FEDERAL
ADVISORY COUNCIL

MINUTES
AND
RECOMMENDATIONS

1936-1940

MINUTES OF MEETING

of the

FEDERAL ADVISORY COUNCIL

February 11-12, 1936

OFFICERS AND MEMBERS OF THE FEDERAL ADVISORY COUNCIL

For the Year 1936

OFFICERS:

President, Walter W. Smith
Vice President, Howard A. Loeb
Secretary, Walter Lichtenstein

EXECUTIVE COMMITTEE:

Walter W. Smith
Howard A. Loeb
Thomas M. Steele
James H. Perkins
H. Lane Young
W. T. Kemper

MEMBERS:

Thomas M. Steele	Federal Reserve District No. 1
James H. Perkins	Federal Reserve District No. 2
Howard A. Loeb	Federal Reserve District No. 3
Arthur E. Braun	Federal Reserve District No. 4
Charles M. Gohen	Federal Reserve District No. 5
H. Lane Young	Federal Reserve District No. 6
Edward E. Brown	Federal Reserve District No. 7
Walter W. Smith	Federal Reserve District No. 8
Theodore Wold	Federal Reserve District No. 9
W. T. Kemper	Federal Reserve District No. 10
Joseph H. Frost	Federal Reserve District No. 11
M. A. Arnold	Federal Reserve District No. 12

BY-LAWS OF THE FEDERAL ADVISORY COUNCIL

ARTICLE I. OFFICERS

Officers of this Council shall be a President, Vice-President, and Secretary.

ARTICLE II. PRESIDENT AND VICE-PRESIDENT

The duties of the President shall be such as usually pertain to the office; in his absence the Vice-President shall serve.

ARTICLE III. SECRETARY

The Secretary shall be a salaried officer of the Council and his duties and compensation shall be fixed by the Executive Committee.

ARTICLE IV. EXECUTIVE COMMITTEE

There shall be an Executive Committee of six (6) members of the Council, of which the President and Vice-President of the Council shall be *ex officio* members. To fill a vacancy, the President, or in his absence, the Vice-President shall be authorized to designate as a member of the Executive Committee for a given meeting another member of the Council other than one elected to the Executive Committee.

ARTICLE V. DUTIES OF THE EXECUTIVE COMMITTEE

It shall be the duty of the Executive Committee to keep in close touch with the Federal Reserve Board and with their regulations and promulgations, and communicate the same to the members of the Council, and to suggest to the Council from time to time, special matters for consideration.

The Executive Committee shall have power to fix the time and place of holding its regular and special meetings and methods of giving notice thereof.

Minutes of all meetings of the Executive Committee shall be kept and such minutes or digest thereof shall be immediately forwarded to each member of the Council.

A majority of the Executive Committee shall constitute a quorum and action of the Committee shall be by majority of those present at any meeting.

ARTICLE VI. MEETINGS

Regular meetings of the Federal Advisory Council shall be held in the City of Washington on the third Tuesday of the months of February, May, September, and November of each year, unless otherwise directed by the Executive Committee.

A preliminary meeting of the Federal Advisory Council shall be called by the Secretary in accordance with instructions to be given by the President of the Council.

Special meetings may be called at any time and place by the President or the Executive Committee, and shall be called by the President upon written request of any three members of the Council.

ARTICLE VII. ALTERNATES

In the absence of the regular representative of any Federal Reserve District, the Board of Directors of the Federal Reserve Bank of that District may appoint an alternate. The alternate so appointed shall have the right to be present at all the meetings of the Council for which he has been appointed. He shall have the right to take part in all discussions of the Council but shall not be entitled to vote.

ARTICLE VIII. AMENDMENTS

These by-laws may be changed or amended at any regular or special meeting by a vote of a majority of the members of the Federal Advisory Council.

February 11, 1936.

MINUTES OF MEETING OF THE FEDERAL ADVISORY COUNCIL

February 11, 1936.

The first and organization meeting of the Federal Advisory Council for 1936 was convened in Room 836 of the Mayflower Hotel, Washington, D.C., on Tuesday, February 11, 1936, at 10:15 A. M.

Present:

Mr. Thomas M. Steele	District No. 1
Mr. James H. Perkins	District No. 2
Mr. Howard A. Loeb	District No. 3
Mr. Arthur E. Braun	District No. 4
Mr. Charles M. Gohen	District No. 5
Mr. H. Lane Young	District No. 6
Mr. Edward E. Brown	District No. 7
Mr. Walter W. Smith	District No. 8
Mr. Theodore Wold	District No. 9
Mr. W. T. Kemper	District No. 10
Mr. Joseph H. Frost	District No. 11
Mr. Walter Lichtenstein	Secretary

Absent:

Mr. M. A. Arnold	District No. 12

Mr. Walter W. Smith was elected Chairman *pro tem* and Mr. Walter Lichtenstein Secretary *pro tem.*

The Secretary stated that communications had been received from all of the Federal Reserve banks certifying to the election of their representatives in accordance with the above list.

Upon nominations for the office of President of the Council being called for, Mr. Walter W. Smith was nominated. On motion, duly made and seconded, the nominations were closed and the Secretary was instructed to cast a ballot for Mr. Smith, who was thereupon declared elected President of the Council for the year 1936.

Upon nominations for Vice President being called for, Mr. Howard A. Loeb was nominated. On motion, duly made and seconded, the nominations were closed and the Secretary was instructed to cast a ballot for Mr. Loeb, who was thereupon declared elected Vice President of the Council for the year 1936.

The President, Mr. Smith, thereupon called for nominations for the four appointive members of the Executive Committee. Messrs. Thomas M. Steele, James H. Perkins, H. Lane Young, and W. T. Kemper were nominated. On motion, duly made and seconded, these gentlemen were unanimously elected members of the Executive Committee for the year 1936, the President and Vice President being *ex officio* members.

On motion, duly made and seconded, Mr. Walter Lichtenstein was elected Secretary of the Federal Advisory Council for the year 1936 at a salary of $2,500.00 per annum.

On motion, duly made and seconded, the Council readopted for the year 1936 the existing by-laws which are attached hereto and made part of these minutes.

On motion, duly made and seconded, the minutes of the Council meeting of November 20-21, 1935, copies of which had been previously sent to the members, were approved.

The Secretary presented his financial report for the year 1935, which had been audited by Mr. J. J. Buechner, Assistant Auditor of The First National Bank of Chicago, which on motion, duly made and seconded, was approved and ordered to be printed. The report is attached hereto and made a part of these minutes.

On motion, duly made and seconded, the following resolution was unanimously adopted:

"Resolved, that the Secretary be and he is hereby authorized to ask each Federal Reserve Bank to contribute $350 toward the Secretarial and incidental expenses of the Federal Advisory Council for the year 1936 and to draw on it for that purpose."

It was voted that the Mayflower Hotel continue to be used as headquarters of the Council.

President Smith made a statement regarding the unauthorized premature publication of the recommendations made by the Council at its November meeting. He pointed out that there was considerable evidence to indicate that the responsibility for this premature publication was that of the Board and not of the Council.

It was voted that the resolution originally adopted by the Federal Advisory Council on May 20, 1926, be re-adopted with the necessary change in terminology to make it conform to the Banking Act of 1935, reading as follows:

"It was decided that in future the members of the Council should formulate topics concerning which they might wish information from the Board of Governors of the Federal Reserve System, or which they wished to have discussed with the Board. Such inquiries should be addressed to the Secretary of the Council, and the Secretary was directed to act as a clearing house for members of the Council and prepare material to be brought up at the joint conference of the Federal Advisory Council and the Board of Governors of the Federal Reserve System."

Mr. Steele brought up the question of sub-section f of Regulation Q which has been suspended by the Board of Governors of the Federal Reserve System since the Federal Deposit Insurance Corporation issued a regulation which did not agree in all respects with the one of the Board. No definite action was taken, though the hope was expressed by several of the members that the clause in question be put into effect.

Mr. Frost read a lengthy statement dealing with the subject of excess reserves. This statement is included as a part of the official record of this meeting.

At 11:00 A. M. Dr. Goldenweiser appeared before the Federal Advisory Council and until 12:50 P. M. discussed chiefly the problems connected with the Government financing.

At 1:00 P. M. the Council adjourned to Room 883 for luncheon at which Chairman Eccles was present.

The Chairman read a memorandum giving the historical, legal, and practical objections to having representatives of the Federal Reserve banks on the Open Market Committee other than presidents of Federal Reserve banks or full time executive officials of the System.

The meeting adjourned at 3:00 P. M.

WALTER LICHTENSTEIN,
Secretary.

REPORT OF THE SECRETARY OF THE FEDERAL ADVISORY COUNCIL

For the Year Ending December 31, 1935.

Balance on hand December 31, 1934	$2,348.03	Salary	$2,000.00
Assessment — Twelve Federal Reserve Banks	4,200.00	Miscellaneous	57.87
		Conference Expenses* (See Note)	2,103.07
		Printing and Stationery	706.63
		Postage, telegrams and telephones	233.49
		Balance on hand December 31, 1935	1,446.97
	$6,548.03		$6,548.03

Note: *This item includes all the expenses connected with the work in relation to the Banking Act of 1935, as well as the expenses of a stenographer. These special expenses were all authorized by vote of the Federal Advisory Council on March 28, 1935.

Chicago, Illinois.
January 13, 1936.

To the Federal Advisory Council:

I have audited the books, vouchers and accounts of the Secretary of the Federal Advisory Council for the year ending December 31, 1935, and certify that the above statement agrees therewith.

Respectfully,

THE FIRST NATIONAL BANK OF CHICAGO,
(Signed) J. J. BUECHNER,
Asst. Auditor.

MINUTES OF JOINT CONFERENCE OF THE FEDERAL ADVISORY COUNCIL AND THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

February 11, 1936.

At 3:50 P. M. a joint conference of the Federal Advisory Council and the Board of Governors of the Federal Reserve System was held in the Board Room, Washington Building, Washington, D. C.

Present: Members of the Board of Governors of the Federal Reserve System:

Chairman M. S. Eccles; Governors Joseph A. Broderick, John McKee, Ralph W. Morrison, Ronald Ransom, and M. S. Szymczak; also Messrs. Lawrence Clayton, Assistant to the Chairman of the Board of Governors of the Federal Reserve System; Walter Wyatt, General Counsel for the Board; Chester Morrill, Secretary of the Board; L. P. Bethea and S. A. Carpenter, Assistant Secretaries of the Board; Dr. E. A. Goldenweiser, Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System; Carl E. Parry, Chief of Division of Bank Loans, Board of Governors; E. L. Smead, Chief of Division of Bank Operations of the Board of Governors; Leo H. Paulger, Chief of Division of Examinations, Board of Governors; and Elliott Thurston, Special Assistant to the Chairman of the Board of Governors.

Present: Members of the Federal Advisory Council:

Mr. Walter W. Smith, President; Mr. Howard A. Loeb, Vice President; Messrs. T. M. Steele, J. H. Perkins, A. E. Braun, C. M. Gohen, H. Lane Young, E. E. Brown, Theodore Wold, W. T. Kemper, J. H. Frost, and Walter Lichtenstein, Secretary.

Chairman Eccles repeated his statement about the election of other than presidents of Federal Reserve banks as members of the Open Market Committee.

In reference to sub-section f of Regulation Q, Chairman Eccles made the statement that the Board had issued this regulation under the impression that the Federal Deposit Insurance Corporation fully agreed and that there would be unanimity in the regulations of the two bodies. However, it developed that the regulation issued by the Federal Deposit Insurance Corporation did not prohibit the exaction of exchange charges by banks. Since then the Federal Deposit Insurance Corporation has reissued the regulation effective as of February 1, but the Board of Governors of the Federal Reserve System has not seen its way clear to concur in the regulation issued by the Federal Deposit Insurance Corporation and, therefore, it has not re-enacted sub-section f of Regulation Q nor has it issued any substitute in its place.

The Secretary of the Council read Recommendation No. 2 adopted by the Federal Advisory Council at its November, 1935, meeting, dealing with margin requirements for collateral loans of banks.

The meeting adjourned at 4:45 P. M.

WALTER LICHTENSTEIN,
Secretary.

MINUTES OF MEETING OF THE FEDERAL ADVISORY COUNCIL

February 11, 1936.

At 4:50 P. M. the Federal Advisory Council reconvened in the Board Room, Washington Building, Washington, D. C., the President, Mr. Smith, in the Chair.

Present: Mr. Walter W. Smith, President; Mr. Howard A. Loeb, Vice President; Messrs. T. M. Steele, J. H. Perkins, A. E. Braun, C. M. Gohen, H. Lane Young, E. E. Brown, Theodore Wold, W. T. Kemper, J. H. Frost, and Walter Lichtenstein, Secretary.

It was decided to notify the Board that the Council wished to meet with it tomorrow, Wednesday, February 12, at 10:30 A. M., and it was decided to have a meeting of the Council in Room 836 of the Mayflower Hotel today, Tuesday, February 11 at 7:15 P. M.

The meeting adjourned at five o'clock.

WALTER LICHTENSTEIN,
Secretary.

MINUTES OF MEETING OF THE FEDERAL ADVISORY COUNCIL

February 11, 1936.

At 7:30 P. M. the Federal Advisory Council reconvened in Room 836 of the Mayflower Hotel, Washington, D. C., the President, Mr. Smith, in the Chair.

Present: Mr. Walter W. Smith, President; Mr. Howard A. Loeb, Vice President; Messrs. T. M. Steele, J. H. Perkins, A. E. Braun, C. M. Gohen, H. Lane Young, E. E. Brown, Theodore Wold, W. T. Kemper, J. H. Frost, and Walter Lichtenstein, Secretary.

The Secretary read a letter from Chairman Eccles dated February 4, 1936, thanking the members of the Federal Advisory Council on behalf of himself and other members of the Board of Governors for the flowers which had been sent in the name of the Federal Advisory Council to the Board on the occasion of the installation in office of the new members of the Board of Governors of the Federal Reserve System.

Mr. Frost presented a resolution, embodying the ideas expressed in the statement made by him at the morning meeting and dealing with the problem of excess reserves. A copy of this resolution is made a part of the permanent record of the meeting.

Mr. Brown made some remarks in opposition to the resolution as presented by Mr. Frost.

It was voted to appoint a sub-committee to draft a resolution, the committee to consist of Messrs. Brown, Frost, Steele, and the Secretary of the Council.

The sub-committee withdrew and presented a resolution which is made a part of the permanent record of this meeting.

It was moved by Mr. Brown and seconded by Mr. Loeb that the statement of the sub-committee be adopted as a recommendation of the Council to the Board of Governors of the Federal Reserve System. The motion was unanimously adopted.

It was unanimously voted that the Board be informed that the Council desires that the recommendation be given publicity within a week.

The meeting adjourned at 10:10 P. M.

WALTER LICHTENSTEIN,
Secretary.

MINUTES OF MEETING OF THE FEDERAL ADVISORY COUNCIL

February 12, 1936.

At 9:40 A. M. the Federal Advisory Council reconvened in Room 836 of the Mayflower Hotel, Washington, D. C., the President, Mr. Smith, in the Chair.

Present: Mr. Walter W. Smith, President; Mr. Howard A. Loeb, Vice President; Messrs. T. M. Steele, J. H. Perkins, A. E. Braun, C. M. Gohen, H. Lane Young, E. E. Brown, Theodore Wold, W. T. Kemper, J. H. Frost, and Walter Lichtenstein, Secretary.

Mr. Steele asked for reconsideration of the recommendation adopted the day previous and it was voted to reconsider.

Mr. Frost presented an amended resolution which is appended to these minutes as Recommendation No. 1. After some discussion it was adopted unanimously.

A resolution was presented which is attached to these minutes as Recommendation No. 2 and deals with margin requirements for collateral loans of banks (Regulation U). This was adopted unanimously.

The meeting adjourned at 11:10 A. M.

WALTER LICHTENSTEIN,
Secretary.

MINUTES OF JOINT CONFERENCE OF THE FEDERAL ADVISORY COUNCIL AND THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

February 12, 1936.

At 11:45 A. M. a joint conference of the Federal Advisory Council and the Board of Governors of the Federal Reserve System was held in the Board Room, Washington Building, Washington, D. C.

Present: Members of the Board of Governors of the Federal Reserve System:

Chairman M. S. Eccles; Governors Joseph A. Broderick, Ralph W. Morrison, and Ronald Ransom; also Messrs. Lawrence Clayton, Assistant to the Chairman of the Board of Governors of the Federal Reserve System; Walter Wyatt, General Counsel for the Board; Chester Morrill, Secretary of the Board of Governors; L. P. Bethea and S. A. Carpenter, Assistant Secretaries of the Board; Dr. E. A. Goldenweiser, Director, Division of Research and Statistics, Board of Governors; Carl E. Parry, Chief of Division of Bank Loans, Board of Governors; E. L. Smead, Chief of Division of Bank Operations, Board of Governors; and Elliott Thurston, Special Assistant to the Chairman of the Board of Governors.

Present: Members of the Federal Advisory Council:

Mr. Walter W. Smith, President; Mr. Howard A. Loeb, Vice President; Messrs. T. M. Steele, J. H. Perkins, A. E. Braun, C. M. Gohen, H. Lane Young, E. E. Brown, Theodore Wold, W. T. Kemper, J. H. Frost, and Walter Lichtenstein, Secretary.

President Smith informed the Board that the Council expected to have its statutory meetings on the third Tuesday of the following months: February, May, September, and November. It was pointed out that as September 1 in this year falls on a Tuesday, it would make the September meeting unnecessarily early. It was thereupon agreed that the meeting in September with the Board should take place on September 22.

The Secretary of the Council read Topic No. 1. Chairman Eccles asked whether the Council desired this recommendation to be given publicity. President Smith replied that the Council did desire the recommendation to be released, but was willing to have such release delayed for a week.

The Secretary of the Council read Topic No. 2 and Chairman Eccles made the statement that this would be given publicity at the same time as Recommendation No. 1.

The meeting adjourned at 12:15 P. M.

WALTER LICHTENSTEIN,
Secretary.

RECOMMENDATIONS OF THE FEDERAL ADVISORY COUNCIL TO THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

February 12, 1936.

TOPIC No. 1. Excess Reserves.

RECOMMENDATION: The Federal Advisory Council wishes to direct the attention of the Board of Governors of the Federal Reserve System and, through it that of the Open Market Committee of the System, to the communication made by the Council to the Board at its meeting of September 24, 1935, concerning the amount of Government securities held by the System, and to its unanimous recommendation made to the Board at its meeting of November 21, 1935, referring to the same subject and further making recommendations with regard to the amount of excess reserves of member banks now carried with the System.

The Council has taken cognizance of a joint statement issued by the Board of Governors and the Open Market Committee under date of December 18, 1935, which seemed to recognize fully that "the special problem created by the continuing excess of reserves" was of such importance as to justify a continuance of the "unremitting study and attention of those charged with the responsibility for credit policy in order that appropriate action may be taken as soon as it appears to be in the public interest."

In view of the fact that, since the above statement was made, a great change has taken place in the membership of the Board of Governors and an entirely new arrangement of the composition of the Open Market Committee is about to be consummated, the Council feels that it would be in every way desirable and proper for it at this time to refer to the communications mentioned and to make known its present views.

Of the slightly less than six billion dollars of reserves, approximately three billion dollars of which are required, no less than two billion four hundred million dollars were created by purchases of Government securities in the open market by the issuance of reserve bank credit. A very large percentage of the remainder of the reserve structure is the result of gold imports which have come into the country in the last two years, not as the result of a settlement of trade balances but largely for protection against unsettled conditions in other countries, and partly for speculative purposes. The gold holdings thus acquired may be largely transitory and temporary.

The Council is of the opinion that it would be unwise and unsound to permit a credit structure to be built on the base of reserves so created.

The Council recognizes and has taken into the most careful consideration the fact that there have been various groups representing very important elements in the business and financial structure of the country who have firmly expressed the opinion that the present huge volume of excess reserves is a most serious menace, but that the first step for the proper correction of the situation would be an increase of reserve requirements, control over which has been granted to the Board of Governors of the Federal Reserve System by the terms of the Banking Act of 1935.

The Council is so deeply impressed with the necessity for prompt preventive action in order to avoid the possibility of the building of a credit structure on the reserves as at present constituted, that it recommends to the Board at this time a substantial increase in the reserve requirements for member banks. This increase should be at least large enough to prevent a credit structure being built on that part of the gold holdings which may be deemed to be transitory or temporary.

In making this recommendation in respect to the raising of reserve requirements, the Council wishes to make it clear that it does not believe that reserve requirements should be varied at frequent intervals or except for grave reasons. It is of the opinion that frequent changes in reserve requirements would destroy confidence both on the part of the borrower and the banker and restrict employment of bank credit needed for continued business recovery.

TOPIC No. 2. Regulations in Respect to Margin Requirements on Collateral Loans of Banks (Regulation U).

RECOMMENDATION: The Federal Advisory Council is still strongly of the opinion expressed in a recommendation made to the Board of Governors of the Federal Reserve System on November 21, 1935 that there is no need at this time to put into force regulations affecting collateral loans made by banks. The Council believes that the nature of the lending operations carried on by banks is essentially different from that by brokers. Regulations governing collateral loans by banks may affect forms of credit which it is not at all intended to regulate, while the business of brokers is confined almost entirely to loans on registered securities made for the express purpose of purchasing and carrying these.

STATEMENT OF J. H. FROST
TO
FEDERAL ADVISORY COUNCIL - FEBRUARY 11th, 1936

Since the publication of the statement of the Federal Advisory Council on the subject of excess reserves, which was adopted at their meeting in November of last year, there has been wide discussion of the subject and there have appeared a considerable number of articles with regard to it in various financial publications. The Open Market Committee met in December, gave careful consideration to the matter, and, as a result of such consideration, joined the Board of Governors of the Federal Reserve System in a statement effectively saying that there was nothing in the situation then prevailing to justify any action looking to a reduction of excess reserves, either by the method recommended by the Council, namely, reducing holdings of Government obligations by the System, or by the method recommended by certain other prominent persons - increasing the percentage of legally required reserves. The statement further assured the country that the matter would continue to receive the consideration of "those charged with the responsibility for credit policy", to the end that control, if necessary or desirable, would be exercised in plenty of time to prevent harmful effects flowing from any undue credit expansion.

It is safe to say that the preponderance of opinion expressed in well-recognized financial publications is substantially in agreement with the statement of the Council. However, I have been more deeply interested in not only the attitude assumed by the officials of the Federal Reserve System, but in such expressions as I have seen of others not in agreement with the November statement of the Council. While it is true that groups of no inconsiderable importance in the way of power and influence do not agree with the thought expressed by the Council with respect to the immediate dangers of inflationary credit expansion, it has seemed to me to be of very great significance that I have yet to see any statement or argument in opposition to that part of the statement of the Council which is the true foundation for the whole statement, and which reads as follows: "The controlling reason for this is the indisputable fact that, so long as Government bonds are held under the ownership of the System, either the currency of the country or the reserves of member banks, to a corresponding extent, are dependent entirely upon a Government obligation. The world history of currency and banking has demonstrated the dangers inherent in such a system or policy too many times to make it necessary for them to be elaborated upon in this communication."

In other words, there seem to be differences in opinion with respect to the dangers of credit expansion at this time, and there seem to be varying views with regard to whether excess reserves should be reduced by any method whatever for the <u>purpose</u> of avoiding credit inflation, but it is evident that there is complete agreement in the at least tacit acceptance of the basic principle expressed by the Council in the above quoted portion of its statement.

Since the correctness or soundness of the Council's statement in at least this one particular seems to be thus tacitly approved by all, it will be universally agreed that the elimination of this fiat element should properly be accomplished at some date, either now or at some time in the future. The only remaining question is - when shall it be done? The answer is perfectly obvious - when excess reserves are sufficiently great to permit the operation without forcing banks either to rediscount or to reduce loans or investments.

That question is not one of whether or not we increase reserve requirements at this time, or possibly at all, nor is it a question of selling Governments held by the System for the purpose of reducing reserves. It simply is one of whether or not the currency and bank reserves are to be purged of the fiat element before a bank deposit structure built upon it becomes a reality, and thus insures its permanency. It is the question of whether the currency and reserves shall permanently consist of gold or some commodity having a value in the markets of the world independent of Government fiat, or whether they shall consist of Government promises.

I hope that, in all consideration of what we are to recommend, the members of the Council will have in mind the basic thought and principle here involved. However, even though no one has publicly or privately, so far as I know, attempted to refute in any manner that portion of our November statement, there are other points of disagreement, and, of course, we should carefully weigh and consider these opposing views in order that we may recommend a sound and wise course to the Federal Reserve Board.

First, there is the group who are seemingly greatly disturbed over what they seem to regard as a real and possibly imminent danger of unsound credit expansion based on prevailing reserves, and who strongly urge preventive measures in lieu of depending upon corrective measures after the expansion should be further developed than it has been up to this time, but who recommend increasing reserve requirements in preference to elimination of the fiat part of the reserve base.

Second, there is the other group, which really consists of the Board of Governors of the Federal Reserve System, the Open Market Committee and those economists, bankers and others who seem to believe that any official action whatever at this time looking to a reduction of the reserve structure would adversely affect public confidence by tightening credit, raising the market price of money, making more difficult the financing of Government deficits at low rates, and, as a general result, interfere with or even prevent the process of recovery.

I think I am correct in saying that the above two groups include all who have expressed disagreement with the recommendations of the Council, and I submit that neither of these groups have said anything at all in contravention of the propriety or importance of some day eliminating the fiat element in the reserve structure. Further, I submit that the omission of reference to that part of our statement on the part of all groups has not occurred inadvertently. You may be assured that the Board of Governors of the Federal Reserve System and the Open Market Committee in acting adversely to our recommendations would not carelessly have failed to point out a fallacy in our reasoning on such a basic principle.

However, let us consider the respective positions of the two groups separately. The first group are in complete agreement with us in that they fear the possibility of dangerous credit expansion, so that I will defer discussion of that phase until we consider the attitude of the second group. In fact, the first group is only out of accord with us in one particular - the method. They agree with us as to the timing of action, and they agree with us that preventive measures are preferable to corrective, even if it be assumed that corrective measures possibly might be applied early enough to be effective. In short, we both recommend reduction of excess reserves, but the point of divergence between us is where we recommend actual reduction of reserves coincidentally with elimination of the fiat element, while they effectively recommend no reduction whatever in actual reserves, nor any reduction (much less elimination) of the fiat element.

They propose to remedy the trouble by a simple change in nomenclature and by an edict of the Board practically saying: "Yes, the basis for credit is there but it is forbidden that it be employed." Personally, I am surfeited with being ruled by edicts from any source whatever. Give us a sound reserve structure first, then let us agree on a definite and fixed required reserve percentage, not to be changed by anybody's edict, and then let us extend credit without fear of the soundness of the credit base and without fear of what some theorist may do by issuing new edicts from time to time changing legal reserve requirements - thus making utterly impossible any semblance of intelligent planning on the part of any individual banker in the country. I could, of course, consume a great deal of time in discussing the superior merit of the method recommended by us in November to that of frequent changes by governmental edicts in reserve requirements, but it would be largely a repetition of much of what was contained in my statement to the Council in November. Let it suffice for me to refer to that statement and to remind you that, as important as may be the exact point at which required reserves should be permanently set by law or by edict of the Federal Reserve System, it is inconsequential in comparison with the desirability of maintaining the soundness of the currency and reserve structure without the least reference to its magnitude.

Now, as to the second group not in accord with our November statement. This group includes the Board of Governors of the Federal Reserve System and the Open Market Committee, and, in view of the fact that they jointly constitute the body which is charged with the full responsibility for action or failure to act, I feel that their statement is worthy of your most careful consideration and analysis. There does not seem to be any indication contained in the statement as to which method of control may eventually be employed, but the final paragraph refers to a "special problem created by the continuing excess of reserves," and assures the country that "appropriate action" will be taken as soon as it appears to be in the public interest. From this paragraph, one must infer that the Board and Committee feel that it is possible that future events will make some action on the matter "appropriate". Naturally, no one can imagine any necessity for increasing excess reserves, so that we are constrained to assume that "appropriate" action means an action for the purpose of reducing excess reserves. It follows, then, that this will be by either increasing the legally required percentage or by reducing the System holdings of Government securities, since these are the only two methods available. Since the statement gives no indication as to which method may be adopted at the time that it "appears to be in the public interest", we can only hope that it may be the correct one. Nor is it necessary here to go over the ground again as to which one that is. At any rate, they already have our recommendation on that point, and, as the members of the Council know, I furnished - in accord with your permission - to each member of the Board a copy of my statement to the Council on the subject.

The remainder of the statement of the Board and Committee includes an opinion expressed in four paragraphs, in the first and third of which the thought is expressed that, although improvement in business and financial conditions has been made, full recovery has not yet been achieved and that there is as yet no evidence of over-expansion of business activity or of the use of business credit. The inference from this can be nothing less than that nothing will justify action until full recovery has been achieved, and, further, until there be actual evidence of over-expansion of business activity or of the use of business credit. Here is where there is apparent a sharp divergence between the views of those preferring preventive action and those preferring corrective action. Those preferring preventive action, of which group I am one, believe that the banks and the public generally are entitled to early, if not immediate, action looking to the reduction of the reserve structure to the point that its composition will be sound, and, further, to the definite settlement of the question of what reserve percentage against deposits not only is, but will be considered to be safe. We believe that it is not only unfair, but basically unsound and extremely dangerous, to either encourage or even permit the building of bank credit upon a base any appreciable part of which may be unsound, or upon a base which may not be of sufficiently high legal ratio to deposits as to justify complete reliance upon a continuance of such legal ratio. We are today occupying a position of being induced to extend credit upon a reserve base with an unsound, or fiat, element almost as great as present total reserve requirements - which statement has not been denied by any Federal Reserve official or anyone else, so far as I have heard or read - and, further, upon a base, in percentage of deposits, which percentage can be increased overnight after the credit has been extended and the deposit structure created.

In addition, the joint statement of the Board of Governors of the Federal Reserve System and the Open Market Committee clearly indicates that whenever there may be, in their opinion, any "over-expansion of business activity or of the use of business credit," bank credit will be restricted or reduced by either one method or the other of those available, or even by both simultaneously. It would almost seem that such an attitude on the part of the Federal Reserve System would preclude the possibility of enough confidence on the part of any banker to lend, or any business man to borrow. Unfortunately, however, human nature is such, and the profit motive is such, that existing reserves will eventually be employed without regard to their soundness and without regard to any dangers whatever of the present reserve ratio being too low. Human nature has not yet been divested of its frailties, nor the profit motive of its potency. Why, in the name of reason and justice, should not the banks and business men have some assurance that it is proper and safe for them to make use of such reserves as are in existence and above legal requirements? If any part of the present reserve structure is "verboten", why should they not be apprized of exactly how much, and why? In other words, why not reduce reserves by eliminating the unsound portion, if there is any, and definitely set a safe reserve ratio, if there is one, and say to banks and business that "verboten" signs are removed and that both may function normally and without fear of punitive action for doing what they have been encouraged and induced to do?

Now, in the paragraph of the joint statement of the Board and the Open Market Committee numbered two therein, the simple statement is made that the primary object of the System is to lend its efforts to a furtherance of recovery. Well, no one can complain at that or differ with the desirability of such an object. There, however, may be some question as to the desirability and effectiveness of the method best calculated to attain the sought-for goal.

The only other paragraph of the statement is that, numbered four, which belabouredly states that the present volume of member bank reserves has been greatly increased by imports of gold from abroad, and continues to be excessive far beyond the present or prospective requirements of credit for sound business expansion. I can imagine no purpose in this statement other than to create the inference that the responsibility for the present reserve structure, with respect both to its size and its composition, does not rest upon the management of the Federal Reserve System. Whatever the purpose, nothing could be further from the truth than such an inference. The plain, undeniable truth is that $2,400,000,000.00 of this huge mass of reserves was created purely by open market purchases of Government bonds by the System, and there is no occasion, in my opinion, for apology on my part in the repetition of the statement undisputed by anyone -- that that much of the reserve structure is not money at all, but is an unsecured promise of the Government to the identical extent that the United States notes, or greenbacks, were when they were issued during the Civil War.

I cannot conclude this statement without asking your indulgence for a few moments more in order that we may go back and consider a few of the principles upon which the Federal Reserve Act was originally based, and determine whether or not they conform to present practices or theories. In the first place, there was no suggestion on the part of anyone that Government obligations were to be considered a proper or safe base for either reserves or currency. On the contrary, provision was made in the law as finally enacted for the gradual elimination of National Bank currency, on the ground that it was a bond-secured currency and consequently unsound. Even during the past year, the present Administration used $650,000,000.00 of the so-called "gold profit" to finally eliminate this admittedly unsound element of the currency structure of the country.

It is true that the original Act authorized open market operations in Government securities, but such transactions were assumed to be only for the purpose of easing temporary, seasonal strains and mitigating the effects of unseasonal and unusually large movements of gold. No one ever thought of a holding of Government bonds of an amount approximately equal to the entire required reserves of all member banks combined, and no one ever dreamed of purchasing billions of Government bonds with the avowed purpose of inducing an increase of "bank money" dependent upon them as a reserve base. The original Act went so far as to prohibit not only Government bonds being held as collateral against Federal Reserve notes, but even prohibited discounted notes of member banks secured by Government bonds being held as such collateral.

When the Federal Reserve Banks were originally established, all reserves were required to be paid in gold or its equivalent, and, if a member were unable to comply with this requirement, there was absolutely no way for it to pay in its required reserve except by rediscounting. Thus, in the beginning, it was contemplated that the Federal Reserve System would hold practically in trust the reserve of member banks, and that they would consist principally of gold, a small percentage of Government obligations to enable the System to ease temporary strains or shocks, a small amount of bankers' acceptances, and a small amount of rediscounts of member banks. It was not even contemplated that rediscounts would be of very great proportions except in order to meet panic conditions bringing on hoarding on a large scale, such as occurred in 1907. It was expected that rediscounts would normally increase during crop-moving periods or other periods when the temporary demand for currency was more than normal, but it was very definitely the expectation that the discount rate would be a penalty rate making it unprofitable to rediscount in order to extend credit. In short, the basic theory underlying the law was that it would furnish the country with an elastic currency which would automatically expand to meet the requirements of trade, or even of panic conditions, but which would just as automatically contract when the necessities of the expansion had passed.

The theory was and still is perfectly sound, and the System would automatically function as intended if the management of the System had followed the intent of those responsible for the legislation. The principal cause for the faulty functioning of the automatic expansion and contraction feature lies, first, in the failure of the management to always maintain a discount rate in each District high enough to make rediscounting definitely unprofitable; and the next important cause for such failure was the presumption upon the part of the Federal Reserve System management that they could by large open market operations improve upon the automatic functioning ideas of Congress. Personally, I have no doubt in my mind that, considering the "sound money" theories then prevailing, if Congress had realized that the managers of the System intended to use the open market operation privilege in the law in order to substitute their judgment in lieu of the automatic fuction provided, the open market operation feature would either have been eliminated or rigidly limited.

It requires no great amount of study or minute knowledge to plainly perceive that we have wandered far from the intention of the Congress which brought the Federal Reserve System into being. It is my fear that further and continued perversion of the original purposes of the Act may ultimately produce such an unsound reserve structure, both for the banks and for the currency of the country, that a fear of the value of money itself may appear and a terrifying price in suffering and privation might have to be paid by the people.

In view of the importance to every person in the United States of the matter contained in our November statement, and of the attitude with respect thereto as announced by the Federal Reserve Board and the Open Market Committee - and especially in view of the fact that a new Board has recently taken office and a new Open Market Committee will shortly be constituted, I believe it is beyond question the duty and obligation of the Council, as a responsible and legally created body, to make a public expression of their present views and recommendations on the subject. They should either reiterate the principles and recommendations made in the November statement, retract them altogether, or modify them to conform with any changes which may have occurred in their opinions.

STATEMENT OF THE SUB-COMMITTEE OF THE FEDERAL
ADVISORY COUNCIL TO THE
FEDERAL ADVISORY COUNCIL
Februry 11, 1936

The Federal Advisory Council desires again to call the attention of the Board of Governors of the Federal Reserve System to the problem of the excess reserves of the System. While these excess reserves are in part due to the large holdings of Government securities in the System, still a very substantial amount is the result of the importation into this country of foreign gold, which came not in settlement of legitimate trade balances, but sought security here because of unsettled conditions elsewhere. This gold is apt to go out whenever conditions abroad become established.

At the present time the gold thus imported has not become a part of the credit structure of our American economic system, but, as stated, is a part of the excess reserves held by the Federal Reserve banks. If this imported gold should enter into the American economic structure, its repatriation would cause a severe dislocation of the American credit structure. Steps should be taken to prevent this gold from being used as a basis for credit while this can still be done without causing injury to our whole credit system and without impeding recovery.

There are two ways to do this.

The first method is by the Federal Reserve banks allowing their Government holdings to "run off" or by selling a part of them; the second method is to increase the reserve requirements of the member banks. The Federal Advisory Council in its unanimous recommendation of November 21, 1935, to the Board of Governors of the Federal Reserve System urged strongly that the first course be followed. The Council has not changed its opinion, but in view of the fact that objections to this method have been raised in responsible quarters, the

Council, regarding it of paramount importance that some action be taken in respect to excess reserves at the earliest possible moment, strongly urges that if the Board and the Federal Open Market Committee to not deem it desirable to meet the situation at this time by reducing the System's holdings of Government obligations, that the Board increase the reserve requirements of the member banks.

While it is recognized that the Board cannot divest itself of its authority to make future changes in reserve requirements, it is the belief of the Council that it would be highly desirable that the Board when increasing reserve requirements accompany such action by a statement that the Board does not intend to make further changes in reserve requirements unless conditions should change materially.

Therefore, the Council recommends that the reserve requirements be raised sufficiently to absorb the excess created by that foreign gold in the country which is likely to be repatriated whenever settled conditions again prevail abroad. It has been estimated that this would require an increase of fifty per cent over the present reserve requirements.

Early draft

STATEMENT OF FEDERAL ADVISORY COUNCIL
TO
BOARD OF GOVERNORS OF FEDERAL RESERVE SYSTEM
FEBRUARY 12, 1936

The Federal Advisory Council wishes to direct the attention of the Board of Governors of the Federal Reserve System and, through ~~them~~ it, that of the Open Market Committee of the System, to the communication made by the Council to the Board at its meeting of September 24, 1935, concerning the amount of Government securities held by the System, and to its statement made to the Board at its meeting of November 21, 1935, referring to the same subject and further making recommendations with regard to the amount of excess reserves ~~of~~ member banks now carried with the System.

The Council has taken cognizance of a joint statement issued by the Board of Governors and the Open Market Committee under date of December 18, 1935, which seemed to fully recognize that "the special problem created by the continuing excess of reserves" was of such importance as to justify a continuance of the "unremitting study and attention of those charged with the responsibility for credit policy in order that appropriate action may be taken as soon as it appears to be in the public interest."

In view of the fact that, since the above statement was made, a very great change has taken place in the membership of the Board of Governors and an entirely new arrangement of the composition of the Open Market Committee is about to be consummated, the Council feels that it would be in every way desirable and proper for ~~them~~ it at this time to refer to the communications mentioned and to make known ~~their~~ its present views in the light of events during the past months.

In the first place, the Council fully appreciates the correctness of the intimation in the published joint statement of the Board of Governors and the Open Market Committee to the effect that they are "those charged with the responsibility for credit policy." The Council, however, takes the liberty of calling the attention of the Board of Governors and the Open Market Committee to Section 12 of the Federal Reserve Act, wherein the Federal Advisory Council is empowered "to call for information and to make recommendations in regard to discount rates, rediscount business, note issues, reserve conditions in the various districts, the purchase and sale of gold or securities by reserve banks, open market operations by said banks, and the general affairs of the reserve banking system."

The Council considers that this legal and specific grant of certain powers carries with it a very definite obligation, upon the part of those invested with the powers granted, to function as contemplated. The Council, therefore, in making recommendations to the Board of Governors of the Federal Reserve System desires to make it entirely clear that it does so not gratuitously but in conformity with an obligation imposed upon them by law, and, further, that it does so with the fullest possible appreciation of the fact that upon the Board of Governors rests the responsibility for the final decision. The Council, however, desires to go one step further and voice the opinion that it is as much the implied legal obligation of the Board to take cognizance of and give full consideration to the recommendations of the Council, as it is for the Council itself to make them.

Since the previous communication of the Council, there has been increased activity in the securities markets at rising prices, additional public discussion of the possibilities of inflation in various forms and directions, increased bank deposits with greater velocity of payments by check, and increased volume of business generally, all of which may indicate a condition ripe for rapid credit expansion. The Council would not be particularly disturbed over the prospect of a bank credit expansion if it were not for the composition of the reserve structure, and wishes therefore to call the attention of the Board of Governors and the Open Market Committee to the fact that, of the slightly less than six billion of reserves, approximately three billion of which are required, no less than two billion four hundred million are composed of Government securities purchased in the open market by the issuance of reserve bank credit. A tremendously large percentage of the remainder of the reserve structure is the result of gold imports which have come into the country in the period since the reduction of the gold content of the dollar, not as the result of a settlement of trade balances but largely for protection against possible devaluation in other countries, and partly for speculative purposes.

The Council is of the opinion that it would be unwise and unsound to permit a bank deposit structure to be built on the base of the Government security holdings of the System, and, further, that it would be dangerous to build a deposit structure on a base of reserves created by an abnormal gold inflow which may be partially or largely transitory or temporary.

The Council therefore desires to recommend to the Board of Governors of the Federal Reserve System and the Open Market Committee the elimination or great reduction of those reserves dependent upon Government securities and created by their purchase. The Council further recommends consideration of the propriety of increasing reserve requirements to such an extent as will prevent the full employment of the present amount of reserves created by the abnormal inflow of gold during the past two years. The increase of required reserves should be such as to prevent a deposit structure being built upon such part of the present reserves as may be deemed temporary or likely to be withdrawn upon the return of more normal conditions in important foreign countries.

Favorable action by the System upon these two recommendations would enable the Board of Governors of the System to assure the country of the soundness of the reserve structure and of the absolute safety with which bank credit or a deposit structure could be built thereon, and it is our opinion that such a program would ultimately create confidence in the credit and currency structure of the country to a greater extent than is attainable in any other manner.