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June 6, 1938.

Honorable George B. Kelly,
House of Representatives,
Washington, D. C.

Dear Mr. Kelly:

In response to your letter of June 3, 1938, there is inclosed herewith a copy of a statement approved unanimously by the Board of Governors of the Federal Reserve System under date of April 9, 1938 regarding H.R. 7230, a bill introduced in the House of Representatives by Mr. Patman and containing substantially the same proposals as those outlined in the mimeographed letter transmitted with your letter.

Very truly yours,

Walter Wyatt,
General Counsel.

Inclosure.

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FOR FILES
Walter Wyatt

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

April 9, 1938.

COMMENT ON H.R.7230
Introduced by Mr. Patman

The fundamental purpose of H.R. 7230 is to establish a mechanism that would control the volume of money with a view to maintaining a fixed price level.

The mandate

In an amendment the Board of Governors is instructed to raise the all-commodity index until full employment of all persons able and willing to work shall have been achieved, and until the price level shall at least reach the all-commodity index of 100, as established by the Department of Labor, for the year 1926. The Board is further directed to maintain this price level with variations not to exceed 2 per cent. To accomplish this the Board is directed to expand and contract demand deposits by engaging in open-market operations.

The position of the Board of Governors on the problem of monetary objectives was indicated in a statement issued on August 2, 1937, in response to a Congressional inquiry. The Board is in full agreement with the ultimate objective of proposals to promote economic stability, which means the maintenance of a volume of business activity and of national income adequate to assure as full employment of labor and of the productive capacity of the country as can be continuously sustained. The Board is aware that commodity prices are an important element in the Nation's economic life and that violent fluctuations of prices have disastrous effects. It believes, however, that price stability does not necessarily lead to economic stability and, therefore, should not be the principal objective of public policy. In its opinion the objective of economic stability cannot be achieved by monetary means alone, but rather should be sought through coordination of monetary and other major policies of the Government which influence business activity.

The principal difficulty with a stable price level as the objective of economic policy is that it is not in itself a satisfactory indicator of a continuously smooth working of the economic machine. There have been periods in the past when the price level was stable and nevertheless there were developing numerous maladjustments which led to an economic collapse. For example, from the latter part of 1927 to the latter part of 1929 the index of wholesale prices showed little change, but other developments were threatening economic stability. Prices and activity on the stock market were rising rapidly, and brokers' loans grew at an unprecedented rate. Construction of office and apartment buildings was being promoted with a view to quick profits at a rate that endangered the longer-time outlook in the building industry. Loans were being made for enterprises abroad without careful investigation of credit risks, and business activity in general was increasing, partly as a result of speculative developments, to a level that could not be sustained. The use of the commodity price level as a guide to credit policy in these circumstances would have been entirely unsatisfactory.

There is no assurance that it would be satisfactory in the future.

The proposal is that the Board of Governors bring the commodity price index up to at least the 1926 level. The average for that year is about 25 per cent above the present level and an advance of that magnitude, except over an extended period, would cause speculative buying and would lead to boom conditions which would culminate in a break and a depression. Furthermore, in periods of rapid advance disparities between prices of different groups of commodities generally become more pronounced and yet, both from the point of view of justice and of economic stability, the most important thing in regard to prices is the maintenance of proper relationships between prices of different commodities that are exchanged for each other. Activity of producers depends on the relationship between their costs, including principally prices of materials, labor, taxes, and debt service, and the prices at which they can sell their products. In the last quarter of 1936 and in the first quarter of 1937, for example, building costs and prices of new houses rose so rapidly and so far as to discourage buying, and this resulted in a decline in residential building. Moreover, the rise in prices of industrial raw materials at that time was much sharper than the advance in finished goods, and this was a factor in causing speculative purchases, forward orders, and building up of inventories, all of which contributed to the subsequent collapse of business.

Present prices of individual commodities in the Bureau of Labor statistics index, compared with 1926, range from a decline of 75 per cent to an increase of 100 per cent. A restoration of the 1926 level could be achieved through an advance of all commodities, including those that are too high, as well as those that are too low, or through a rise in one or the other group of these commodities. There is nothing in monetary policy that could determine which of the commodities would rise, and yet this would be all-important from the point of view of the effects that the rise in prices would have on the economy.

In the Board's view the essential objective of monetary policy is to contribute to the maintenance of a flow of money and income through the channels of trade, industry, and agriculture that would tend to utilize to the full the country's human and material resources. This is the Board's understanding of the broad mandate stated in the Federal Reserve Act as "accommodating commerce and business". To this end and to the maintenance of sound banking conditions the Board devotes its efforts, and there is nothing in the proposed mandate that would add to the Board's desire or ability to achieve these objectives.

In directing the Board to achieve price stability and full employment through open-market operations, the proposed mandate disregards the limitations on the effectiveness of this instrument of credit policy. It assumes that open-market operations can always create or destroy deposits, and that changes in the volume of deposits in turn are immediately reflected in the price level. The fact is that open-market operations do not always create deposits, since purchases of securities from the banks do not increase deposits. Whether open-market purchases result directly in an increase in deposits or not, they do result in the creation of a corresponding amount of reserves. These reserves may or may not result in the creation of deposits, depending on whether conditions are favorable for the expansion of loans and investments by banks. The great bulk of deposits in the banks of the United States are created through such an expansion. A given volume of reserves created by Board action, therefore, might result in no increase in deposits at all, or on the other hand might result in a growth of deposits several times as large as the reserves. Which of these developments would actually occur would depend on forces that are largely, if not wholly, outside the control of the Board of Governors.

It is not true, furthermore, that the creation of deposits necessarily results in an equivalent rise in prices. We have had increases in deposits without corresponding increases in prices. The volume of deposits at the present time is greatly in excess of the amount that existed in 1929 and yet the price level is much lower. Nor is it clear that a rise in prices necessarily results in an increase in employment. An unbalanced advance in prices may, on the contrary, be an influence in decreasing employment, as was the case early in 1937.

Aside from many factors that are not under the control of the Government, there are numerous phases of Government activity other than monetary action by the Federal Reserve System that have effects on prices and on economic activity. Among such factors are the actions of the United States Treasury in relation to the inactive gold account and the stabilization account; policies in regard to taxation, exchange rates, the volume and character of Government spending; its action in regard to the capital market, to railroads and utilities; the Government's housing program, its agricultural policies, and its policies in regard to labor. All of these Government activities have a distinct bearing on the volume of business activity and on the price level. They are beyond the influence of the Federal Reserve System, and yet without them and their coordination with monetary policy the System would be powerless to achieve either an advance in prices or the restoration of full employment, as would be required under the proposed mandate.

The Board of Governors, therefore, does not favor the adoption of the proposed mandate.

Federal Reserve System operates in the public interest

In addition to prescribing a mandate for the Federal Reserve policy, the bill proposes a reorganization of the Federal Reserve System. The reasons offered for this reorganization are that the System has not been operated in the public interest; that it has been dominated by bankers; that it has been conducted in the selfish interests of a small group, and that it has made large profits at the expense of the community. The Board of Governors does not believe that any of these assertions can be sustained by the record.

Ownership of stock by member banks does not enable the bankers to control the Federal Reserve System. It is more nearly in the nature of a compulsory capital contribution than stock ownership. Although the member banks elect two-thirds of the directors of the Reserve banks, the large banks elect only two out of nine directors. The small banks elect two, the medium-sized banks elect two and the Board of Governors in Washington appoints three. Only a third of the directors can be bankers and all directors and officers are subject to removal by the Board of Governors. The Board in Washington appoints the chairman and deputy chairman of each Reserve bank, and the appointment of all presidents and first vice presidents, as well as the salaries of all officers and employees, are subject to its approval.

Complete authority over all matters of major national policy, such as the determination of discount rates, reserve requirements, margin requirements on security loans, and maximum rates of interest to be paid on time deposits, is vested in the Board of Governors. Authority over open market operations is vested in an open market committee consisting of seven members of the Board of Governors and five members elected by the Reserve banks.

It is clear, therefore, that in matters with which the bill is primarily concerned the System is dominated not by banks, but by the Board of Governors, a Governmental body whose members are appointed by the President and confirmed by the Senate.

Federal Reserve banks not operated for profit

During the twenty-three years of its existence the Federal Reserve System has earned approximately one and a quarter billions of dollars, of which about one-half has been used for operating expenses incurred largely in performing public services, such as the clearing and collection of checks, the supplying of currency to the banks and to the public, the performance of many duties for the United States Government, and in furnishing rediscount facilities for the member banks.

Earnings of the Federal Reserve banks above these expenses and reserves for contingencies amounted to $600,000,000. Of this amount approximately $150,000,000 has been paid to the Government as franchise tax, about $140,000,000 has been appropriated by Congress for the Federal Deposit Insurance Corporation as capital, $160,000,000 has been paid as the statutory dividends to member banks, and the remainder is held in a surplus account which in case of liquidation becomes the property of the Government.

Member banks contribute 3 per cent of their capital and surplus to the capital of the Reserve banks and receive 6 per cent annually on this contribution. In addition, member banks are required to keep balances with the Reserve banks amounting on the average to 16 per cent of the member banks' deposits and receive no return on these balances. For example, a member bank having a capital and surplus of $100,000 and deposits of $1,000,000 contributes $3,000 to the Reserve bank's capital and, on the average, would be required to hold $160,000 on deposit with the Reserve bank as legal reserves, on which it receives no interest. The dividends such a bank would receive on its stock in the Reserve bank would be $180 a year.

The System was established and is operated in the public interest and dominated by public officials; it performs a service that saves the people of the country far more than the cost of the System; and it makes no profits for any private interest other than the amount paid annually to stockholders at a fixed rate, which has been prescribed and can be changed by Congress.

Proposals would not improve banking system

Proposals in the bill for reorganizing the Reserve System would transfer ownership of the stock in the Federal Reserve banks to the Government and would have all the directors of the Reserve banks appointed by the President and approved by the Senate. It would enlarge the membership of the Board of Governors to fifteen, including three ex-officio members -- the Secretary of the Treasury, the Comptroller of the Currency, and the Chairman of the Federal Deposit Insurance Corporation.

A Board of Governors of fifteen members proposed in the bill would be too unwieldy to function promptly and effectively. The proposal in the bill to offer all the privileges of membership to nonmember banks so long as they choose to keep their reserves in a Federal Reserve bank would remove all incentive to become members of the System. It would enable all banks to profit by the services of the System so long as it suited them, without contributing anything to its strength or complying with its regulations, and to withdraw their reserves when to maintain them would seem to be burdensome. It would make futile the proposed enlargement of the power to increase reserve requirements. It would remove all incentive to membership and would make it impossible for the System to discharge its responsibility for maintaining sound credit conditions.

Distinction between monetary and fiscal authorities should be maintained

The primary function of the Treasury is to collect taxes, borrow money, and provide funds for the various agencies of the Government in accordance with Congressional appropriations. The primary function of the Federal Reserve System is to influence the flow of money and to contribute to the soundness of the banking situation. In a broad sense the objectives of both agencies are the same, namely, to serve the public interest, but their points of view and experience, and their approach to current problems may at times be different. The maintenance of an organization for the regulation of credit separate from the fiscal arm of the Government has been found advantageous in most countries of the world, and its abandonment, which is proposed in the bill, would, in this Board's opinion, be a backward step.

Local autonomy in local matters should be preserved

Since its establishment in 1914, the Federal Reserve System has undergone many changes in the direction of increased control by the Board of Governors. With the passage of the Banking Act of 1935 this control has been greatly strengthened in so far as national policies are concerned. In regard to local matters, the maintenance of local autonomy under general supervision and close Government regulation is advantageous in a country like the United States, consisting of various regions with diverse economic interests. The maintenance of locally elected directors on Federal Reserve bank boards is of great advantage in creating local pride and local interest in the System and in inspiring the business community with confidence in its management. This advantage would be lost if the appointments of all local directors were handled entirely from Washington. Consequently, the System's ability to render a disinterested public service to all classes of the community would be greatly diminished.

To sum up, the Board is convinced that improvement in our banking system is needed but sees nothing in this bill that would tend in this direction. The Board is convinced that the main objective of the bill is not practicable; that the evils which the reorganization features of the bill propose to correct do not exist; that the organization which it proposes to establish would result in less satisfactory service to the country; and that enactment of the bill would be a backward and not a forward step in the development of the banking system in the public interest.