

STRICTLY CONFIDENTIAL

SECTION BY SECTION ANALYSIS

OF

PATMAN BILL

(H.R. 7230)

NOTE: This is not intended as a document to be transmitted to Congress or published in any way. On the contrary, it is intended solely for the confidential use of the members of the Board in preparing themselves to testify on the Patman Bill. It is contemplated that the members of the Board would select and use such of the arguments herein contained as might appeal to them and would disregard the others. Therefore, it contains arguments which may not appeal to some members of the Board.

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SEC. 1. DECLARATIONS OF POLICY

This states five objectives which would be declared to be the policy of Congress and which apparently indicate the purposes of the Bill. These objectives are: (1) "to provide for Government ownership of the twelve Federal Reserve banks"; (2) "to prevent injurious expansion and contraction of credit and currency"; (3) "to stabilize and maintain a dollar of uniform purchasing power for the purpose of assuring the kind of dollar which a generation hence will have the same purchasing and debt-paying power"; (4) "to permit all banks, the deposits of which are insured by the Federal Deposit Insurance Corporation, to receive all rights and privileges from the Federal Reserve System"; and (5) "to encourage the sound local bank, recognizing the contribution that the local bank makes to the social and financial betterment of the local community."

Discussion

(1) Government ownership of Reserve banks. - This is discussed in connection with section 2 of the Bill.

(2) Prevention of injurious expansion and contraction of credit and currency. - Except for the addition of the words "and currency", this is already prescribed as the standard to be followed by the Board in changing reserve requirements. The Bill adds nothing to the Board's power to accomplish this objective except to remove the present limitations upon the power of the Board of Governors to change reserve requirements. This change is desirable in principle, but the provisions of the Bill which would, in effect, permit banks to maintain such reserves only when they chose to do so tend to nullify any advantages of the change. It also is questionable whether the present time is advisable for making such a change.

*Not in agreement  
with statement.*

(3) Price Stabilization as Monetary Objective. - This subject is discussed in the Board's statement on Objectives of Monetary Policy, of which a copy is attached, as published in the September 1937 Federal Reserve Bulletin at page 827. The objections there set forth to price stabilization as a primary monetary objective will, however, be briefly summarized.

Most important of all is the fact that the real aim and desire of Government should be economic stability and general well-being rather than price stability. It seems likely that the proponents of price stabilization really have in mind these broader objectives and are thinking of price stabilization as a means towards the ultimate end. Undue concentration on price stabilization, however, may defeat efforts to achieve the more important goal.

Unstable economic conditions may develop, as they did in the 1920's, while the price level remains stable. Changes in the price level also can occur without relation to general business stability. For example, the price index might rise owing to an advance in agricultural products which might be the result of either (1) a crop failure in the United States, or (2) a short world crop while the harvest in this country was bountiful and full employment prevailed. If price stabilization were the sole guide to monetary policy, a restraining policy would be indicated in both cases, although in the former case such a policy might result in a general business decline, while in the latter case it might or might not be justified depending on other circumstances.

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Price stabilization as a mandate for the Federal Reserve System also would be objectionable because of the inherent limitations of monetary powers and the fact that certain monetary powers are not entrusted to the Board either at present or under the proposals in the Bill. Even if the System's powers were altered as proposed in the Bill, they would not be sufficient to maintain price stability if that was desirable; and they would be even more inadequate to achieve unaided the real goal of general economic well-being.

The System can regulate within limits the supply of money but there are other factors affecting prices and business activity fully as powerful as the money supply. Many of those factors are nonmonetary and cannot be controlled by monetary action. This is particularly true of Government policies regarding taxation, expenditures, lending, foreign trade, agriculture, and labor. Their effect on business activity may express itself in an increased or decreased rate of use, or turnover, of the existing supply of money as well as in a change in the supply itself. The System's influence may be entirely offset by such other factors.

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Aside from the general undesirability of price stabilization as a primary monetary objective, there would be great difficulty as a practical matter in determining the prices to be stabilized. Stabilization of individual prices by monetary means is not proposed and would not be feasible. Therefore, an index is required; but, although considerable differences result if different indices are used, there is no general agreement as to what constitutes a satisfactory index for the purpose. This really is only another aspect of the impracticability and unrealistic nature of the proposal.

(4) Access of all insured banks to Federal Reserve facilities. - This is discussed in connection with section 3 of the Bill.

(5) Encouragement of sound local bank. - This is a desirable objective. There is, however, nothing in the Bill to carry it out, with the possible exception of the provision for permitting all insured banks to have access to Federal Reserve facilities, which is discussed in connection with section 3 of the Bill.

SECS. 2(a) AND 2(b). OWNERSHIP OF RESERVE BANK STOCK

Section 2(a) would authorize and direct the Secretary of the Treasury to acquire and hold on behalf of the United States all shares of capital stock of the Federal Reserve banks held by member banks and, in order to reimburse each member bank, to "establish a credit for such bank in the Federal Reserve bank" equal to the amount originally paid for such stock, with interest at the rate of one-half of 1 per cent a month from the last dividend to the enactment of the Act.

Any member bank that failed to surrender its Reserve bank stock would not be "entitled to exercise any privileges of membership in the Federal Reserve System" after the Secretary of the Treasury tendered to such bank the amount specified for the purchase; but it would be restored to such privileges upon surrender of the stock and acceptance of payment.

Section 2(b) provides that "the assets, property, and records of the Federal Reserve banks shall be the property of the United States", but that the transfer of member bank's Reserve bank stock to the Treasury shall not deprive any such bank of its rights and privileges under the Act.

Discussion

Ownership different from control.— Probably the most important defect in the proposal is the failure to distinguish between ownership and control. No one would question that the Federal Reserve System should operate in the public interest; but there is nothing to indicate that it does not so operate at present, and the ownership of the Federal Reserve banks is relatively unimportant in determining how they operate. Indeed it is questionable whether the member banks' holding of limited-dividend, restricted-voting stock should properly be called even "ownership" of the Reserve banks. In substance, it is an enforced contribution to the capital of the Reserve banks.

Control is the important thing, and this in effect is indicated by the Bill itself. It would not stop with transferring ownership to the Treasury but would also make certain changes in the Board of Governors, Reserve bank directors, Advisory Council, and Open Market Committee. -- all apparently aimed at effecting changes in control. These proposals are considered in connection with the appropriate sections of the Bill, but the very fact that it is thought necessary to propose such changes in addition to change in ownership shows the unimportance of mere ownership of the Reserve banks, and particularly the irrelevance of the attenuated form of stock "ownership" now held by the member banks.

Secs. 2(a), (b).  
Ownership of  
Reserve Bk. Stock.

It probably is this some failure to distinguish between ownership and control that causes some persons to say that the Federal Reserve System should be changed in order for Congress to exercise its constitutional authority to "coin money and regulate the value thereof." Just as in regulating interstate commerce and other matters within its jurisdiction, Congress necessarily must entrust the actual administration of the statutes to someone, since Congress could not itself directly perform these detailed functions. Congress, in exercising its constitutional authority to coin money and regulate the value thereof, created the Federal Reserve System as the agency through which part of this function is administered. It seems that those who would urge the Congress to exercise its power to "coin money and regulate the value thereof" really have in mind changes in the manner in which Congress is already exercising the power.

Income of member banks from Reserve bank stock.- During the 23 years of the Federal Reserve System, only about one-eighth of the gross earnings and about one-fourth of the net earnings have been paid out as dividends to the member banks. These dividends amount to about \$150,000,000 when aggregated for all member banks during the entire 23 years of the existence of the Federal Reserve System. They are relatively insignificant so far as each member bank is concerned. A member bank having a capital and surplus of \$100,000 contributes \$3,000 to the Reserve bank's capital and surplus and receives annual dividends of \$180, or at a rate of less than two-tenths of one per cent of its own capital and surplus.

Features of Treasury purchase- The aggregate annual dividend on all Reserve bank stock at present amounts to about \$8,000,000. The net profit to the Government from a purchase of the \$133,000,000 of Reserve bank stock would, of course, be only the difference between this annual dividend and the interest cost on the money borrowed to make the purchase. (If the cost to the Government of borrowed money be considered to be, say 2-1/2 per cent per annum on the basis of long-term bonds to finance the purchase of the Reserve bank stock, the net profit which would accrue to the Government would be less than \$5,000,000 per annum, which is less than one-tenth of one per cent of the current budget.)

Under the proposal of section 10 of the Bill to relieve national banks of the assessments which they now pay for examinations, over \$2,900,000 collected annually from this source would have to be supplied elsewhere, presumably by Congressional appropriation. This would still further reduce the net profit which would accrue to the Government under the proposed changes.

Moreover, the assumption of a 2-1/2 per cent interest rate on the money borrowed to purchase the Reserve bank stock is based on

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the present interest rates which are about the lowest long-term rates in history. Even under the present low rates, borrowings at 2-1/2 per cent would not be for longer than about fifteen years. The bonds presumably would have to be refunded within such a period, or sooner, at which time interest rates might be considerably higher. It seems clear, therefore, that even if the Treasury were interested in making investments for long-term income, the purchase of the Reserve bank stock would not have unusual attractions.

It is obvious, however, that the real purpose of the Treasury is not to make various investments for long-term income, even though the investments might be very remunerative over a long period of time. Its real concern is with meeting the present demands on the Treasury for relief, rearmament, etc. The investment of about \$133,000,000 in Reserve bank stock would create no employment, offer no relief or work relief, and add nothing to the Nation's defenses. It would merely decrease the funds available for these purposes. Such an expenditure would be particularly hard to justify with the present unbalanced budget.

Damage to confidence.- In the present state of business fear, it would hardly be conducive to public confidence for the Congress to even seem to move sharply in the general direction of Government ownership or stricter regulation of business. Any fears that Government ownership of the Reserve banks presaged general Government ownership of business probably would be unwarranted, as the discussion above would rather indicate, but enactment or extended consideration of this proposal would almost certainly cause such misgivings in many quarters. It is the nature of fear that it is unreasoning, and there are obvious reasons at present for not giving it further impetus.

Alternatives.- If Congress should wish to change either the ownership or the yield of Federal Reserve bank stock it could do this much better than by a Treasury purchase.

It could change the dividend rate or make the dividend dependent upon some variable such as the yield on Government securities.

It could provide for public distribution of the stock in the manner which the original Federal Reserve Act provided as an alternative if sufficient stock had not been subscribed by banks; and it could forbid any bank to own such stock. The stock would, of course, be non-voting, and could be made subject to any of the dividend limitations mentioned above. Some feel, however, that public ownership of Reserve bank stock would be worse than member bank or Treasury ownership, since it might create a public demand for payment of dividends which would impair the nonprofit operation of the System.

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E.O. 12065, Section 6-102  
by IB NARS, Date 8-13-05

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Another alternative would be to eliminate the Reserve bank stock entirely and have the Reserve banks operate with their present surplus as their capital. This could be done without cost to the Treasury by having the Reserve banks retire the stock and cancel it just as is done at present when banks withdraw from the Federal Reserve System.



SEC. 2(c). RESERVE BANK EARNINGS COVERED INTO TREASURY

After all necessary expenses have been paid or provided for, the net earnings of the Federal Reserve banks would be covered into the Treasury as miscellaneous receipts.

Discussion

Apparently this proposal is based on the assumptions that:

- (1) The net earnings of the Federal Reserve banks, after the payment of dividends, are substantial;
- (2) The United States Government will have no claim on such net earnings if they are not paid to the Government currently each year; and
- (3) The surplus of the Federal Reserve banks is adequate in relation to their liabilities.

Sec. 2(c). Reserve Bk. Earnings covered into Treasury.  
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Small net earnings after dividends.- The net earnings of the Federal Reserve banks available for transfer to surplus during recent years have been relatively small, amounting to \$2,616,352 in 1937, to \$352,524 in 1936, and to \$607,422 in 1935. In some years the Federal Reserve banks, after payment of dividends, have had deficits in net earnings which were charged to surplus.

During the period of the World War and for a few years thereafter member banks were borrowing very large amounts from the Federal Reserve banks, and as a consequence the earnings of the Federal Reserve banks were exceptionally large. At that time Federal Reserve banks paid a franchise tax, the franchise tax payments amounting to over \$120,000,000 for the calendar years 1920 and 1921, as compared with total franchise taxes of \$149,138,300, for the period from the organization of the Federal Reserve banks to the end of 1932 after which the requirement for the payment of a franchise tax was repealed. It was also during this period that the Federal Reserve banks added substantial amounts to their surplus accounts.

The Federal Reserve Act, as amended on March 3, 1919, provided that all of the net earnings of a Federal Reserve bank remaining after the payment of dividends, including those for the calendar year 1918, should be paid into a surplus fund until it amounts to 100 per cent of subscribed capital and that thereafter 10 per cent of such net earnings should be paid into the surplus and the remainder paid to the United States as a franchise tax.

This provision of the law was again modified by the Bank Act of 1933, to provide that all of the net earnings of a Federal reserve bank, after payment of the 6 per cent dividend provided by law shall be paid into its surplus fund; but at the same time Congress effect appropriated one-half the surplus of the Reserve banks for the establishment of Federal insurance of deposits, by requiring the Reserve banks to use one-half of their surplus to purchase stock in the Federal Deposit Insurance Corporation, on which they receive no dividends.

Federal Reserve notes.— It is frequently stated that the Federal Reserve banks obtain Federal Reserve notes from the United States Treasury for the cost of printing, and that they place large volumes of such notes in circulation and thus obtain substantial profits which should belong to the Government. It is important, therefore, to point out the factors that determine the volume of Federal Reserve notes in circulation, what the Federal Reserve banks have to do to get them and the costs connected with the supplying of currency to the public.

The amount of money in circulation at a given time represents what the public collectively wants, since currency always moves out of the Federal Reserve banks when the demand for it increases and returns to them when the demand subsides. This is what is meant by an elastic currency. When currency is needed, the public obtains it from the local banks, and the latter obtain it from the Federal Reserve banks. When it is not needed, the public deposits it in the local banks, and the local banks in turn redeposit it in the Federal Reserve banks. The Federal Reserve banks may be regarded as reservoirs from which additional currency is drawn when the public requires it and to which currency not required by the public is returned. The Federal Reserve banks have no direct way of keeping in circulation a larger amount of currency than the public requires, or reducing the amount of currency that the public needs to finance its current operations.

The demand for currency is determined by various conditions. A certain minimum is required for day-to-day cash expenditures of individuals; a certain minimum is required for payrolls. There are times when personal expenditures rise, as during holidays, and there are times when payrolls rise, as during harvest. Certain individuals, businesses, and communities have their own periods when they need more or need less cash than ordinarily. The net effect of all of these factors is a normal and regularly repeated cycle of demand for currency year after year -- slack after the first of January, when retail trade falls off following the holidays, larger during the succeeding spring months, when payrolls increase and outdoor industries become active, slack again in mid-summer, and steadily increasing during autumn and early winter to the regular peak in December.

In addition to this regular annual cycle, the amount of currency also responds to increases and decreases in the volume of retail trade and of payrolls as the amount of business done by the country increases or decreases. There have been times also when the demand for currency was greatly increased as in the period preceding the banking holiday in 1933. In the course of a few weeks at that critical time the Federal Reserve banks furnished the public with as much as \$2,000,000,000 of additional currency.

For more than twenty years the Federal Reserve banks have fully met the normal demands of the country for currency; they have also fully met peak demands both in times of prosperity and in times of depression, and they have made it possible for the volume of money to decline automatically when the public demand for it declined.

Before a Federal Reserve bank can obtain Federal Reserve notes it must deposit as security with the local representative of the Government, known as the Federal Reserve agent, collateral at least equal in amount to the notes to be issued. This collateral, as provided by law, may consist only of the following assets: (1) promissory notes, drafts, bills of exchange, or acceptances, usually referred to as "eligible paper"; (2) gold certificates on hand or due from the United States Treasury; and (3) until June 30, 1939, United States Government securities bought in the open market. In addition to being secured by the pledge of specific collateral, Federal Reserve notes are a first lien on all the assets of the issuing Federal Reserve bank, and a 40 per cent reserve in gold certificates must be maintained against them.

As of March 16, 1938, the Federal Reserve banks had obtained \$4,440,000,000 of Federal Reserve notes from the Federal Reserve agents, of which \$4,125,000,000 were in circulation, constituting about two-thirds of the total of \$6,330,000,000 of money in circulation, and \$315,000,000 were held in the vaults of the Federal Reserve banks. The collateral held against these notes was as follows:

Gold certificates on hand and due from U.S. Treasury	\$4,533,000,000
United States Government securities	10,000,000
Eligible paper	7,000,000
Total	<u>\$4,550,000,000</u>

Gold certificates are receipts which are issued to the Federal Reserve banks by the United States Treasury for gold deposited with it by the Federal Reserve banks in compliance with the Gold Reserve Act of 1934, which required all monetary gold in the United States to be delivered to the Treasury. As indicated, the Federal Reserve banks have pledged \$4,533,000,000 of these certificates against \$4,440,000,000 of their

own notes in circulation. Federal Reserve notes, therefore, at present are virtually substitutes for gold held in the United States Treasury. So long as the Federal Reserve banks pledge one dollar in gold certificates against each dollar of Federal Reserve notes in circulation they cannot, of course, obtain a profit by issuing Federal Reserve notes. Moreover, it cost the Federal Reserve banks nearly \$6,000,000 during 1937 to obtain currency from the Treasury and supply it to member banks and through them to the general public.

Congressional control over surplus funds.- Congress has the right at any time to legislate with respect to the surplus funds of the Federal Reserve banks. If at any time Congress should consider the surplus of the Federal Reserve banks more than adequate, in the light of their liabilities and responsibilities, it could appropriate a portion thereof for such purposes as it saw fit. As stated above, Congress did in 1933 appropriate one-half of the surplus of the Federal Reserve banks to be used as a part of the capital funds of the Federal Deposit Insurance Corporation. While the Federal Reserve banks technically own stock in the Federal Deposit Insurance Corporation, they are not permitted under the law to receive any dividends on such stock.

Under present law, member banks are entitled to a 6 per cent cumulative dividend on their paid-in subscription for Reserve bank stock. No further distribution to member banks of the net earnings of the Reserve banks is possible under existing law. All other earnings go into the surplus account of the Reserve banks where they will become the property of the United States in the case of the liquidation of a Reserve bank. Even without such liquidation, the surplus funds may be appropriated by Congress for other purposes, as was done in the case of the Reserve bank contribution to the capital of the Federal Deposit Insurance Corporation.

Adequacy of surplus.- The Federal Reserve banks now have deposit and note liabilities of about \$11,960,000,000 and surplus accounts aggregating \$148,739,000, the surplus accounts amounting to about 1.2 per cent of deposit and note liabilities.

If the operations of the Federal Reserve banks are to be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country as required by statute, the Federal Reserve banks cannot function with a profit motive in view. Moreover, if they are to discharge effectively their statutory responsibilities, they must have adequate surplus funds to permit them to operate at a loss, if necessary, over substantial periods. Present surplus funds, amounting to 1.2 per cent of liabilities are certainly not excessive and could easily prove inadequate particularly as there are no present prospects

for substantial increases therein. If the surplus of the Reserve banks should be so inadequate as to form an insufficient "cushion" to absorb possible losses, they might be deterred from extending credit as freely as might be required for emergencies such as those experienced during the period incident to the World War or the years 1930-33.

Nature of Reserve bank expenses.- Of the \$1,241,000,000 of gross earnings of the Reserve banks since they were organized in 1914, \$610,000,000, or approximately 50 per cent, has been utilized to cover costs of operation.

The expenses of the Federal Reserve banks were incurred in rendering the services and performing the functions required by the Federal Reserve Act. As stated above, they furnish the public with an adequate, safe and elastic currency; they collect large volumes of checks and other items payable upon presentation for member banks; they provide rediscount facilities for member banks; and perform fiscal agency, depository and custodianship services for the Treasury and a large number of Government agencies. In carrying out these and other important functions the Federal Reserve banks have endeavored to be of as much service to their member banks, and through them to commerce, industry, agriculture, and the public in general, and to the United States Government, as is consistent with the efficient and economical operation of the System.

All compensation provided by the boards of directors of the Federal Reserve banks for directors, officers or employees is subject to the approval of the Board of Governors. The Board requires each Federal Reserve bank to submit periodically detailed reports of its expenses and of salaries paid each officer and employee. The reports of expenses are tabulated by the Board's staff and summaries thereof are furnished each Federal Reserve bank in order that it may compare its costs with similar costs at other Federal Reserve banks.

Shortly after the present Board took office on February 1, 1936, it instituted a survey of the organization at each Federal Reserve bank and as a result thereof many economies were effected, among which were the placing of the chairmanships at the Federal Reserve banks on an honorary basis and the fixing of their compensation on the same basis as that of any other director in lieu of annual salaries of from \$20,000 to \$50,000, as had been the previous practice. Wherever it is found that certain operations can be handled more economically without sacrificing efficiency prompt steps are taken to effect the economies. Current expenses were \$1,600,000 less in 1937 than in 1935.

It seems fair to say that, while improvements in economy and efficiency have been made in the past and will continue to be made in the future, the functions performed by the Federal Reserve banks could not be performed as economically by any Government department. However, questions regarding salaries, operating expenses, etc., are, of course, extremely controversial; and some persons might take issue with this statement regarding the economy of Reserve bank operations, or might question the distribution of the expenses between salaries in different groups or between various other items.

Alternative.- It has been indicated above that the earnings of the Reserve banks beyond their dividend requirements remain available for appropriation by Congress without any necessity for covering them currently into the Treasury. Therefore, there is no need for any legislation to provide in advance for such surplus earnings, and, as indicated above, there are positive reasons why such earnings should be permitted to remain in the surplus of the Reserve banks.

If there should be any objection, however, to permitting such funds to accumulate in the surplus of the Reserve banks, a franchise tax similar to that which was in effect prior to 1932 would be better than the proposal to cover all net earnings into the Treasury. Under such a tax a certain percentage of earnings could be transferred to surplus fund and the remainder could be paid to the Treasury as a franchise tax, except that it probably would be advisable to transfer all, or at least a larger percentage, of the earnings to surplus, until the ratio of surplus to note and deposit liabilities was built up to a higher figure than the present 1.2 per cent.

SECS. 3(a), (b). ACCESS OF ALL INSURED BANKS TO  
FEDERAL RESERVE FACILITIES

Section 3(a) provides that the provisions of the Federal Reserve Act relating to the subscription for Reserve bank stock shall not apply in respect of admission to and continuation of membership in the Federal Reserve System.

Pursuant to section 3(b) any State bank, with deposits insured by the Federal Deposit Insurance Corporation, would, under "such reasonable rules and regulations as the Board of Governors of the Federal Reserve System shall prescribe, be entitled to all the rights and privileges under the Federal Reserve Act, as amended, if such bank carries its reserves with a Federal Reserve Bank." Any such bank could "withdraw at will from such affiliation upon written notice to the Board of Governors."

Discussion

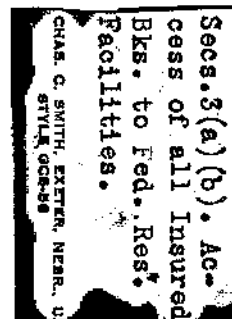
Unimportance of Reserve bank stock ownership.- The provision terminating the stock ownership requirements of the Federal Reserve Act is largely a mere correlative of the provisions for Treasury acquisition of the Reserve bank stock. Its inclusion in this section of the Bill, however, indicates an assumption that such requirement is a burden and prevents banks from joining the System.

Possibly there was some reason for this view in the early days when the System was untested and investment yields generally were higher than at present. Ownership of Reserve bank stock today, however, definitely is not a burden to the member banks.

"Affiliation" of insured banks with System.- The extension of the benefits of the Federal Reserve System to all insured banks on a proper basis would seem to be desirable. The only proper basis for such extension, however, would seem to be a definite requirement that (1) they comply with the reserve requirements at all times (and not merely when they choose to avail themselves of the benefits of the System), and (2) that they comply with all other provisions of law which Congress has deemed necessary for the maintenance of sound banking conditions.

The only restrictions upon access to Federal Reserve facilities at present are those written into the law by Congress and which at least at the time of adoption were thought to be in the public interest. The Board, of course, prescribes certain regulations regarding membership in the System but similar regulations regarding "affiliation" would also be authorized under the proposal.

Any State bank can now become a member bank of the Federal Reserve System upon complying with the requirements specified by



Congress. If these requirements are sound there is no reason to permit access to Federal Reserve facilities without complying with them. If Congress feels that any of them are not sound, they should be corrected and made to fit present conditions and serve the public interest. In the main, they are definitely sound. For example, the existing member bank restrictions on security affiliates, on loans to executive officers, and on purchase of speculative securities clearly are in the public interest and desirable for all banks, whether or not members of the Federal Reserve System.

It obviously would be inequitable to permit banks to profit by the services of the System so long as it suited them and to withdraw from it whenever the maintenance of reserves or compliance with any regulation by the Board appeared to them to be burdensome.

Reasonable notice of withdrawal, such as the present requirement of six months' notice also is necessary to prevent sudden drastic changes in the Federal Reserve System and the financial mechanism of the country. When banks keep their reserves with the Federal Reserve banks, the effects of changes in Reserve bank credit, Treasury operations, and capital movements, can be calculated with a fair degree of accuracy. A dangerous unpredictable factor would be introduced, however, if the situation was complicated by the possibility that reserves may be suddenly withdrawn from Reserve banks and redeposited with other banks where they would, in turn, form the base for other deposits and permit pyramided reserves of the type the Federal Reserve Act was especially intended to prevent. Such shifts in reserves would seriously impair the machinery of credit control and would be quite likely to operate in the direction most strongly opposed to the public interest.

This may be illustrated by an example of the possible interference with credit control. In time of boom when banks did not need to borrow from Reserve banks they would be inclined to withdraw their reserves from the Reserve banks, and redeposit them with other banks. This would, in effect, tend to broaden the credit base by increasing the pyramiding of reserves, and thus contribute to the boom conditions. On the other hand, in times of stress when the banks needed to borrow from the Reserve banks, they would be inclined to withdraw their reserves from other banks and redeposit them in the Reserve banks in order to get the rediscount privilege. This would, in effect, tend to reduce the pyramiding of reserves and narrow the credit base. The effect would be in the direction of credit stringency exactly at a time when the monetary authorities might be trying desperately to relieve the situation.



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E.O. 12065, Section 6-102

by JR... NARS, Date 8-13-05

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It also should be obvious that the possibility of bank reserves being instantly shifted to and from the Reserve banks would virtually nullify the Board of Governors' power to change reserve requirements. The present facilities for withdrawing from the Federal Reserve System, while much more orderly, tend to weaken monetary control, and it has often been suggested that the compulsory features of monetary control should be increased rather than decreased. The present proposal would be a step in the opposite direction and would add greatly to the existing difficulties of monetary control - an action directly in conflict with the Bill's general idea of expecting even greater results from such control.

SEC. 4. BROADENED POWER TO CHANGE RESERVE REQUIREMENTS

This section would authorize the Board of Governors to change reserve requirements, by vote of ten members of the new fifteen-member Board, in order to prevent injurious credit expansion or contraction, "and to carry out its duty under subsection (a)." It would eliminate the restrictions at present in section 19 of the Federal Reserve Act that (1) the change be for central reserve and reserve cities, for other cities, or for both, and (2) that requirements not be reduced below those specified in the Act nor increased to more than twice such amount. The power would extend to "affiliated" as well as to member banks.

Discussion

In principle, the elimination of restrictions as here proposed is desirable. Such restrictions were not contained in the earlier drafts of the Banking Act of 1935, and the proposal would be nearer the suggestions offered by Chairman Eccles in that connection.

If it is desired to oppose the proposal, however, there are certain matters which may be pointed out in rebuttal. The monetary problem at present is not the prevention of excessive expansion but the prevention of excessive contraction. There is much more difficulty in getting the member banks to utilize their existing excess reserves than in preventing such reserves from causing trouble. It may well be that if the changes were made and member banks were confronted with the possibility of further increases in reserve requirements they would be even more reluctant to utilize their excess reserves. Thus, the legislation might have deflationary effects.

Aside from the specific factor of member banks holding their reserves uninvested in anticipation of further increases in reserve requirements, there is the generally upsetting influence which the enactment or extended consideration of any such sweeping legislation might have at this time. Few powers have as great or direct an influence upon any business as the power of changing the reserve requirements has upon the banking business. The enactment or extended consideration of such a proposal at this time might further aggravate the fears -- possibly unwarranted but nevertheless

Sec. 4. Broadened  
Power to Change  
Reserve Require-  
ment.

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existing at the present time -- of bankers and businessmen regarding additional Government regulation or control. These factors at the present time may outweigh any theoretical or even practical but long-term advantages of the proposal.

Nullified by voluntary features.- The provision of section 3(b) which, in effect, would require banks to maintain reserves only when they wish to borrow from the Federal Reserve banks would virtually nullify the power to increase reserve requirements. Even the present voluntary features of Federal Reserve membership would require serious consideration in connection with any proposal to increase reserve requirements further, and might well nullify any power to effect such increases.

SEC. 5. CHANGE IN BOARD OF GOVERNORS

The Board of Governors would consist of fifteen members. One member would be appointed from each Federal Reserve district by the President with the advice and consent of the Senate; and the Secretary of the Treasury, Comptroller of the Currency, and Chairman of the Federal Deposit Insurance Corporation would be ex officio members with full powers. The present members of the Board would be continued in office. The term of one appointive member, either a present member or a new appointee, would expire each year, and successors would have twelve-year terms. Whenever under existing law the concurrence of four or more members of the Board is required "such requirement of law shall be held to be complied with by the concurrence of eight members."

Discussion

Unwieldiness of large Board.- The proposed Board of fifteen members, or even the twelve appointive members, would be too unwieldy for proper administration. It would be difficult for it to formulate or carry out policies expeditiously.

The Board is not a deliberative Board like the Courts and many Government agencies, but is confronted with rapidly shifting conditions which it must constantly study and promptly act upon of its own volition. Timing is often extremely important. While the group should be large enough to insure reasonable counsel, consultation and study, it should not be so large as to place unnecessary difficulties in the path of prompt action. To increase such difficulties is to take a step backward and diffuse responsibility in a field where it should be fixed and clearly ascertainable.

Another defect of expanded membership would be the increased tendency towards sectionalism in Federal Reserve policies. The Federal Reserve System should be operated in the public interest of the entire nation and by having one member from each district there would be an unfortunate connotation that each member represents his own district rather than the entire nation. Monetary policy is particularly a sphere in which the welfare of the entire nation rather than of particular sections should be paramount.

No present need.- The record does not indicate any lack of contact with present conditions on the part of the Board, or any difficulty between the Board and the present Administration which needs to be resolved by making additional appointments to the Board, or otherwise. In addition to the fact that all present members of the Board were appointed since 1935, the policies of the Board and the Administration have been very similar and there are many visible

Sec. 5. Change  
in Board of  
Governors.

evidences of cooperation. For example, the original Gold Sterilization Policy of the Treasury was worked out in collaboration with the Board and the changes made since its adoption were either made at the specific request of the Board or in cooperation. Similarly, the System has officially indicated that it would undertake to preserve order in the Government bond market in certain circumstances. Cooperation has, if anything, been closer since the Banking Act of 1935 terminated the ex officio membership of the Secretary of the Treasury and the Comptroller of the Currency. It is clear, therefore, that there is no need to bring the Board into closer cooperation with the present Administration.

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On March 22, 1938, at the House Banking and Currency Committee hearings on the Bill, Mr. Patman proposed to introduce amendments to the Bill which would (1) expressly make the Board of Governors an administrative agency of Congress, but appointed by the President, (2) make any or all of its members removable at the will of Congress by a vote of either House of Congress, and (3) eliminate the provisions of the Bill for ex officio members of the Board of Governors. (Secretary of the Treasury, Comptroller of the Currency, Chairman of the Federal Deposit Insurance Corporation.)

The proposal to make the Board an administrative agency of Congress apparently has little significance except in connection with the proposal to make Board members removable by vote of either House of Congress. The proposal is a novel one and no reason appears for applying it to the Board more than any of the other governmental agencies. It also might produce a divided responsibility in which one House of Congress would remove a Board member for following one course of action while the other House of Congress would remove other Board members for following exactly the opposite policy.

Elimination of the provision of the Bill for ex officio members of the Board is believed to be a desirable change. The following paragraphs are, in effect, arguments for such a change and may be disregarded if the change is made.

Administrative defects of ex officio memberships.- The proposed ex officio members already have many duties to occupy their time and obviously could not give their full attention to Federal Reserve problems. These matters, however, require the full time and attention of those responsible for their control. Experience shows that ex officio members on almost any Board, particularly the Board of Governors, tend to be deadwood. They would contribute little to

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the functions of the Board and increase the difficulties of action at critical periods, making it more difficult to fix the responsibility for action or inaction in monetary matters.

Relations of Federal Reserve with Treasury.- 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 the 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. The ultimate 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 would be a backward step.

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By IR NARS, Date 8-13-05

SEC. 6. SELECTION OF RESERVE BANK DIRECTORS

Class A, B, and C directors of each Reserve bank would be appointed by the President with the advice and consent of the Senate. No such director could be an officer, director, or stockholder of any bank; each director would have to be a resident of the district in which the Reserve bank is located; and each would be appointed for a term of nine years after the first appointment, with the appointments arranged for one to expire each year.

It would be unlawful for any director of a Reserve bank or "official" of the Board of Governors to be employed by any bank within three years from the time of service as a director or official.

Discussion

On March 22, 1938, at the House Banking and Currency Committee hearings on the Bill, Mr. Patman proposed to introduce amendments to the Bill to provide that the Board of Governors appoint all the directors of the twelve Federal Reserve banks. Such a change would have advantages over the proposal in the original Bill and probably also over the present arrangement. All the following paragraphs, except the last one relating to the service of former Federal Reserve officials with banks, are in effect arguments for such a change in the Bill, and if the change is made, they may be disregarded. ?

Present arrangement.- The proposal to have the directors of the Federal Reserve banks appointed by the President with the advice and consent of the Senate apparently is based on the assumption that the Federal Reserve System has not been operated in the public interest and has been dominated by bankers. This assumption cannot be sustained by the record.

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 also largely under the control of the Board.

Sec. 6. Selection  
of Reserve Bank  
Directors.

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 appointment of all Presidents and First Vice Presidents and the salaries of all officers and employees are subject to approval by the Board in Washington.

Especially with the changes made by the Banking Act of 1935, the Board is in a position to see that the entire System is administered soundly, efficiently and for the national welfare. While the autonomy of the Reserve banks is preserved in local matters, the Board is in a position to see that this autonomy serves a useful rather than a harmful purpose.

Defects of proposal.- If the directors of the Reserve banks were appointed by the President with the advice and consent of the Senate, there would be a sharp division of authority within the Reserve System, and it would be difficult or impossible for the Board to exercise the general coordination and control which it can and does at present. As a matter of practice, the Board simply could not adequately supervise the activities of directors who were thus appointed by the same authority that appoints the Board.

It might be claimed that there are instances in the Government of subordinates being appointed by the same authority as their superiors, for example the Commissioner and Collectors of Internal Revenue, and the Attorney General and the District Attorneys. These, however, are all individuals with indefinite terms and in both theory and practice directly responsible to the President. The situation with two large boards whose members are appointed by the same authority for long fixed terms is quite different. So far as is known, there is no instance in which one such board is expected to supervise the other.

Even if it were technically true as a strict matter of law that the Board would retain its power of removal for cause, it is clear that as a practical matter it could not use either this power or its general powers of advice and persuasion to anywhere near the extent that it can at present. The dangers of divided responsibility within the System would be intensified by the provision for nine-year



terms instead of three-year terms for the Reserve bank directors.

The proposal also would tend to introduce party politics into the System, which would further impair its operation. No matter how sincerely anxious the Board and each of the boards of directors might be to serve the public interest to the greatest advantage, such an arrangement would be administratively impractical and almost certainly would not function properly.

Alternatives.- If the desire is to prevent bankers from serving as directors of the Federal Reserve banks, or the banks from selecting any directors, it would be much better to accomplish these purposes without disrupting the administrative set-up of the Federal Reserve System. For instance, all the directors might be appointed by the Board in the manner of the present Class C directors. Some modified arrangement might be worked out whereby, for example, the Class A directors might be abolished and only the Class B and Class C directors retained, or the Class A directors could be abolished and the Class C directors increased to six, or some other such changes might be made. Any such plan would more nearly achieve the intended purposes, while at the same time preserving a workable set-up and fixed responsibility.

Former Reserve officials not to serve banks.- While the general provision against former Reserve bank directors and former "officials" of the Board serving any bank within three years has certain theoretical appeal, former members of the Board of Governors are already forbidden to serve member banks within two years unless they served out their terms with the Board. The meaning of the term "official" is not indicated; and it may well be asked whether the present restriction is not sufficient -- or at least whether it would not be sufficient if extended to cover Reserve bank directors. No reason appears for singling out the Federal Reserve System for such a restriction as that proposed, which is much broader than that applied to similar agencies such as the Interstate Commerce Commission, Federal Communications Commission, etc. Such a restriction might handicap the System in seeking the best personnel.

However, it is believed more important for this restriction to apply to Reserve bank directors and officers than to members of the Board, since the former are in a position to extend favors to individual banks.

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by JB NARS, Date 8-23-05

Sec. 7. Abolition  
of Federal Ad-  
visory Council.

SEC. 7. ABOXLITION OF FEDERAL ADVISORY COUNCIL

The Federal Advisory Council would be abolished.

Discussion

In many respects, the proposed change would be desirable.  
It can well be argued that the Federal Advisory Council serves no useful purpose and should be abolished for this reason, if no other. It also can be argued that its advice on monetary and credit matters is either useless or worse and that the time consumed by Board members in considering such recommendations and dealing with the Council could be better spent in other ways. Some might even claim that the Council is a dangerous means of foisting banker-influence upon the Board and thus harming the public interest.

If it is desired to oppose the proposal, there are certain arguments that support such a position. The Advisory Council has no substantive power and can only advise and consult. It would seem that some form of consultation with the bankers, the persons who feel the first and most direct effects of any monetary policies, is inevitable; and it can well be argued that it is better to have consultation through an organized above-board body such as the Federal Advisory Council rather than by other means.

It also might be claimed that the Federal Advisory Council is worth something merely as a good-will medium for interpreting Government policies to business and business policies to Government in somewhat the same way that the Advisory Council in the Commerce Department attempts this for general business.

It may also be pointed out that it has been thought advisable to provide similar advisory councils for other agencies, such as the Home Loan Bank System.

There is also presented here, as elsewhere, the question of whether any advantage to be obtained by the proposal is sufficiently great to offset the possible damage to business confidence at this time.

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ADMINISTRATIVE MARKING  
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by JB NARS, Date 8-23-05

SEC. 8. BOARD OF GOVERNORS TO CONSTITUTE OPEN  
MARKET COMMITTEE

The Board of Governors would constitute the Federal Open Market Committee, replacing the present committee which consists of the seven members of the Board of Governors and five Reserve bank representatives.

Discussion

The proposed change would be desirable in many respects. It tends in the direction of definitely fixing responsibility for monetary control. It tends to further remove any possibility of monetary control being influenced by motives of personal gain, or the interests of particular geographical or economic groups, rather than the public interest of the nation generally. The change would be similar to the proposals which were urged by Chairman Eccles in connection with the earlier drafts of the Banking Act of 1935.

The only objections to the proposal would seem to be that it might be unnecessary or untimely. The seven members of the Board of Governors constitute a majority of the twelve-man Open Market Committee and, the other members are subject to the Board's approval in their positions as presidents of the Reserve banks. It may be that while the proposal would offer theoretical advantages over the present arrangements, the change as a practical matter, would not have enough advantages to justify enactment or extended consideration at the present time.

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## SEC. 9. RESERVE BANK PERSONNEL

All positions, except those of directors and officers, in the Reserve banks would be included in the Classified Civil Service. Incumbents would acquire a Civil Service status if, at the expiration of the six months' probationary period, their services were certified to the Commission as being satisfactory. No officer, director or employee of any Reserve bank or the Board could receive an annual salary in excess of \$25,000.

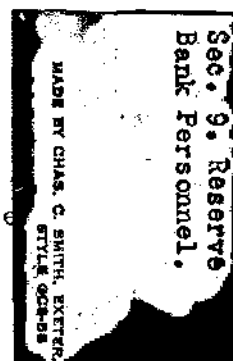
### Discussion

It is to be noted that the proposal for covering Reserve bank employees into the Civil Service would not affect officers or directors. The exemption seems proper, since Civil Service would clearly be unsuitable for such positions. However, the remaining positions are ones as to which there apparently has been no complaint. So far as is known, the general personnel of the Reserve banks is considered to be at least as efficient as Civil Service employees and working conditions are satisfactory. There has been no suggestion of political influence in such positions. Therefore, there would seem to be no reason to change the present arrangement which has served satisfactorily for twenty-three years.

While the Civil Service has many advantages and is often necessary to avoid partisan political pressure or other problems that sometimes arise in large organizations, it also has definite limitations. The inflexibilities of Civil Service cannot fail to have certain undesirable results. One of these is an unsatisfactory tendency toward "clock watching" and suppression of initiative. These tendencies often make it difficult to meet emergency conditions such as those which often confront Reserve banks.

Most of the Reserve bank duties involve special skills for which Civil Service standards would be poorly suited and, as a matter of fact, although all Reserve banks perform the same general functions, their requirements for personnel vary somewhat from bank to bank because of the differences in the size of the banks and in the relative volume of the various classes of operations. Civil Service, of course, is not applied universally even to various Government departments and agencies.

It is doubtful that Civil Service could take into account local conditions to the same extent as do the Reserve banks. Thus,



Civil Service might tend to break down the local autonomy of the Reserve banks and the contact with local conditions which is desirable in a country as large as this.

The salaries specified in the classification act for Government employees do not take into account variations in living costs and other factors in different parts of the country. This is not a serious factor in the case of Government employees since most of them, at least until recently, have been concentrated in Washington. The situation would be quite different with the Federal Reserve banks, however, since they are scattered over all parts of the country under widely diverse conditions.

Various arguments on both sides may be offered on the basis of comparisons of the salaries of Reserve bank officers and employees with those in Civil Service or in commercial banks. As a general proposition, salaries of officers are somewhat higher than Civil Service standards but lower than commercial bank standards in the same locality. Salaries of employees are generally lower than Civil Service standards but equal to or greater than the standards of progressive commercial banks in the vicinity. Thus the salaries of Reserve bank officers and employees are, to a certain extent, midway between Civil Service and commercial bank standards.

The Reserve banks have to a large extent been able to combine the good features of the employment policies of Government agencies and private business, and to eliminate the bad features of both. When an organization can operate without the evils at which Civil Service is aimed, it would be a useless and objectionable addition of red tape to introduce the Civil Service requirements.

Retirement system.- The idea of a retirement system for employees is not confined to the Federal Reserve System. There is a similar system for Government employees, and many private businesses have similar plans, to say nothing of the provisions of the Social Security Act that apply generally. In addition to being justified on grounds of fairness to the employees, such systems improve the efficiency of the organizations which use them by removing deadwood from the organizations and making employment more attractive for desirable employees. It is understood that the Division of Bank Operations is preparing more detailed information regarding the retirement system.

\$25,000 a year limitation on salaries.- This would introduce an unnecessary rigidity. The Board already has authority over all Reserve bank salaries, and the very fact that the proposal would set the limitation as high as \$25,000 - more than any Cabinet member or any Supreme Court Justice - indicates that the usual standards cannot be applied. Only six officers in the Federal Reserve banks receive over \$25,000, and if their salaries were reduced to this figure the total annual reduction would be only \$55,000. Arbitrary restrictions might be detrimental to the System since the Reserve banks often must compete with commercial banks in obtaining personnel.

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SEC. 10. FREE BANK EXAMINATIONS

Examinations of member and "affiliated" banks of the Federal Reserve System by any Federal agency would be made without charge or assessment against such banks.

Discussion

Except in rare instances, costs of examination of State member banks are now borne by the Federal Reserve banks. The Federal Deposit Insurance Corporation does not charge for examinations of insured nonmember banks. National banks, therefore, would be practically the only ones affected, and it might be argued that they should be relieved of the burden as a matter of fairness. It also might be claimed that more thorough examinations could be made if the banks did not bear the cost.

The assessments on the national banks amount to over \$2,900,000 a year. If the change were made, it would be necessary to provide for this expense in some other way, such as through appropriation by Congress. This is of interest in connection with any estimates of how much the Treasury might gain from other provisions of the Bill.

It may be noted that although State banks usually are not assessed for two examinations a year as are the national banks, most State banks are assessed by the State supervisory authorities for one examination a year.

The proposal is not particularly desirable or objectionable so far as it goes. It is defective chiefly because of what it fails to do. Improvement and coordination of the present machinery of Federal examinations is much more important than changes in the method by which the cost is borne. The proposal for free examinations would leave this entirely unaffected.

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SECS. 11, 12, 13, 14. REGULATIONS; EFFECTIVE DATE; ETC.

These provisions would authorize the Board of Governors "to prescribe such rules and regulations as may be necessary to carry out the policies and provisions of this Act", state the Act's effective date (January 1, 1938 in the Bill), repeal conflicting laws, and authorize appropriations necessary to carry out the Act.

#### Discussion

These are general provisions which are covered by the discussion of the other provisions.

