglas Dillon

Attachments

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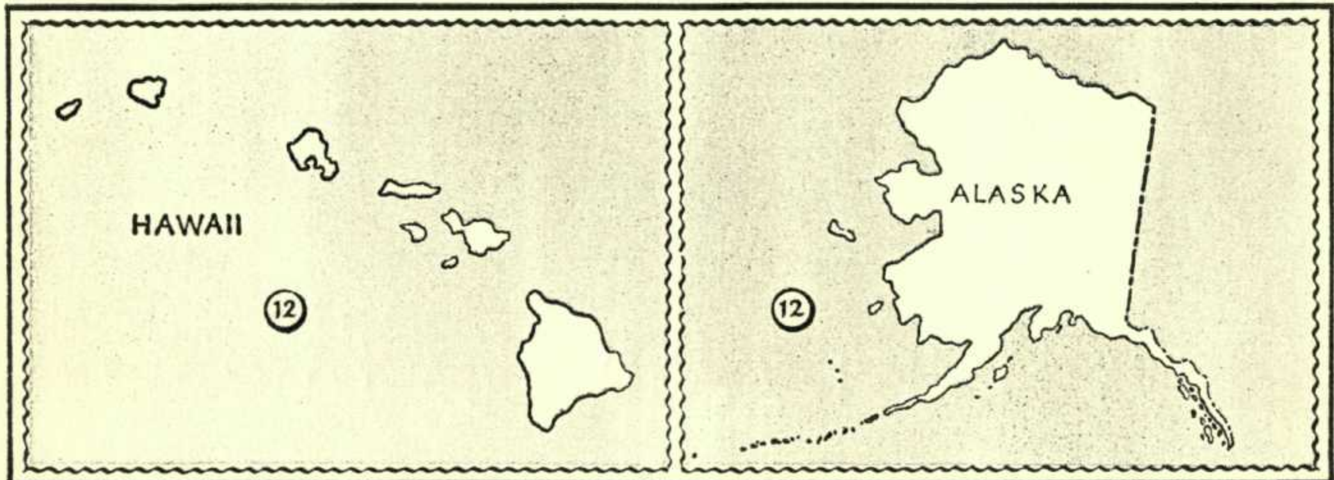
BOUNDARIES OF FEDERAL RESERVE DISTRICTS AND THEIR BRANCH TERRITORIES

Seattle
Portland
Helena
Minneapolis
Boston
New York
Philadelphia
WASHINGTON
Buffalo
Detroit
Cleveland
Pittsburgh
Baltimore
Cincinnati
Chicago
Omaha
Salt Lake City
San Francisco
Denver
Kansas City
St. Louis
Louisville
Richmond
Charlotte
Nashville
Memphis
Little Rock
Oklahoma City
Los Angeles
Birmingham
Atlanta
Dallas
El Paso
Jacksonville
Houston
New Orleans
San Antonio
1 2 3 4 5 6 7 8 9 10 11 12
Aug. 21, 1959
Drawn by R.W. Galvin, Cart

THE FEDERAL RESERVE SYSTEM



Legend

▬ Boundaries of Federal Reserve Districts — Boundaries of Federal Reserve Branch Territories

✪ Board of Governors of the Federal Reserve System

⊙ Federal Reserve Bank Cities • Federal Reserve Branch Cities

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PRESENT MEMBERSHIP: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Governor	Age to Nearest Birthday	Appointed from: State	Appointed from: District	Appointed by: President:	Term Expires January 31:
J. L. Robertson	56	Nebraska	Kansas City	Truman (1952)	1964
C. C. Balderston	67	Pennsylvania	Philadelphia	Eisenhower (1954)	1966
C. N. Shepardson	68	Texas	Dallas	Eisenhower (1955)	1968
Wm. McC. Martin	57	New York	New York	Truman (1951) Eisenhower (1956)	1970
A. L. Mills	65	Oregon	San Francisco	Truman (1952) Eisenhower (1958)	1972
J. D. Daane	46	Virginia	Richmond	Kennedy (1963)	1974
G. W. Mitchell	60	Illinois	Chicago	Kennedy (1961) Kennedy (1962)	1976

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FREDERICK L. DEMING:

President of the Federal Reserve Bank of Minneapolis, is 51 years of age. He is an economist and banker.

He has had some teaching experience at Washington University and St. Louis University, mainly part-time, at intervals from 1935 to 1949. His college specialization was in history and economics; he received the degrees of A.B., A.M., and Ph.D. from Washington University in St. Louis over the years 1934-41. He also worked from 1936 to 1941 as a Special Agent, Insurance Underwriter, and Safety Engineer for the James R. Hill Insurance Company in St. Louis. His principal employment has been in the Federal Reserve System.

Beginning as Assistant Manager of the Research Department of the Federal Reserve Bank of St. Louis in 1941, he had advanced through various positions to that of Vice President by 1951 and Executive Vice President in 1953. He was appointed President of the Federal Reserve Bank of Minneapolis in 1957 and has been active in a wide range of activities in the central, north central, and northwestern regions of the United States.

During his Federal Reserve experience he has been active at one time or another in virtually every aspect of Federal Reserve activities and operations, serving on interbank and interdistrict committees, and also serving brief tours of temporary staff duty at the Federal Reserve Board prior to becoming President of the Federal Reserve Bank of Minneapolis.

In current regional activities, he is Vice President of the United Fund of Hennepin County; is Vice President as well as Chairman of the Research Committee for the Upper Midwest Council; is President of the Board of Trustees of Macalester College. He is a Democrat and a Presbyterian.

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GEORGE HATHAWAY ELLIS:

President of the Federal Reserve Bank of Boston since 1961; now 44 years of age; has been associated with the Federal Reserve Bank of Boston since 1951. B.A. degree in economics; University of Maine, 1941; graduate study in economics at Harvard, M.A., 1948, and Ph.D., 1950. War service 1941-45 in the Army, 2nd Lieutenant to Major.

As an industrial economist, Ellis has specialized in development problems of the New England Region. In 1950-51, when President Truman's Council of Economic Advisers set up a special committee on the New England Economy, Mr. Ellis was one of the most active members. He also served as Director of the Research Committee on New England for the National Planning Association from 1953-55; from 1955-57 he was Economic Adviser to the Committee on Public Transportation of the New England Governors Conference; and since 1957 has been Chairman of the Research Committee of the Greater Boston Economic Study Committee. He is also a Director of the New England Council; a trustee of the New England Council for Economic Education; and is active in the Chamber of Commerce of Greater Boston as well as in various banking associations and associations of professional economists.

He was born in Maine; he is a Congregationalist; and has not been identified with either political party.

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REX J. MORTHLAND:

President of the Peoples Bank and Trust Company of Selma, Alabama, is an economist and banker. A native of Topeka, Kansas, now 51 years of age, he received an A.B. degree from U.C.L.A. in 1933; his M.A. from U.C.L.A. in 1934; and his Ph.D. from the University of Chicago in 1946. He was a Teaching Assistant at U.C.L.A. from 1934-35 and a Pre-Doctoral Fellow of the Social Science Research Council from 1935-38. He was a Research Assistant at the Illinois State Tax Commission, 1938-40, working under George Mitchell (whom President Kennedy appointed to the Federal Reserve Board from Illinois in 1961). While in Illinois he completed his preparatory work for a Doctor's degree in Government finance, preparing a dissertation on "Municipal Debt in Illinois." Before the degree was completed, he went to the University of Connecticut as an Assistant Professor, 1940-41, and was then called to service in the United States Army. He continued in the Army until 1946, rising to Major of Infantry.

After completing his Doctor's degree at Chicago, he became Vice President of the Peoples Bank and Trust Company, continuing until 1953, at which time he was promoted to the Presidency. He was an instructor at the Selma Extension Center of the University of Alabama 1950-52. Since 1961 he has served as section leader and lecturer at the School of Banking of the South at Louisiana State University. In the Alabama Bankers Association, he has been Chairman of the Committees on Banking Education, Executive Management, and Revision of the Banking Laws. He is a Methodist, was raised in Glendale, California, and went to high school there.

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WALTER LEE LINGLE, JR.:

Deputy Associate Administrator for Industry Affairs, National Aeronautics and Space Administration, is now located in Washington although a resident of Cincinnati, Ohio. He is 56 years of age, was born in Atlanta, Georgia, and received his Bachelor of Science degree from Davidson College in 1928.

From 1931 until 1961 he was associated with the Proctor and Gamble Company in Cincinnati, becoming Vice President in Charge of Overseas Operations in 1948; a Director in 1950; and Executive Vice President in 1954. He is a member of the U. S. Chamber of Commerce and was Vice Chairman of the United States Council of the International Chamber of Commerce.

He is a versatile and able businessman with wide experience in the financial side of business operations.

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JAMES LOUIS ROBERTSON:

James Louis Robertson was born and reared in Broken Bow, Nebraska. His birth date was October 31, 1907. After attending Grinnell College, he studied at George Washington University, from which he received both A.B. and LL.B. degrees. He then did graduate work at the Harvard Law School, from which he received his LL.M. in 1932. He entered the Government service in 1927 in the United States Senate Post Office. Later he was a Special Agent of the Federal Bureau of Investigation. In 1933 he joined the legal staff of the Office of the Comptroller of the Currency. He served in the United States Naval Reserve in 1943-1944. Thereafter, he served as Deputy Comptroller of the Currency until he took office as a Member of the Board of Governors of the Federal Reserve System on February 18, 1952. He was admitted to the Bar of the Court of Appeals for the District of Columbia in 1931, and to the Supreme Court of the United States in 1935. Mr. Robertson is married and has three sons.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 24, 1964.

To Chairman Martin

Subject: "Money to Grow On" by Stuart Chase

From Guy E. Noyes

It is hard to generalize about this book. In some ways and at some points it veers sharply in the direction of oversimplification and popularization. It makes many points by appeal to authority rather than reason. If the New York Times and Mr. Chase agree on something the reader is expected to accept it without question. Similarly, statements by the President's Council of Economic Advisers are quoted as if they were the word of God.

On the other hand, the detailed process by which Mr. Chase proposes to enhance aggregate demand seems a carefully planned masterpiece of obfuscation--designed, one suspects, to get around some of the more obvious "prejudices" against perpetual bank-financed Federal deficits that the author feels make the average citizen reluctant to embrace the "new economics." The underlying reasoning is simple and not unfamiliar.

First, the "gap" is accepted without critical examination. It is simply stated as a fact that our GNP is running about $30 billion below "potential."

Second, it is assumed that an expansion in aggregate demand sufficient to stimulate the economy to the assumed higher potential of GNP would not be inflationary.

Third, it is concluded that the expansion of bank credit is the easiest and quickest way to generate this additional demand.

Essentially, the remainder of the book is devoted to an intriguing and rather complex specific proposal to assure that this additional credit expansion shall take place, and that it shall initially be "invested" in four broad areas, which the author feels have been skimped--to the disadvantage of healthy economic growth in the United States.

In brief, the proposal is to capture the unused and wasted resources which are represented by the presumed gap between the actual and potential output of our economy for certain social purposes the author regards as highly desirable.

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Cleverly, I think, Mr. Chase wastes very little time criticizing past policies or urging changes in the structure or policy of existing institutions. He seems to regard the Federal Reserve as beyond redemption and passes very quickly over the fact that the same additional credit expansion he proposes to achieve by a new agency could be accomplished within the existing institutional framework simply by an easier monetary policy.

Again, briefly, the author proposes to establish an "Agency for Economic Growth," which would be empowered to issue notes called "Growth Certificates." These certificates would bear a low (1/2 of 1 per cent) rate of interest and would have no fixed maturity. They would be "allotted and placed" with commercial banks in exchange for demand deposits, which would then be expended for the growth promoting social purposes listed. It is argued that, since this process would be <u>in addition</u> to the lending and investing activity that the banks would otherwise undertake, they can easily afford to accept the low rate of return, which would more than cover their "bookkeeping costs."

Relying on calculations made by the "Committee on Cash Flows," Mr. Chase estimates that some $18 billion of additional bank credit financed expenditure should be carried out in the first 18 months to "close the gap," and that it would take about $6 billion per year thereafter to "hold GNP at potential." This latter figure is, in effect, an estimate of the deflationary bias of the Federal Reserve System. He might have said, "We can assume that because of its old-fashioned hyperconservatism the Federal Reserve will permit the generation of $6 billion per year less bank credit than the economy needs to operate at capacity. Hence, we will simply let them go along as they have in the past--hewing to their overcautious line--but, through a new agency we will slip the economy an extra $6 billion a year on the side." Unstated is the assumption that the Federal Reserve is so stupid that it would go right ahead with its policy as before, ignorant or oblivious of the extra stimulus provided by AEG generated bank credit.

The flaws in the specific proposal are so numerous and obvious that it is hard to believe that the author really intends that it be taken seriously. One is inclined to suspect that the specifics are simply tacked on to attract fire away from the very dubious initial assumptions. This could lead an unwary reader to conclude that, while the new agency and the growth certificates are

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unnecessary and unworkable, we could achieve much higher growth rates and fuller resource utilization simply by inflating demand through higher rates of bank credit creation than have been permitted in the past. All we really need to do is just get the Federal Reserve off the dime! If Mr. Chase merely succeeded in leading a substantial number of readers to this conclusion, I suspect he would be well satisfied.

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

May 19

Mr. Martin

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It is a copy for our files here. We are not giving out copies. We understand the Council has in its permanent file a copy which they will let anyone see who wants to come in and read it. They are not making it available on request.

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Transcript

THE ADVERTISING COUNCIL

WASHINGTON CONFERENCE

Panel Discussion on the Economy

May 6, 1964

Moderator:

Honorable Frederick G. Dutton
Assistant Secretary of State

Panelists:

Honorable C. Douglas Dillon
The Secretary of the Treasury

Honorable Luther H. Hodges
The Secretary of Commerce

Honorable William McChesney Martin
Chairman, Federal Reserve Board

Honorable Walter W. Heller
Chairman, Council of Economic Advisors

Representing the Conference:

Mr. T. R. Berner, Chairman & President
Curtiss-Wright Corporation

Mr. Joseph A. Grazier, President
American Radiator &
Standard Sanitary Corporation
Mr. Gabriel Hauge, President
Manufacturers Hanover Trust Company

Mr. William A. Hewitt, President
Deere & Company

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THE ADVERTISING COUNCIL

WASHINGTON CONFERENCE
Wednesday, May 6, 1964

MR. MARTIN: When I had the privilege of visiting with this group a year ago, the situation was definitely different than it is today. We were having a quiet run on our dollar, not perhaps a too serious one, but its cumulative effect was giving all of us concern. We recognized that we had long had a tax situation which had been delayed in being corrected after the war. And while there were disagreements as to whether it was tax revision, tax reform or tax reduction which was needed, there was very little disagreement that something had to be done about our tax system if we were to get the maximum benefit from our economy.

To me, the most dramatic achievement of 1963 was the change in the competitive position of American business. I am generalizing when I say that, but I think the profit margins did begin to improve by the end of the year. And whether they were what people to like them to be or not, there is no question that

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our competitive position in the world improved. And it demonstrated once again that American business, when it gets a head of steam on and sees the problem, can do what is necessary to compete.

President Kennedy in his balance of payments message in July of last year covered this problem adequately. Whether enough was there or not was not the point. The fact was that he had covered all the avenues that would need to be followed if we were to bring about equilibrium in our balance of payments. And he indicated that in the event we were not successful in this program, which included, as you know, an increase in the Federal Reserve discount rate from 3 to 3-1/2 percent, and a recognition that we could not be isolationists on interest rates any more than we can be isolationists in politics today. The flow of money around the world is such that we have to be aware of interest rate differentials, particularly with respect to short term movements, if we ever hope to maintain our position as a leading trading power.

It also seemed to me that his message indicated a recognition of the fact that reducing unemployment and promoting growth in bringing about equilibrium in our balance of payments, but regardless of the emphasis that was placed on one or the other at the time was one and the same problem. And it seems to me that the results since that time have indicated that we can move in these directions simultaneously and with a certain amount of

Belt 6

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success.

Now, as we approach the present situation we are not under the gun of a possible deflation as we were a year ago. I am doing something that I try to keep away from here when I am indicating the future, because in the Federal Reserve we try not to be forecasters, but try to analyse things as they are. But, nevertheless, I don't believe in my judgment that deflation is the problem at the moment. I think that we all recognize that we have more unemployment than we would like to have, and there are differing views as to how we should tackle this unemployment problem. And we should certainly bend every effort that we have to improve the unemployment picture. But at the same time we must recognize that we are now in an expanding economy. And the majority, I think, of consensus today is that we are not immediately faced with a possibility of a decline in business. Therefore, the threat of inflation rears its ugly head once again. And we have had recurring threats of inflation and recurring inflation in the entire postwar world. This means, obviously, that the period that we are now moving into requires prudence and caution. I think that the President has rightly stressed the responsibility of business men and of labor to be prudent and cautious in the way they handle the prosperity that we are presently enjoying. But when I use this word "prosperity," I am not saying that it's what it ought to be or that it's necessarily all that it is going to be, but I am saying that we are in a

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situation now where we can accept a certain amount of prosperity. And we should never be afraid of prosperity.

There are a certain number of people who constantly say, "Well, things are so good they just can't go on this way." I don't believe that we should ever take that view. I think that prosperity is nothing to be afraid of. But how you manage prosperity is in the long run the question of how you sustain it. And this is where the role of the central bank comes in, and this is really the gist of my comments today.

It seems to me that what we have and what is required in the central banking system is an understanding that, first, the central banks should see that there is enough money for the legitimate requirements of business. That's a primary responsibility. But having done that, it is our responsibility to regulate the total supply of money in such a way, including its cost and its availability, that the marginal requirements of business, the low requirements of business and the low priority requirements of government, do not waste themselves in speculation and rising prices in a time of expanding business. So that conversely you can use, to the extent that it can be used in a period of declining business monetary policy to stimulate some speculation and some new ideas, and to perhaps contribute to adjusting and keeping the decline from getting out of hand.

In other words, to put it simply, to level the peaks and to fill in the valleys. This is the basic role of a central

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bank. It requires judgment, it requires courage, it requires making from time to time some judgments with respect to the future. It's more flexible than other instruments of policy because it can be adjusted more quickly. You can move in either direction without, in my judgment, doing too much damage, and it certainly is not the controlling factor alone in the economy.

Let me just close by saying that I rate the forces in the economy, as many of you have heard me rate them before, as budgetary being number one, and in this connection, I think that the President's emphasis on reducing unnecessary expenditures in government has been helpful to all of us in the period that we are presently in.

In the second place, we are using fiscal policy because the tax program is now under way. To what extent it will stimulate business, we don't know. But we know that cumulatively it is likely to encourage business further.

In the area of debt management, the Federal Reserve has worked very closely with the Treasury and the Treasury has been most cooperative in seeing to it that we have issues that make it possible for us to finance the deficit outside the banking system.

Of course the Treasury has a problem in this because we have a 4-1/4 percent interest ceiling. And if we reached a point where we could not deal with that, there is a real problem with the Treasury and the Federal Reserve in that.

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So far, however, we have had no problem in financing the deficit outside the banking system. And there has been complete cooperation and harmony between the Treasury and the Federal Reserve.

You are all familiar with the wage price problem and here we have to watch developments and await developments.

Monetary policy is the fourth of these policies. Monetary policy must be maintained alert, but it must also keep in front of people the fact that when money is as available as it has been there is a tendency for a deterioration in the quality of credit to persist and continue. In the building of hotels and motels and multi-family dwelling units and in other real estate ventures, and in particular, there has been a tendency to extend terms and to engage in activities which may ultimately cause us trouble. I don't think that point has been reached yet, but I think we would be unwise not to be calling attention to it.

And let me just close by saying that I think it's good for all of us, in a period such as the present, when we have an opportunity to think about it, to be beginning to think about what we do when we have another recession, because we will have another recession at some time. And I hope no one will think I am forecasting a recession now. But it is in periods like this that we have got to think about it. It will be more difficult to get a tax cut the next time if we are trying to stimulate the economy, because we are no longer to the same extent as we were before under the gun of the war time tax problem. It

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will be more difficult for us to use easy money policy because we have used it, very effectively, and aggressively during this recent period. And it will be, therefore, incumbent upon us to see to it that we do what we can by prudence and discipline to stretch out the current period of prosperity and to use what expenditures we can to improve the employment picture at every opportunity, so that we can continue to have the growth and the development and the move toward equilibrium in our balance of payments which is required.

Thank you.

(Applause.)

MR. DUTTON: We will now open up the four officials to questions from the panel.

I would like to just very briefly introduce them, although I am sure most of you know them all.

First, Mr. Gabriel Hauge, President of the Manufacturers Hanover Trust Company.

Mr. Joseph Grazier, Chairman of the American Radiator and Standard Sanitary Corporation.

Mr. T. R. Berner, Chairman and President of the Curtiss-Wright Corporation.

And Mr. William Hewitt, President of Deere and Company.

Just fire away.

MR. HAUGE: Well, I don't know whether I am to start, because I am up here at this end, but I will open off, Mr.

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Chairman, with a question that has been prompted by the remarks of two or three of the speakers.

And I might do it in terms of an article I read in the New York Journal of Commerce the other day, written by Professor Henry Wallack of Yale University. He recalled that at the time the tax cut was proposed an important part of the analytical basis for the tax cut was that the burden of sustaining or developing the economy could be put on fiscal policy, and the burden of fighting for stability on a price and balance of payments fund could be more logically reserved to monetary policy.

Now we have had the tax cut, and we are out into the beginning part of the effective period of this tax cut. And from the comments that have been made here today, it is fair to conclude that we can expect to have some more favorable effects from this tax cut.

The question posed by Professor Wallack, and I think would be of interest to many members of the Conference, and this goes back in a way to a statement in the President's economic report of last January that it would be self-defeating to cancel the stimulation of a tax cut by tightening credit, is what is the thinking today of the relation of monetary and fiscal policy at this stage of the cycle, and with the prospect for apparently a good deal more pressure on the economy as time goes on?

SECRETARY DILLON: Well, I would be glad to say at

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least a beginning word on that.

I think that probably applies to a number of us here. It covers a broad area.

I do think that the argument that fiscal policy had to bear a greater proportion of the load in stimulating our economy has been just what's happened because fairly on, right in the beginning, and even in the spring of 1961, we never allowed -- or in the winter of 1960, we never allowed monetary policy the freedom that it had in the preceding recessions during the 50's, when the price of short term money went down to roughly half of one percent. This time, because of balance payments reasons and no other reason, it never went below for a very short period maybe 2-1/8 percent, which is quite a lot different. And then it kept, as we saw the needs moving upwards, the short term rate, right along. And, finally, with the discount rate increase last summer and stabilization as a result of that rate shortly thereafter of our short term rates at about 3-1/2 percent, and fitting into that relaxations, two of them of regulation Q by the Federal Reserve System, which allowed the payment of higher rates on time deposits and savings deposits, I don't think that there is anything much further that monetary policy could very usefully do in the balance payments field. And so then we did turn parallel to all this during this period, to tax reduction as the prime motor to allow this improvement, economic improvement to

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carry on. And I think that situation is still maintained .

As Mr. Martin points out, we have come to sort of a new situation where it is far more difficult with convertible currencies to use monetary policy in the event of a recession the way it used to be used because we have got to maintain short term interest rates relatively parallel throughout the world, throughout the parts of the world where money flows. That can be done by action on both sides and is done that way.

Some may say, "Why don't we handle the whole long term portfolio problem, also, by monetary policy?" And the argument in that is that that just isn't possible. To do it would require at least a full one percent increase in the present levels of interest rates for mortgages, for all sorts of other -- for municipal bonds, corporate bonds, borrowing generally. We do some $40 billion or $40 billion to $50 billion of that sort of business in a year here. That is the flows of savings in and the flows of savings out. And to somehow to be able to force that rate up one percent to cut down a $2 billion outflow, a very small piece of that that's going abroad, is sort of an extreme example of the tail trying to wag the dog. And we just don't think it could be done, even if you set out to try and do it.

Also, if you look back historically over any long period of time, the longer term rates that are presently currently in Europe are far higher than they were in many periods of the

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past. Taking the whole Nineteenth Century, for instance. And our rates are much nearer what would appear to be, at least past history, proper rates of an economy that is relatively advanced. In under-developed countries, of course, they have much higher rates.

So I don't think that anything that's happening now is contrary to what -- the question you are posing certainly I don't think anyone in the government, and certainly not the President, would feel that we should not use monetary policy. The dollar got in trouble, he has said so very clearly, and is fully prepared to back up the Federal Reserve, whose primary responsibility is to do that. So I think that there really isn't a great problem there.

MR. DUTTON: Mr. Martin, do you have any comments?

MR. MARTIN: Well, I would just comment that we have been very aware of the problem. A year ago, to go back again, we were talking about not financing whatever deficit that developed through the banking system. And we have been successful in maintaining that position.

Now, just to show you how you can be wrong on these things, if you had asked me at that time what would be the effect on interest rates when the tax reduction--

VOICE FROM THE FLOOR: Louder.

MR. MARTIN: (Continuing) If you had asked me what would have been the effect on interest rates when the tax

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reduction went through, I would have said it would have caused an increase in interest rates. It actually has not, because retained earnings and depreciation of corporations has been adequate up to the present time to meet their requirements. And on the projections that we use at the Board, those that I personally use at the Board, the requirements of the community for money have been far below anything that I anticipated. Therefore, we have pursued a neutral policy in the Federal Reserve. We are waiting for the market to determine what the forces are. And I believe that there is no immediate prospect of an increase in interest rates based on supply and demand factors.

Now, we have been dealing here with a lot of expectational forces that are always in markets. There are a lot of people in the market who immediately jump to the same conclusion that I was jumping to, that when the tax reduction program went through the demand for credit would surge here. Only they went one step further and said, "And the Federal Reserve will lead the move toward higher interest rates." Well, the Federal Reserve hasn't lead the move toward higher interest rates, and I don't think the Federal Reserve should lead the move toward higher interest rates. I think we try to lean against the wind but we don't try to make the wind. And two or three times the money market has been fooled by these expectational forces here. What they will be in the future, I am not forecasting, but I can assure

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you, as I tried to in my general remarks, that the Federal Reserve is very aware and alert to this problem, and that it is our intention to do what we can here to prevent a speculative boom developing, or an inflationary surge which could come at any time, which would mean that the sustaining of this prosperous period would be shortened. And if it were shortened, unless all of us are alert and active on this, it will mean that we will have a larger recession than we would otherwise have from the inevitable corrections that always come in an economy.

MR. DUTTON: Walter, do you have a comment on this?

MR. HELLER: Well, just one quick comment, which I think Gabe Hauge is well aware of, and that is that as compared with about seven years ago, before our persistent balance of payments deficit became a balance of payments problem, and before we developed the persistent slack in the economy, many of us were advocating just the opposite policy; namely, tighter budget policies, surpluses at full employment and relatively easier monetary policy to put more funds into investment. And I think that there has been a very substantial change. Economists are capable of adapting to the situation and I think there is a general acceptance of the proposition that relatively speaking there should now be a heavier reliance on fiscal policy for expansion. And that this, obviously, in the course of time gives greater freedom to monetary policy to do the job on the international front.

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And I think that the explanations given by both Secretary Dillon and Chairman Martin indicate that the tool is there, but that at the present time we are in the happy position, both on expansion and on the balance of payments front of not having to tighten on the monetary front.

QUESTION: Continuing the same thought, all of us, I am sure, applaud the courage and foresight of the Administration and its action on taxes. But I wonder if we aren't over-estimating, or if we haven't over-estimated from the top down the rapidity with which the tax cut or the benefits of it can be translated into those things which create jobs, and unemployment remains a very serious problem. And since it does, can't this result in rather serious political frustrations, and perhaps some pump priming activities which may accentuate and aggravate this monetary situation?

MR. DUTTON: Walter?

MR. HELLER: Well, as I tried to say in my comments, we have, I think, pretty consistently, both in the Treasury and in the Council, in fact, throughout the Administration, tried to say that the impact of the tax cut was not going to be an over-night impact, that we weren't going to just jump from persistent levels of 5-1/2 percent unemployment, let's say, to 4 percent unemployment, or persistent levels of 85 percent utilization capacity to a preferred average operating rate of 92 percent.

It's interesting, by the way, that in the British

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tax cut about a year ago, which was almost exactly comparable to ours in terms of the balance of payments -- excuse me, in terms of the translation of the gross national product, there was a rather flat period of lull and not much response in retail sales, and so forth, for a couple of months after the tax cut came in and then a very much enhanced and increased response in the later months. Of course, the British economy is much more exposed. They are in a tougher and tighter position to take the kind of expansion that we are able to take with our lesser foreign exposure and with our greater flow of both labor and industrial capacity available to meet the impact of the tax cut.

I think it fair to say that the employment record of the past few months, whether it's the buoyancy of the tax cut or not, has been outstanding. We have created over 900,000 new jobs -- that's not even counting the April results -- which I think will add to that -- over 900,000 new jobs since December. And about 1,400,000 -- this is non-farm jobs, -- about 1,400,000 since a year ago. And our prediction, after all, is fairly modest; not that we will be jumping down to 4 percent by the end of the year, but that we will be getting down to about 5 percent unemployment and then going below that as we move on. The full impact of the tax cut won't have worked its way through the economy for about two years.

QUESTION: The recent joint economic report proved the elimination or reduction of the gold cover requirements of

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the Federal Reserve credit. What substitute restrictions or limitations on the Federal Reserve in extending credit to the U. S. banking system in issuing money are contemplated?

SECRETARY DILLON: Well, I think that again hits a lot of us.

The Joint Economic Committee did make this recommendation, and many bankers, students of the problem, are in agreement with them fundamentally. The reason for this is that the United States is presently the only country that has such a connection between gold and domestic currency and credit. Gold everywhere else is used solely as the medium to settle international payments and that's what it really is under the present gold exchange standard. That's what it is under our laws, because under our laws you cannot any more, ever since 1934, turn in currency or obtain gold or own gold yourself. So logic would indicate that we should have, as we do have, our whole gold supply available to protect the dollar in international dealings. We do have it because the present law gives Federal Reserve the flexibility to waive this requirement when necessary. And the Chairman of the Federal Reserve, Mr. Martin, has repeatedly said that he would exercise that right if such a situation arose.

Now, the second question is the question of timing. This is a highly emotional issue in this country. There are a lot of people who feel that because we have always had this connection, we should continue it, although we have changed it

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from time to time. It used to be 40 percent a few years ago, now it's 25, that that should continue. And certainly we have felt that it would be unwise to ask the Congress to make that change and precipitate a major battle there, a major emotional battle in the country, which would bring in the question of the stability of our currency because those who attack it would say that the currency would no longer be any good at the time when our balance of payments was still in relatively large deficit. So if anything was to be done, it should be done at a later date when we have got our balance of payments in order so people wouldn't think we were doing it so we could continue to run very big deficits.

That is the way we have looked at it in the Treasury. Now, this can be technically modified in many ways. It doesn't haveto be done away with completely. We have gone down from 40 to 25 at once, and it applies to both currency and to deposits of banks with the Federal Reserve System. It could be left to apply maybe only to currency which would free up about half the gold that's tied up behind that. So there are a number of things that could be done. I think, basically, our feeling is that it is not much of a restraint on the Federal Reserve and never has been. The Federal Reserve could issue literally billions and billions, tens of billions of dollars of extra credit, bank credit even with the leeway they now have. The Federal Reserve hasn't shown that it needs that sort of a restriction on them,

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and I would think that when the time came that the Federal Reserve needed that sort of a restriction that we would be in pretty bad shape ourselves. I think we ought to rely on the Federal Reserve as an institution rather than on this sort of artificial means of trying to tell the Federal Reserve or control their actions.

MR. DUTTON: Mr. Martin.

MR. MARTIN: No embargo on gold has been our consistent policy, and it's only as an international media of exchange, as the Secretary has pointed out, that it is primarily important today. There are only two important currencies in the world that have a statutory gold reserve covered today, that is the Belgian franc and the Swiss franc. Our ratio now stands at 30.3 per cent, 25 percent is the requirement. I would certainly hope that we would get our balance of payments situation under control before we go down below that 25 percent.

MR. HEWITT: I would like to address a question to Secretary Hodges.

Mr. Secretary, in the last sentence of your presentation you referred to a subject that's of considerable current interest. I have in mind the question of trade between the United States and Russia and the Russian satellite countries in eastern Europe.

The sales of goods by western countries to the Soviet Bloc last year totalled $4.2 billions and these sales by western

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countries to the Soviets are increasing at the rate of about 10 percent a year. The United State's share of this export to Russia totalled about 2 percent or $166 million.

Now, it is relatively difficult for United States companies to trade with Russia, Hungary, Czechoslovakia, Bulgaria and East Germany. It's relatively easier to trade with Romania and Yugoslavia.

I am wondering, Mr. Secretary, if you could tell us whether you anticipate any relaxation in the government controls of exports by United States companies to the Soviet Bloc? And if you do anticipate that, I wonder if you could help clarify the criteria which should control, rather, which should determine what strategic materials are and what non-strategic goods are. This is sometimes a little confusing. I believe that approval is necessary by a number of different government agencies, any one of which, any department can cancel a bona fide opportunity to sell to the Soviet Bloc. These include, I believe, the State Department, Agriculture Department, Defense Department, the Commerce Department and also, I believe, the CIA.

SECRETARY HODGES: Well, the last part of your statement is not entirely correct, Mr. Hewitt. Unfortunately, we have the responsibility in Commerce, so you can put the total responsibility on us. Because under the designation of the President the Commerce Department Secretary has the responsibility of passing or not passing applications for license.

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As a practical matter, however, we naturally would consult with those agencies you are talking about. And if one of them had a bona fide argument or case, we would sit down and discuss it. And, of course, it would go up to the very highest level. But you do not have to go to all of these places, nor does each one of them have a veto. I just wanted to make that clear. Of course, you have raised a serious, current question, in the matter of how we do in trade with the Soviet and the Bloc. I am using that now, if you don't mind, with two premises; that we are separating Red China, North Korea and Cuba from your question. We are only talking about dealings with the Soviets, particularly in Europe, and we are only talking about items that are non-strategic.

Now, to try to answer your question about strategic. Bernard Baruch one time said, "Nothing is nonQstrategic." But, actually, we go basically by the COCOM list, the list that the allies and ourselves have agre.d on are strategic items and should not be shipped to the Soviets et cetera, as it would add to their military potential.

The truth of the matter is that we in this country -- I am making this very short -- we in this country are very sentimental about a thing like this. We are not in a way as strong in our controls and our negative point of view as the Congress and much of the public would like us to be. We are far more liberal today, in May 1964, than we were in May 1962.

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MR. DUTTON: I am sorry, I am going to have to cut it off here now for the President to come in.

We thank you, gentlemen, very much for coming today.

(Applause.)

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BOARD OF GOVERNORS
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Office Correspondence

Date August 14, 1964.

To Chairman Martin

From J. Herbert Furth

Subject: Revision of quarterly payments figures for 1964.

The Commerce press release reveals that the divergence between our original estimates and the official released figure for the second-quarter payments deficit is due exclusively to new estimates for "special receipts" and "seasonal adjustment."

"Special receipts" remained negative but the (favorable) correction was reduced from an estimated $70 million to $40 million. The seasonal adjustment factor was raised from an estimated $70 million to $119 million.

The official deficit figure is now $623 million before, and $742 million after, seasonal adjustment; the latter figure corresponds to a seasonally adjusted annual rate of $2,968 million.

The seasonal adjustment factor for the first quarter was raised from $249 million to $282 million. This revision raises the seasonally adjusted deficit from $181 million to $214 million, equal to a seasonally adjusted annual rate of $856 million.

Incidentally, the increases in the seasonal factors for the (seasonally favorable) first and second quarters mean that the seasonal correction for the current (seasonally unfavorable) third quarter also will be greater than expected. Since the fourth quarter is seasonally almost neutral, the correction for the current quarter should be nearly as large (with reversed sign) as the sum of the adjustments for the first two quarters, or nearly $400 million.

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In response to Mr. Balderston's question of this morning, the seasonal adjustment for short-term capital movements is, according to the Commerce Department, very small for the first but about $90 million for the (seasonally favorable) second quarter; this means that the seasonally adjusted outflow would be about $90 million _larger_ than the reported unadjusted figure.

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BOARD OF GOVERNORS
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Office Correspondence

Date August 5, 1964.

To Chairman Martin (through Mr. Young)

Subject: Will Britain Need Foreign Credits During Next Six Months?

From Samuel I. Katz

CONFIDENTIAL (FR)

United Kingdom officials expect they will have to draw upon foreign credits this year. During my stay in London last week, senior British Bank and Treasury officials stated privately that the United Kingdom would be indeed fortunate if it did not find it necessary to draw upon international credits within the next six months. The election may make Britain's payments problem more substantial, but the fundamental cause of their concern is the continuing large deficit in Britain's current and long-term capital accounts. Any pre-election speculative capital flows would merely add to the underlying payments deficit; on the other side, an election outturn considered by financial markets to be favorable is not expected to provide sufficient capital inflow to preclude difficulties.

Weakness in underlying payments position. Deficits in both the current and the long-term capital accounts are responsible for the weakness in Britain's external payments position. On the trade side, the cyclical increases in imports are about in line with the expectations of the authorities when they undertook their expansionary program about 15 months ago; but there is concern that exports may not expand fast enough in the second half of 1964 to finance the economy's needs for imported materials.

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On the long-term capital side, British oil companies are making heavy investments abroad this year after two years of only limited payments. The Shell investment in Italy and capital spending in the new field in the Middle East are among the projects underway.

Thus far, Britain's reserves have been more favorable than had been expected because the outer sterling countries have been accumulating sterling balances. But the view was expressed that the underlying deficit was bound to lead to reserve losses over the next six months: one figure mentioned (as a rough measure of magnitude and not as an estimate or official projection) was reserve losses of as much as £200 million during the next two or three quarters. Any pre-election capital flight would merely add to the large current payments deficit and to expected reserve losses.

Attempts to hold domestic interest rates. The publication of the adverse trade figures for June produced a significant shake-out in British financial markets in mid-July. The Treasury bill yield rose about 20 basis points, and the discount houses obtained very heavy amounts of bills at the weekly tender because "outside" investors withdrew from the market. At the same time, bond yields also moved up, even though the Government Broker bought £100 million of bonds in a single week.

After about a week, financial markets regained an element of stability, and the authorities were even able to sell some bonds. However, both the bill and gilt-edged markets continue to be brittle and poor trade returns or other unfavorable news could produce a further shake-out in these markets.

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Despite rumors in financial markets, the British authorities are strenuously trying to avoid a rise in Bank rate at this time. In present circumstances, they want to avoid a rise in Bank rate from 5 to 6 per cent at this time so that it would be available as a policy instrument should a run on the pound develop in August or September.[1/]

Because the election is still three months off, Bank officials are trying to check the rise in Treasury bill rates. Bank officials at all levels are expressing this view in conversations with the discount houses. To keep yields steady, the monetary authorities are prepared to see some expansion in short-term credit supplies. For example, the weekly Treasury bill tender was increased from £230 million to £250 million in late July because the Government Broker had been forced to buy bonds in mid-July. One suggestion made was that the Bank could act to ease short credit conditions for a temporary period to gain time, if such drastic action were required. Conditions in British financial markets are not good. As a result, distinctly unfavorable news could threaten to force the hand of the monetary authorities at any moment.

1/ It is assumed that a 2 per cent rise in Bank rate would be required under emergency conditions. A 6 per cent Bank rate now would thus mean an 8 per cent Bank rate: but the rate only reached 7 per cent during the massive exchange crises in September 1957 and again in July 1961. An 8 per cent Bank rate would be considered out of proportion to the extent of weakness in Britain's underlying position; it would also have obvious political implications at this time.

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How to finance reserve losses? Because expected reserve losses would be primarily a matter of an underlying payments deficit (not merely reversible shifts of temporary short-term capital), British officials are thinking in terms of medium-term financing--that is, a drawing from the Fund and not short-term central bank swaps.

However, the Fund might have to actuate the General Agreement to Borrow if the United Kingdom wanted large amounts of European currencies. Certain European representatives (the French and the Dutch) are known to wish to impose conditions on the United Kingdom. On their part, the United Kingdom officials are prepared to resist conditions they consider unreasonable. They will maintain that drawings against their stand-by for the gold and first credit tranche should continue to be favorably treated: an attempt by European representatives to impose conditions for such drawings would (in the British argument) amount to a change in long-standing Fund policies and would, therefore, be entirely unacceptable.

It was reported that British officials have already confirmed with Mr. Schweitzer that the Fund is prepared to meet its commitment. One British official expressed the hope that Mr. Schweitzer would do as much of the negotiating with the Group of Ten as possible but he did recognize that there was bound to be some consultation within the Group of Ten with active participation by United Kingdom representatives.

To meet a British drawing, Mr. Schweitzer may finally have to fall back, at least in part, upon the Fund's gold holdings.

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Use of central bank swaps. Either of two contingencies might lead the United Kingdom to make use of central bank credit facilities, at least in the first instance, instead of the Fund stand-by. In the first place, the time needed to complete arrangements under the Borrowing scheme might create a problem of temporary finance; in addition, the terms laid down might be such as to lead British officials to seek funds from other sources.

Secondly, as the election approaches, the United Kingdom might experience speculative capital outflows thought to be reversible. Central bank swaps are ideal for this purpose.

It is my impression that the Bank of England has no specific advance understandings with European central banks for this contingency and will wait to see the volume and destination of any outflows before deciding on tactics. They do have experience in using such credits in the past. However, Bank officials seem to be uncertain whether their European counterparts would try to impose conditions on such swaps at this time. They seem to think that the credits would not be bilateral, as in the past, but that there would be some joint discussion by the central banks of the Common Market countries. In fact, the bankers from these countries have begun to meet regularly as a group on Monday afternoon after the regular monthly meeting in Basle. One British official thought that despite the position taken by Common Market representatives in other forums, the central bankers would make swaps available with only minimum conditions.

Because of these uncertainties, however, it is evident that the British authorities find the facilities available under the Federal Reserve swap particularly attractive at this time.

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Major changes in British economic policy in prospect? It became clear (in discussions with Bank and Treasury officials, with Sir Robert Shone of Neddy and with Christopher Saunders of the National Institute for Economic Research) that a good deal of ssrious thinking about British economic policy is already underway. Some of the studies deal with the steps to be taken should payments difficulties arise before the election. But the fact that the payments weakness is not temporary in character has provoked inquiry into what went wrong this time.

There is general disappointment that, once again, domestic expansion may have to be cut off by balance-of-payments difficulties. Proponents of two lines of policy have been particularly disappointed: those who thought that enough demand in the economy would lead to sustained economic growth (through advances in productivity) and those who thought that the key to steady growth was through the Neddy-type of economic "planning."

The headline in the Financial Times (July 30) that "Economic Problems Will Dominate The Next Five Years" (of the new Parliament) confirms my own impression that significant changes in economic policy may well be in the making.

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BOARD OF GOVERNORS
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Office Correspondence

Date August 14, 1964.

To Chairman Martin

Subject: Weekly payments indicators.

From J. Herbert Furth

CONFIDENTIAL (FR)

Tentative data for the week ending August 12 suggest a payments deficit of $147 million; the deficit for the preceding week was revised downward to $73 million. While the average of these two weeks suggest a monthly deficit much lower than the (revised) $612 million figure for July, the decline in the deficit has so far been much smaller than in the corresponding months of this year's first and second quarters.

Incidentally, I have not yet received the Commerce press release announcing the payments data for the second quarter. Press reports indicate, however, that the announced deficit is somewhat higher than had been expected (seasonally adjusted annual rate of $2.9 billion rather than of $2.7 billion), and that the figure for the first quarter also has been revised upward (to a seasonally adjusted rate of $800 million, from $720 million).

Mr. Dahl intends to discuss the figures in Monday's Board briefing, and I shall include an analysis in Tuesday's FOMC presentation.

JHF

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AUG 13 1964

CONFIDENTIAL--(F.R.)

August 7, 1964 (handwritten: 14)

Changes in Foreigners' Liquid Assets in the U.S. and in U.S. Monetary Reserves
(In millions of dollars)

W E E K L Y   S E R I E S

Period	Changes in principal liquid assets held by foreigners: Official FRBNY	Official "Street"	Official Total	Private	Changes in United States monetary reserves (signs reversed): Gold a/	Foreign currencies	IMF position	Total	Foreigners net gains (+) or losses(-)
Ending:									
1964 - July 8	+ 3	- 44	- 41	+114	- 16	+ 2	+ 2	- 12	+ 61
July 15	+ 69	+123	+192	+147	- 1	+ 24	- 2	+ 21	+360
July 22	- 49	+ 31	- 18	+225	--	- 26	- 1	- 27	+180
July 29	+ 59	- 36r	+ 23r	+ 1r	- 23	+ 1	--	- 22	+ 2r
Aug. 5	+ 10	~~+ 23p~~ 14	~~+ 33p~~ 24	~~+ 79p~~ 72	+ 10	- 30	- 3	- 23	~~+ 89p~~ 73
Aug. 12	44	51	95	44	5	1	2	8	147

(Six Week Totals)

Covering:	Official Total	Private	Reserves Total	Foreigners net gains (+) or losses(-)
May 28-July 8	+108	-192	+292	+208
June 4-July 15	+257	+ 21	+286	+564
June 11-July 22	+163	+397	+117	+677
June 18-July 29	+116r	+380r	+ 76	+572r
June 25-Aug. 5	119 +128p	+503p 496	--	+631p 6..
July 2-Aug. 12	275	603	-55	823

M O N T H L Y   S E R I E S

Period	Official	International and Regional b/	Private	Total	Gold a/	Foreign currencies	IMF position	Total	Foreigners net gains (+) or losses(-)
May 1-31	+223	- 45	-183	- 5	+ 34	+ 11	- 2	+ 43	+ 38
June 1-30	+200	- 30	-287	-117	+ 70	+ 71	+123	+264	+147
July 1-31	n.a.	n.a.	n.a.	648	- 6	- 29	- 1	- 36	612

a/ Treasury gold stock plus gold in Exchange Stabilization Fund.
b/ These claims are included in official holdings in the Weekly Series.

p - preliminary
r - revised

Balance of Payments Division
Federal Reserve Bank of New York

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