

RECOMMENDATIONS OF THE FEDERAL ADVISORY COUNCIL TO
THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM~~333.3~~
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November 21, 1935.

Topic No. 1. Open Market Operations.

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RECOMMENDATION: The Federal Advisory Council, in view of the fact that it has been advised by the Chairman of the Board of Governors of the Federal Reserve System that the Board does not have the authority to initiate open market operations, requests the Board to submit the following recommendation to the Open Market Committee and to call for that purpose a special meeting of said Committee at an early date.

The Federal Advisory Council of the Federal Reserve System has received the communication of the Board of Governors of the System, wherein reference is made to the statement of the Council made to the Board at its meeting of September 24, 1935, concerning the amount of Government securities held by the System, which has not varied for a long time, and calling the attention of the Board to the basic theory of open market operations: that there should at all times prevail sufficient flexibility to prevent undue expansion and contraction in the credit structure of the country. The Council enquired whether the Board agreed with the principle enunciated.

The present communication of the Board recognizes "the necessity for the consideration of the factors referred to in the statement as elements in the determination of open market policy" and closes with the statement that "if the Council has any proposals to make with respect to the operation of the open market account of the Federal Reserve System,

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which it believes to be pertinent in the existing situation, all factors considered, the Board will, as in the past, be glad to receive them and consider them".

The Council is fully cognizant of and thoroughly appreciates the importance and significance of the obligation imposed upon it by law "to confer directly with the Federal Reserve Board" 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", and it has given its most careful and earnest consideration to the suggestion by the Board that it will be glad to receive from the Council such proposals as it may make with respect to the open market account of the System.

As a result of this consideration the Council desires to call the attention of the Board to the fact that, since the discontinuance, more than two years ago, of open market purchases by the System, excess reserves of member banks held by the System have now reached the unprecedented total of more than three billion dollars, which may well be considered as a base upon which additional bank credit can be extended to the extent of at least thirty billion dollars with a corresponding increase of bank deposit liabilities.

The Council believes that there have now been some considerable evidences of recovery in business, of an increase in prices generally, and particularly in the security markets of the country, with the possibility, at least, that a too rapid advance of security prices could easily develop

into a new wave of speculation such as preceded the market collapse of 1929. The constant pressure of the very large excess reserves of the member banks creating a plethora of the available supply of bank credit has a very distinct tendency to foster and encourage speculative activity, increase prices, and raise the living cost of the population. The Council believes that, even with the practically complete elimination of excess reserves, the banking system of the country would still be prepared and ardently desirous of meeting any and all legitimate and proper demands for bank credit, and it is strongly of the opinion that, in order to obviate the probability of an undue and dangerous credit inflation, it is desirable from every point of view to eliminate or at least greatly reduce the excess reserves now being carried in the System.

Since the enactment of the Banking Act of 1935, there exist two methods by which this can be accomplished. 1. The selling or "permitting to run off" of a portion or all of the System holdings of Government securities. 2. Raising of reserve requirements.

The Council has most earnestly considered the question as to which of these two methods might be the more desirable under the present circumstances and has determined to recommend as strongly as possible the first method.

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.

There is, however, another reason for preferring the first method, namely, the ease and flexibility with which it may be administered. Under that method, Government security holdings may be permitted to run off or may be sold, rapidly or gradually, as in the judgment of the Open Market Committee, may seem to be feasible or advisable. If at any time, the effects seem to be too severe, it is possible to suspend or even temporarily to reverse the policy.

Under the second method, namely, increase of reserve requirements, rigidity is substituted for flexibility, since it must be entirely apparent to any one that frequent changes in reserve requirements would create a chaotic condition in planning for the future by member bank management.

Finally, the Council wishes to make perfectly clear to the Board that, after Government security holdings of the System have been eliminated or greatly reduced, and if, then, further curbs upon speculation should seem to be desirable, there would certainly be no possible objection to an increase in reserve requirements. On the contrary, it would become the clear and plain duty of the Board fearlessly and promptly to take such action.