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FEDERAL RESERVE POLICY-MAKING

FEDERAL RESERVE POLICY-MAKING

*A Study in
Government Economic Policy Formation*

By

G. L. BACH

Professor of Economics, Carnegie Institute of Technology



New York

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FIRST EDITION

T O
R. J. B.

Preface

THIS LITTLE BOOK is a study in modern economic policy-making. It has two main purposes. The first is to report in some detail a recent extensive study of the process of Federal Reserve monetary and bank-supervisory policy formation. The second is to look analytically at the policy-making experience of the past quarter century to see what lessons it may have for the future.

No one who has participated in the economic policy-making of modern government needs to be warned against the fallacy of a neat dichotomy between "policy formation" and operating government. Congress seldom passes statutes on economic questions which clearly define policy and require no *de facto* administrative policy-making. "Economic policy" is not something neatly separated from political, social, and other kinds of policy. And the positions held by other officials, agencies, and pressure groups often unfortunately preclude even serious attention to careful analyses made by professional economists in the agencies formally responsible for policy-making. Nor is it so clear as it may appear superficially that in a democratic society where the various branches of government manage, however imperfectly, to mirror many of the pressures of manifold public demands, economic policy *ought* somehow to be set apart from and protected from these other forces.

Whatever "should" be in the eyes of the professional economist (who sometimes views with condescension anything below the pure "policy formation" level), most economic policy is something hammered out, or arrived at by default of positive action, in negotiations among men representing different agencies, different interests, different points of view. Much of the *de facto* policy-making occurs in the administration of congressionally approved directives. What goes on here is often only loosely related to the formal organization charts, careful statutory language, and textbook descriptions on which the outsider must rest so heavily for information. Monetary policy is made by human beings, often not very "expert" ones, in human situations and as part of a complex, operating government. It would be a mistake to overrate as determinants of policies the organizational arrangements and informal processes in the executive branch of the government. But it is surely also a mistake to neglect completely this practical side of economic policy-making.

The primary concerns of this monograph are the processes of policy formation and their impact on the policies that evolve, not monetary theory or an evaluation of different monetary policies. But it will not take a very sharp eye to detect that predilections on monetary theory and policy are basic to most of the examination—predilections that monetary policy does matter and that some kinds of monetary policy are clearly preferable to others. The whole study, so far as I am concerned, rests explicitly on the crucial importance of the question: Have the present organization and proce-

dures been conducive to the formation of "good" monetary policy, and how could they be bettered from this point of view.

This monograph is presented, therefore, as a report of a case study of this aspect of American governmental policy formation in the monetary and bank-supervisory areas. So far as I know, there is no other similar published account of the working, informal processes, within the Federal Reserve and in its relations with other agencies, by which monetary and supervisory policy decisions are actually framed, adopted, and carried out. Hence, as a modest supplement to the many works on formal organization of the Federal Reserve and on monetary theory and policy *per se*, I hope this monograph may prove of some benefit to students—professional economists, political scientists, college students, and others—of modern monetary and banking developments, and to those who are just interested in how modern government works. To aid those who are relatively unacquainted in the field of money and banking, the first two chapters of the book provide a brief account of the history and present formal organization of the Federal Reserve System, aimed at providing the background essential to an understanding of what comes after. Readers well acquainted with the Federal Reserve will do well to start directly with Chapter III, which plunges into the monetary policy issues involved. Parts Two and Three of the book are purely descriptive of the internal and external aspects, respectively, of Federal Reserve policy-making. Part Four contains the analysis of these findings.

This monograph rests in considerable part on a study of the Federal Reserve System which I conducted in 1948 for the Hoover Commission (Commission on Organization of the Executive Branch of the Government). In some parts, it is substantially identical with the report prepared for that commission, though the present book is broader in its orientation throughout and is not concerned with numerous more narrowly administrative matters that were of importance in the commission study.¹ But here, as in the commission study, I find it impossible to separate what I found in the formal 1948 study from the larger body of facts, attitudes, and impressions on Federal Reserve operations and relations with the external world obtained while I was a member of the board's staff during the immediate prewar and war years. I suspect that most of what insight I have comes from this earlier experience, but I have rigorously avoided the inclusion here of anything that is not completely public information, either through release of the Hoover Commission study or otherwise.

My debts of gratitude for information and insights into Federal Reserve policy-making thus are mainly to

¹ The report to the Hoover Commission was presented to Congress as a working paper, "The Board of Governors of the Federal Reserve System," attached to the report of the Task Force on Independent Regulatory Agencies (Appendix N of the commission's final report), which contains a brief summary of the reasoning and recommendations of the more detailed working paper. The commission itself adopted some of the basic coordinative recommendations made, but took no action on most of the substantive recommendations for internal Federal Reserve changes, forwarding the Task Force report without comment on these points.

the many Federal Reserve officials with whom I was in contact during my years there and who were so genuinely cooperative during the Hoover Commission study. To name one without many others is improper, but not to mention Drs. E. A. Goldenweiser, Woodlief Thomas, and R. I. Robinson, and Governor M. S. Szymczak would be inexcusable. Various other high-level Washington officials provided valuable information and advice during the extensive Hoover Commission interviews, and the friendly cooperation of the Task Force on Independent Regulatory Agencies of the Hoover Commission should be recorded. Beyond these, I am particularly indebted to Messrs. Homer Jones and J. E. Reeve for penetrating criticisms and suggestions at many points throughout the study.

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PART ONE

*Federal Reserve Organization and Policy
Responsibilities*

I

Development of Federal Reserve Functions¹

Prior to the Federal Reserve Act of 1913, central banking and the concept of positive credit policy aimed at protecting the public interest were essentially absent in the United States. Since the inception of banking in this country, the banking system, which issued part of the circulating currency as well as holding deposits, had been subject to intermittent crises and ensuing waves of liquidation and depression. During these periods, the public demanded gold and currency from the banks. Such wholesale cash drains the banks were not prepared to meet. The pressure of withdrawals forced individual banks to call loans and liquidate other assets, putting deflationary pressure on businesses, individuals, and the security markets. This in turn intensified the aura of pessimism and uncertainty, leading to further currency withdrawals, and so the deflationary spiral went.

Recognition of the problem of mitigating monetary deflations was widespread, and banking had long been

¹ Chapters I and II are intended primarily to provide a minimal background of information on the history, functions, and organization of the Federal Reserve System for nonspecialists in monetary economics. Those well acquainted with the Federal Reserve will do well to begin directly with Chapter III.

subjected to a variety of restraints as to capitalization, stockholders' liability, types of holdable assets, reserves, and other such matters. But these restraints had apparently accomplished little. Awareness of the unsatisfactory banking organization was intensified by the sharp financial crisis of 1907, when the country was apparently saved from still more disastrous panic mainly by the pooled efforts of a few dominant private financiers headed by J. P. Morgan.

In this atmosphere, the National Monetary Commission, headed by Senator N. W. Aldrich, was established by Congress to recommend a more effective banking organization for the nation. The extensive report of this commission in 1912 recommended adoption in the United States of a system of centralized bank reserves, centralized note issue, and central banking facilities for the rediscount of commercial paper to provide commercial bank reserves in times of stress—advantages of existing European banking systems that had been long recognized by students of banking theory. Nevertheless, a profound distrust of the whole idea of central banking was widespread in America. There was broad antagonism to the thinly disguised central-banking proposals of the Aldrich Commission, heightened by belief that Senator Aldrich was a spokesman for the powerful eastern financial groups which had long dominated the banking scene.

President Woodrow Wilson and the Democratic Party were elected in 1912, pledged against a central bank or a central reserve association. It seemed apparent that the problem of American banking reform

was largely to get a reasonably unified monetary system and to pool bank reserves without loss of local prerogatives. The experts were agreed on the need for the former; the public seemed adamant on the latter.

The Federal Reserve Act of 1913

The outcome of this situation was a compromise, a federally established regional banking system with certain elements of loose central control. In the words of its preamble, the purposes of the Federal Reserve Act were: "To provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." More specifically, it was generally agreed that the new legislation was aimed at accomplishing four major goals. These were:

(1) Provision of an "elastic" currency, that would expand as business activity grew seasonably or cyclically and would contract as the need for currency diminished, thus avoiding periodic crises as the public wanted to withdraw more currency than the banks could provide.

(2) Centralization of bank reserves, in order to "pool" the system's reserves for common use in periods of credit stringency—in contrast to the preceding situation where at any suggestion of credit stringency each bank felt obliged to "hoard" its own reserves and thereby helped intensify deflationary pressures, and where the concentration of most bank reserves on de-

posit in the large private New York banks put drastic deflationary pressure on New York when other banks concertedly tried to withdraw their reserves to meet their own depositors' withdrawals.

(3) Establishment of an effective interregional check and currency clearing system.

(4) Provision of adequate banking facilities for the federal government, which had previously used nine subtreasuries and some 1,500 depository banks under an inefficient system that was also subject to political favoritism in the deposit of public funds.²

In substance, the act provided (1) for a new form of currency, the Federal Reserve note, which would expand and contract with the "needs of business," as commercial banks rediscounted customers' notes and other paper at Reserve banks when business borrowing expanded; and (2) a regional system of twelve Federal Reserve banks, loosely supervised by a Federal Reserve Board in Washington, which together were to pool the reserves of the banking system, provide an interregional clearing system for currency and checks, and act as fiscal agent for the federal government, in addition to issuing Federal Reserve notes as required by the public.

The act as passed represented not only a compromise between regionalism and centralism, but also a compromise between the philosophies of credit accommodation and of control. While the desire to mitigate financial crises and depressions was apparent through-

² Various other advantages were widely claimed. For example, it was hoped that generally lower interest rates would follow from the more effective use of bank reserves and a more efficient monetary system.

out, contemporary banking theory and popular feeling on the whole agreed that improved currency and reserve arrangements, coupled with "sound" individual banking practices (restriction of lending to the security of short-term, self-liquidating commercial paper), were all that were needed. If banks accommodated their customers soundly, on the basis only of short-term, self-liquidating paper, and if facilities were provided to ease the stringencies of financial crises, the proper amount of money to meet business needs would be automatically forthcoming, and no other conscious control would be needed. In the background, the gold standard provided a basic determinant of the volume of bank reserves, again a largely automatic control requiring little conscious centralized "monetary" or "credit" policy.

Reflecting this philosophy, the original act paid little explicit attention to what has since become the main purpose of the Federal Reserve authorities—the establishment of a national monetary and credit policy conducive to maintenance of general economic stability. Instead, the act was mainly concerned with what are now generally termed "service" functions—pooling reserves, clearing interregional checks and currency, providing currency, and serving as fiscal agent for the government. Credit control, in so far as it was envisaged in the act, was seen largely as a problem of establishing "sound" banking practices. The act did provide for various powers, including changes in rediscount rates, open-market operations, and examination of member banks, that were aimed at promoting

“sound” credit conditions. But, on the whole, these were secondary to the basic gains expected from provision of an elastic currency and centralization of bank reserves. Determination of the proper amount and use of currency and bank credit was felt to be provided by adherence to the gold standard plus sound commercial-banking practices. With little recognition of the need for any conscious policy of credit control, only minor emphasis was given to the possible need for a unified national credit policy, and only general supervisory powers were placed in the Federal Reserve Board to control the credit policies (rediscount rates, open-market operations) of the twelve Federal Reserve banks which dealt directly with the member (commercial) banks.³

³Detailed, authoritative accounts of the background of the act are provided by H. Parker Willis, *The Federal Reserve System* (Ronald Press, New York, 1923) and Paul M. Warburg, *The Federal Reserve System* (Macmillan, New York, 1930). Mr. Warburg was a prominent banker who served for four years on the newly established Board. Professor Willis is generally considered to have been immediately responsible for converting the prevailing banking theory of the period into legislative form. As a major draftsman of the act, he worked primarily with and through Representative Carter Glass, who sponsored the bill in Congress and before the public, and who for over three decades thereafter played a leading congressional role in any legislation concerning the system. Carter Glass' *An Adventure in Constructive Finance* (Doubleday, New York, 1927) records the inner history of the adoption of the act, and the majority report of the House Banking and Currency Committee which he presented on the floor provides an authoritative statement of the act's philosophy and purposes. The best account of the development of banking theory in the United States underlying the act is that of L. W. Mints, *History of Banking Theory* (University of Chicago Press, Chicago, 1945), especially Chapters XI and XII; this study also provides a penetrating critique of the theory of the act.

The Federal Reserve Act Since 1913

Like most written law, the Federal Reserve Act has developed and changed through the process of administration, interpretation, and gradual acceptance of precedents. Only once has the legislation itself been basically altered; that was during the early years of the New Deal in 1933-35. As with most other governmental functions in this country, the drift has been toward greater centralization of policy-making powers through both practice and legislative amendment. This process of change falls roughly into three periods, after the embryonic years of the World War I period.

The 1920's,⁴ a decade of mild experimentation in banking policy, were followed by the depression of the early 'thirties and a corresponding wave of despair concerning prevailing monetary and banking arrangements. The beginnings of a Federal Reserve drift toward both greater unification of policy-making and a more active policy attitude were evident by the mid-twenties. As early as 1923, the Reserve Banks established an informal open-market investment committee to help coordinate their newly developing open-market operations. This five-man committee, though it had no legal basis, gradually grew in power and status. Finally in 1930 it was replaced by a more formal open-market committee, on which all twelve banks were

⁴ The most authoritative, yet brief, account of the development of Federal Reserve policy through the 1920's is C. O. Hardy, *Credit Policies of the Federal Reserve System* (Brookings Institution, Washington, 1932).

represented and which had recognized, though still nonlegal, power of directive to unify the twelve banks' open-market operations.

During most of the 1920's, policy decisions of the system appear to have been dominated in considerable part by the New York Federal Reserve Bank, under Benjamin Strong, then governor of the bank. In 1928 and 1929, a growing controversy between the Federal Reserve Board in Washington and the New York Reserve Bank over the proper role and tools of credit policy in the light of general business conditions and the inflated stock market burst into open conflict. The board in Washington asserted its authority over rediscount rates, in an attempt to tighten the flow of credit into speculation. The balance of power on open-market operations, basically the more powerful tool, remained with the banks. During these years and into the ensuing deflation of the early 1930's, this division of authority, with indecision and argument, prevailed in spite of considerable progress during the 'twenties toward unified open-market policy.

Meanwhile, the passive credit policy role implied by the act for the Reserve authorities was increasingly questioned. Academic economists challenged the "commercial bills of credit" doctrine (that lending on only short-term, self-liquidating paper would automatically provide the proper money supply to meet the legitimate needs of business) as an adequate basis either for guaranteeing sound banking practice or for providing a proper volume of money (currency and bank deposits) to meet the economy's needs. The allegedly

“legitimate” business demand for such loans, said these critics, was largest in inflationary booms, just when restraint was needed. Similarly, the demand for such loans vanished in depressions, just when easier credit was most needed. Moreover, even if loans were restricted to such borrowers, what would keep the new credit out of other “inflationary” uses once it was spent by the original borrowers? The over-all impact of these criticisms of the basic banking philosophy of the Reserve Act pointed strongly in the direction of more conscious Federal Reserve policy to maintain greater stability in the money supply.

At the same time, doubt was arising concerning the adequacy of gold flows as the primary determinant of bank reserves and thus of the nation’s money supply. According to gold-standard tradition, the movements of gold into and out of a nation’s bank reserves were the best index of that nation’s credit conditions. A gold inflow indicated a need for monetary expansion; a gold outflow the reverse. But even under the gold standard, central banking officials needed to exercise some discretion. Obviously temporary and minor gold movements, for example as a result of seasonal trade factors, were properly offset by central-bank credit policy to avoid unnecessary disturbances to the domestic banking system and money supply. Only bona fide gold movements should be permitted to affect the domestic economy.

As the gold-standard philosophy broadened to make the cause and anticipated duration of gold flows crucial, the automatic gold criterion for the nation’s money

supply was gradually supplanted by the need for discretionary central banking decisions. Within and outside the government controversy was widespread about whether the Federal Reserve should take positive steps aimed at checking booms or recessions rather than passively permitting gold flows to ease or tighten credit. In 1923, and on several occasions between 1925 and 1929, the Reserve authorities directly intervened to offset gold flows by credit policy, though the action was mild and the exact objectives of Federal Reserve policy were far from clear.

The Banking Acts of 1933 and 1935

The 'twenties had seen some development of an active Federal Reserve credit policy. But only the disastrous financial collapse of the early 1930's succeeded in impressing vividly on monetary experts and the public, though less strongly on the banking community, the necessity for a unified central banking organization with the major purpose of consciously helping to mitigate general economic instability and with more adequate powers to accomplish this purpose. Following the 1929 crash, Federal Reserve authorities took moderate steps to ease monetary conditions, and in early 1931 intensified these policies. But financial panics abroad and falling gold reserves at home led to what now appears to have been a disastrous reversal of monetary-fiscal policy in the autumn of 1931. Interest rates were increased by the Federal Reserve authorities, and increased taxes intensified the deflationary pres-

sure. Whatever the basic causes, tightening credit was accompanied by a new plunge in business and financial activity, culminating in the complete financial collapse of early 1933.⁵ As the new Democratic President and Congress came to office, there was no doubt about the desire of the country for prompt, drastic, and centralized action on the banking front. The public and the experts were convinced of the need for strong central action to open the banks, to keep them open, and to reverse the disastrous credit deflation. The gold standard as an automatic arbiter of the money supply had lost much of its glamour, both abroad and in the United States.

Reflecting this changing conception of the role of central banking, the Banking Acts of 1933 and 1935 and the Securities and Exchange Act of 1934 made two major changes. First, the Federal Reserve System was given important new powers aimed at more effective control over the total quantity of bank credit and the uses to which it could be put. The most important of these were: (a) power to vary legal reserve requirements against deposits held by member banks between the levels previously established by statute and twice those levels; (b) power to prescribe margin requirements applicable to trading in securities; and (c) power to make working-capital loans directly to business enterprises in exceptional circumstances where the business could not obtain funds at a reasonable rate through

⁵ See the careful analysis of H. H. Villard, "The Federal Reserve System's Monetary Policy in 1931 and 1932," *Journal of Political Economy*, December 1937.

regular banking channels. In addition, further bank regulatory powers were granted, aimed at lessening the use of bank credit for "speculative" purposes and at lessening "unsound" interbank competition for bank deposits.

Second, control over the system's credit-policy decisions was vested more completely in the Federal Reserve Board (renamed the Board of Governors of the Federal Reserve System). In effect, this represented a shift in the locus of power to the "public" board, whose members were appointed for fourteen-year terms by the president with the consent of the Senate; it moved power away from the Reserve bank presidents, elected through each Reserve bank's board of directors by the commercial banks of each district subject only to the approval of the Board of Governors. Power over open-market operations was vested in a Federal Open Market Committee, composed of the seven board members plus five Reserve bank presidents. This formalized the existence of the Reserve bank governors' (later presidents') informal open-market committee and moved to a joint bank-board basis policy-making decisions on open-market operations. Simultaneously with this increased centralization of responsibility and power in the hands of the Board of Governors, the "independent" status of the board was strengthened by removing from membership the Secretary of the Treasury and the Comptroller of the Currency, who had previously served *ex officio*.

As part of the same wave of legislation, federal insurance of bank deposits up to \$5,000 for each de-

positor was established under the Federal Deposit Insurance Corporation, which was also given joint supervisory powers over all insured banks. This complicated further the already complex division of authority among national and state supervisory authorities.⁶

World War II and Postwar Developments

Since 1935 there have been only minor changes in the structure of the Federal Reserve System and in the general nature of its responsibilities. During the recent war period, as during World War I, the system turned largely to the problem of helping finance the war effort. It provided this assistance primarily by furnishing a huge volume of additional reserves to the commercial banks through Federal Reserve purchases of government securities, in order to permit the commercial banks to extend additional credit to the federal government. In total, the banking system bought roughly \$95 billion of government securities (40 per cent of the total amount borrowed), creating thereby a corresponding amount of new bank deposits for expenditure by the government. This vast expansion of the money supply prevented any effective anti-inflationary

⁶ For careful analyses of the banking legislation of this period, see J. Viner, "Recent Legislation and the Banking Situation," and J. H. Williams, "The Banking Act of 1935," both in the *American Economic Review, Proceedings*, March 1936. A detailed account of the legislative history of the acts is given by A. W. Crawford, *Monetary Management Under the New Deal* (American Council on Public Affairs, Washington, 1940), especially Chapter VIII.

credit policy. But in 1941 the board was given power to regulate the extension of consumer credit by banks and other institutions,⁷ and exercise of these controls, together with other policy actions, exerted some resistance against the steadily growing mass of inflationary monetary pressure.

The pattern of war finance demonstrated clearly the intimate relation between the credit policies of the Federal Reserve on the one hand and the fiscal and debt policies of the Treasury on the other. As during World War I, during World War II it became clear that credit policy could exercise little anti-inflationary force as long as the Federal Reserve felt obliged to help the Treasury finance the war at low interest rates. This intimate relation has continued to dominate the credit-policy picture since V-J Day. Any realistic statement of the present responsibilities and powers of the Federal Reserve to control the supply of currency and credit must reckon with this war-finance legacy as a major and perhaps dominant factor. Just as changing economic developments and concepts of central-bank responsibilities during the 1920's led to an important change in the Federal Reserve Act, so the events of the past decade appear to have developed new attitudes toward central-bank powers and responsibilities. Recognition of these relations is crucial to an understanding of the position in which the Federal Reserve now stands, even though little recognition of the *de facto*

⁷ This power, granted on August 9, 1941, by Executive Order No. 8843, lapsed on November 1, 1947, in accordance with a joint resolution of Congress approved on August 8, 1947. It was reinstated in 1948 on a "temporary" basis, and expired in 1949.

situation appears in the statute, last extensively revised over a decade ago.

Out of the developments of the past two decades have come other Treasury–Federal Reserve interrelations not foreseen by the framers of the act. The Treasury itself now has powerful direct instruments of control over bank reserves and hence over the volume of bank lending and deposits. With federal receipts and expenditures now billions of dollars each month, merely by permitting its cash balances with the Reserve banks to increase or decrease moderately the Treasury can sharply decrease or increase the volume of commercial bank reserves. Through its handling of the various government trust funds, which now hold \$35 billion of government bonds, it can exert a similar effect. By changing the volume or character of government securities available for bank purchase, the Treasury can influence the pattern and volume of commercial-bank investments. Through operations of the so-called Exchange Stabilization Fund,⁸ it can regulate the impact of the international gold flows and foreign-exchange transactions on the domestic banking structure and influence the volume of bank reserves. If it desired to use these instruments, the Treasury's "credit policy" powers could largely negate or greatly intensify any credit policy measures likely to be taken by the Federal Reserve.

⁸ When the gold content of the dollar was reduced in 1934, the nominal "profit" of \$2 billion was used to establish a "Stabilization Fund," administered by the Treasury, to purchase and sell gold and foreign exchange "for the purpose of stabilizing the exchange value of the dollar."

Current Functions and Powers of the Federal Reserve

The responsibilities of the Federal Reserve have recently been summarized as follows by the Board of Governors in an official publication:

The principal purpose of the Federal Reserve is to regulate the supply, availability, and cost of money (currency plus bank deposits) with a view to contributing to the maintenance of a high level of employment, stable values, and a rising standard of living.⁹

Central banking is essential to the economic stability of any modern country. The central banking organization may be a single bank, as in England, or a system of regional banks with a national governing body, as in the United States. The main central banking function, however, is similar in all countries. It is to endeavor, within the powers granted by law or vested by custom, to see that the money supply is neither too large nor too small for the maintenance of stable economic progress.¹⁰

The Reserve Board thus today recognizes as paramount this general credit-policy objective, which is only implicit in the statute.¹¹ Including this goal, the

⁹ *The Federal Reserve System—Its Purposes and Functions* (Board of Governors of the Federal Reserve System, Washington, D. C., 1947) p. 1.

¹⁰ *Ibid.*, p. xi.

¹¹ The statute does include various partial directives, mainly inserted in the revisions of 1933, 1934 and 1935. For example, the Board is authorized to change reserve requirements "in order to prevent injurious credit expansion or contraction" (Sec. 19 (6)); each Reserve Bank is directed to "keep itself informed of the general character and amount of loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for the speculative carrying of or trading in securities, real estate, or

major current functions and powers of the Federal Reserve may be summarized as follows:¹²

1. Regulation of the total supply and cost of credit, primarily through regulation of the volume and use of commercial bank reserves:

- a. Through open-market operations in (that is purchases and sales of) United States government securities
- b. Through changes in legal reserve requirements
- c. Through changes in rediscount rates and policy on direct advances to commercial banks
- d. Through direct pressure, or "moral suasion" on banks and borrowers

2. Regulation of the use to which bank credit is put:¹³

- a. Through varying margin requirements for security transactions
- b. Through varying down payments and payment periods for "consumer" credit, extended through both direct loans and credit on consumer purchases

commodities, or for any other purpose inconsistent with the maintenance of sound credit conditions" (Sec. 4 (8)); and the Board is authorized to change margin requirements on security transactions "having due regard to the general credit situation of the country" (Sec. 7 (b) of the Securities and Exchange Act).

¹² For a more complete description of these functions and powers, see *The Federal Reserve System—Its Purposes and Functions* (1948), and *Banking Studies* (1941), both published by the Board of Governors of the Federal Reserve System. The former is brief and simple; the latter goes into the various functions and powers in more detail. A list of the main statutory powers and responsibilities of the Board of Governors is given in Appendix I, below.

¹³ Often termed "qualitative" credit controls, as distinct from the "quantitative" controls listed in the preceding group.

- c. Through regulations and “moral suasion” against “unsound” loans and investments, particularly through bank examination policy
3. Supervision of member banks:
 - a. Through issuance of regulations, examinations, requirements of reports, designation of reserve cities, control over bank holding company voting permits and exercise of trust powers, and so forth
4. Direct loans to business:
 - a. For working capital purposes under special circumstances only (Sec. 13 (b) of the Federal Reserve Act)
 - b. During the war period, Federal Reserve guarantee of loans and advances to war contractors, closely akin to direct loans (Executive Order of the President No. 9112)
5. Service functions:
 - a. Issuance and distribution of currency
 - b. Clearance and collection of checks
 - c. Hold legal reserves of member banks
 - d. Fiscal agent for the United States government
 - e. Depository and fiscal agent for foreign central banks and international organizations
6. Provision of economic and statistical information:¹⁴
 - a. Many of the data and analyses compiled for general credit policy decisions are made available to other government agencies, banks, business, and the general public

¹⁴ This function is not prescribed by the statute.

II

Structure of the Federal Reserve System

As constituted by law to carry out its functions, the Federal Reserve System is composed of the following:

1. The Board of Governors
2. The twelve Federal Reserve Banks
3. The Federal Open-Market Committee
4. The Federal Advisory Council
5. The Member Banks

The Board of Governors

Broad supervisory powers over the operation of the entire system are vested in the Board of Governors, which has its offices in Washington. The board is composed of seven members, appointed by the president and confirmed by the Senate. Members are appointed for fourteen-year terms, with one term expiring every two years. According to the act, they are removable by the president only "for cause." Members are not eligible for reappointment after completing a full term. No two members of the board may come from the same Federal Reserve District, and the president is required to give "due regard to a fair representation of the

financial, agricultural, industrial, and commercial interests" of the country in making appointments. One of the board members is designated by the president to be chairman and another to be vice-chairman, each for a term of four years.¹ According to the act, the chairman of the board "shall be its active executive officer."

Expenses of the board's operations are paid by assessments on the twelve Federal Reserve banks, in accordance with the statute.² At the end of 1949 the board's staff totaled about 525, and its total budget (exclusive of reimbursable expenses incurred for other government agencies) was about \$3 million, of which over \$2 million went for salaries.

It is the board's responsibility to formulate the major credit policy decisions for the system, except for open-market operations which are controlled by the Federal Open-Market Committee. The board is a policy-making body; it has virtually no operating functions: Operating functions are performed by the twelve Federal Reserve banks, acting under regulations and general supervision of the board (and the Open-Market Committee). Beyond its major credit-policy deliberations, the board carries out its statutory responsibilities primarily through the issuance and maintenance of regulations, supplemented by direct examinations of

¹ Apparently unintentionally, these terms begin in the last year of each presidential term.

² Thus the system receives no government appropriated funds. Since the earnings of the Reserve banks are now predominantly from government securities, however, the Board of Governors' as well as the Reserve banks' operations are indirectly financed in large part from government funds.

the Reserve banks and of a few other institutions specified by the statute. The board represents the Federal Reserve System in most of its relations with executive departments of the government and with congressional committees, although on some occasions the Reserve banks act directly in these connections. The board is required to exercise special supervision over foreign contacts and international operations of the reserve banks. The Board members are also members of the Federal Open-Market Committee.³

A more detailed description of the board's organization is presented in Appendix II.

The Federal Reserve Banks

There are twelve Federal Reserve banks, each serving a Federal Reserve District. Ten of the banks have branches, of which there are a total of twenty-four to facilitate contacts with the member banks of their districts. Although the stock of these Reserve banks is owned, by law, by the member commercial banks of the various districts, the intent of the law is clearly that the Reserve banks shall be operated in the public interest. Reserve-bank earnings now arise largely from interest on government securities purchased and on

³ Prior to the Banking Act of 1935, the Federal Reserve Board consisted of eight members, including the Secretary of the Treasury and the Comptroller of the Currency, *ex officio*. In 1923 the number of members was increased from seven to eight, reflecting pressure from agricultural interests for representation. The Banking Act of 1935 eliminated the two *ex officio* members of the board, reduced it to seven members, and added the requirement for due representation of financial, agricultural, commercial and industrial interests.

funds advanced to member banks. The earnings of the Reserve banks are used, by law, to pay the operating expenses of the banks themselves and of the board, to pay a fixed 6 per cent dividend on stock held by member banks, and to build up the surplus accounts of the Reserve banks. Since April 1947, however, in accordance with a policy adopted by the board, the Reserve banks have paid into the federal Treasury approximately 90 per cent of their net earnings after expenses and after payment of the dividend prescribed by statute on all stock held by member banks.⁴ This action reflected the fact that the Federal Reserve's large net earnings are now received almost exclusively from interest on United States government securities held as the result of open-market operations during the war and the desire of the Reserve officials to be entirely free of any suspicion that they were endeavoring to make profits at the expense of the treasury.

✓Each Federal Reserve bank has nine directors, three each in classes A, B, and C. Class C directors are appointed by the Board of Governors, and one of them is designated by the board as chairman of the Board of Directors. ✓Class A and B directors are elected by the

⁴ Until 1933, 90 per cent of the Reserve banks' net earnings were recaptured by the Federal Treasury under a special franchise tax. As part of the banking legislation of 1933, \$140 million of Federal Reserve surplus was transferred by act of Congress to help set up the capital account of the Federal Deposit Insurance Corporation. At that time provision was made for all Federal Reserve bank net earnings to remain in surplus accounts of the Reserve banks. In case of liquidation, all Reserve bank surplus after payment of obligations becomes the property of the United States.

member banks of the district. The three class A directors are bankers, representing the large, medium, and small banks of each district, respectively. The three class B directors must be actively engaged in the district in commerce, agriculture, or industry, and none of the B or C directors may be officers, directors, or employees of any bank, nor may any class C director be a stockholder in any bank.

Under the original Federal Reserve Act, it was apparently contemplated that the chairman of the Board of Directors would be the chief officer of each Reserve bank, directly representing the Federal Reserve Board as "Federal Reserve Agent." He was originally paid a large salary, at the discretion of the Federal Reserve Board, and was expected to devote a substantial portion of his time to the position. In practice, however, the chief administrative duties in each Federal Reserve bank tended to fall into the hands of the governor (later president), who is a full-time employee elected by the Board of Directors of each bank, subject to the approval of the Board of Governors. Thus, the Banking Act of 1935 specified the president as the chief executive officer of each bank. The chairman is no longer a paid official and he serves mainly as the chief public representative in the deliberations of the board of directors. Salaries of presidents of the twelve Reserve banks, on the other hand, are now \$50,000 per year for the president of the New York Reserve bank, \$35,000 per year for Chicago, and \$25,000 per year for each of the other banks, in contrast with the members of the

Board of Governors in Washington, who are limited to salaries comparable to those of other top government officials—specifically, to \$16,000.

Decentralization is an important characteristic of the Federal Reserve System. Each Reserve bank and each branch office is a regional and local institution as well as part of the nation-wide system. This arrangement is maintained to give effective representation to the views and interests of the various parts of the country as well as to provide an efficient system for carrying out the policy decisions made by System authorities.

Most of the Reserve banks' 19,000 employees are engaged in rendering the many routine services provided by the banks—clearing checks, handling currency, and taking care of the fiscal affairs of the Treasury (on a reimbursable basis). In 1948, over two billion checks totaling nearly \$900 billion were cleared; over seventeen million United States government bond coupons were paid; \$322 billion in government securities were issued, redeemed, or exchanged; and about \$24 billion of currency was handled.

Beyond these service activities, the Reserve banks carry out the commercial bank supervisory responsibilities vested in the Board of Governors; provide the system's loan, rediscount, and guarantee facilities; carry on the system's open-market operations; advise and counsel the member banks; and generally act as the operating units of the system and the primary liaison between the Board of Governors and the banking and financial system, all under the general supervision of the board and the Open-Market Committee. The main

statutory responsibility of the Reserve banks for general credit policy is through their participation in the Federal Open-Market Committee, though the Federal Reserve Act is sprinkled with directives to protect the "soundness" of the banking and credit system. In practice the participation of the Reserve banks, especially the New York bank, has been greater than is suggested by the language of the statute.

Federal Open-Market Committee

The Federal Open-Market Committee, consisting of the seven members of the Board of Governors and five representatives elected by the Federal Reserve Banks,⁵ was created by the Banking Act of 1935 to exercise control over open-market operations by the Federal Reserve. It grew out of a comparable informal Reserve bank committee which had developed over the preceding decade. The Federal Reserve banks are required by law to carry out the decisions of the Open-Market Committee. The committee meets in Washington four times a year, or oftener if necessary, and reviews the entire business and credit situation.

In practice, the full committee makes only broad policy decisions; the more detailed operations are carried out by an executive committee of five members, three of whom are from the Board of Governors and

⁵ The president of the New York Reserve Bank is now by law always a member of this committee, and serves as vice-chairman of the committee, in view of his strategic position in the nation's security markets. The other four presidential openings now rotate in the annual elections held by the Reserve banks.

two from the presidents. The executive committee also makes recommendations with respect to financing policies of the Treasury and consults with the Treasury on matters of debt and financing. As a practical matter, the deliberations of the Open Market Committee inevitably touch on all questions of credit policy, since the several credit instruments available to the Federal Reserve authorities cannot be considered realistically in isolation from one another.

Although not provided by the statute, a conference of chairmen of the boards of directors of the Federal Reserve banks and a conference of presidents of the Federal Reserve banks meet frequently in Washington to discuss common problems and to consider with the board the problems of credit policy currently facing the system. The conference of presidents, in particular, has attained a role of substantial importance as a device for coordinating the views and activities of the several Reserve banks. The board also, as occasion requires, invites conferences of businessmen, bankers, or others to Washington to consider with it problems of credit policy and their effect on the nation's economy.

The Federal Advisory Council

This council consists of twelve private commercial bankers representing the member banks of each district. One member of the council is selected annually by each of the twelve Federal Reserve banks. The council meets with the Board of Governors at least four times a year

to advise the board on general business and credit conditions and to make recommendations on Federal Reserve policies. In connection with this function, the council has legal power to call on the board for information on these issues. The council's function is purely advisory; it has no power to force the Reserve authorities to act on its recommendations.

‘The major purpose of establishing the council was to guarantee to the member bankers adequate hearing on all matters; a second purpose was to expose board decisions to the public view whenever the council deemed desirable. The mechanism has served the first of these purposes. As to the second, the council has taken little action, probably because the board gives extensive publicity to its own views and policies. While the council was specifically established to advise the board, open-market operations are specified by statute as within its purview, and its advice to Board members is clearly intended to cover also their roles as members of the Open-Market Committee.

The Member Banks

At the end of 1949 about 7,000 banks were members of the Federal Reserve System, out of a total of slightly over 14,000 commercial banks. Member banks thus constituted about half the total, but they held nearly 85 per cent of all commercial-bank deposits. All national banks (banks chartered by the federal government) are required to be members of the Federal Reserve System;

state banks may become members if they so desire. At the end of 1949, about 5,000 national and 2,000 state banks were members. Thus, the Federal Reserve System contains most of the banking assets and deposits of the country, including those of all national banks, but nonmember banks operating under nonstandardized state regulations still constitute a substantial bloc.⁶

Each member bank is required to buy and hold stock in its Federal Reserve bank equal to 6 per cent of the member bank's capital and surplus; it receives an annual 6 per cent dividend on this stock.⁷ Each member bank is also required to maintain its legal reserves with the Federal Reserve bank in its district and is subject to regular supervision by the Federal Reserve authorities. Member banks are on the whole subject to more stringent reserve requirements and operating regulations than are nonmember banks. Moreover, their minimum capital requirements are generally higher. On the other hand, member banks are able to borrow from the Federal Reserve banks when they need additional funds; to use Federal Reserve facilities for collecting checks, settling balances, and transferring funds; to obtain currency as required; and to participate in the election of six of nine directors of each Federal

⁶ Under the legislation of 1933 establishing federal deposit insurance, a provision was included requiring all banks to become members of the Federal Reserve System if they wished to obtain federal deposit insurance. As the result of extended controversy within and outside of Congress this requirement was several times postponed and finally removed before it was scheduled to become effective.

⁷ To date only half this legal subscription has been called by the Reserve banks.

Reserve bank. Membership in the system also confers prestige and has publicity value.⁸

⁸ Nonmember banks utilize large city "correspondent" banks for some of these purposes; they are permitted to use Federal Reserve check clearing facilities directly upon compliance with certain regulations. For a more detailed analysis of the advantages and deterrents to Federal Reserve membership, see *The Federal Reserve System—Its Purposes and Functions*, pp. 48–51, and *Banking Studies*, pp. 273–94.

III

The Role of Monetary Policy

The major purpose of this study is to describe the operations of the Federal Reserve as a policy-making organization, and to suggest how these operations might be more effectively carried out. It is therefore essential, as a basis for evaluation, to specify the policies under consideration and to set forth relevant criteria of "good" policy-making.

Three major policy functions usually specified for the Federal Reserve, aside from routine service functions, were indicated in Chapter I:

1. To regulate the availability, cost, and use of money,¹ both in the aggregate and in segments, so as to make a maximum contribution to high-level economic stability (roughly, high-level employment of men and productive capacity without inflation).
2. To supervise member banks so as to prevent "unsound" banking practices and to aid in maintaining high-level economic stability.
3. To engage in direct lending to business, or to

¹"Money" is here used throughout to include currency plus demand and time deposits held by the nonbanking public. The Federal Reserve figure of "Adjusted Deposits of All Banks and Currency Outside Banks, Less U. S. Government Deposits" (e.g., p. 539 of the May 1949 *Federal Reserve Bulletin*) provides an easily accessible statistical series approximating this concept.

guarantee such loans, in cases where "regular" financing channels fail to provide adequate credit at a reasonable cost.

Although such was probably not the intention of the framers of the Federal Reserve Act, monetary (credit) control is the main policy responsibility of the Federal Reserve, and it is this policy function that is the main concern of the present monograph. Both bank supervision and direct lending may be viewed as, in part, subsidiary devices of monetary policy, though they have important independent goals. Since monetary policy is the prime concern of the Federal Reserve, the balance of this chapter is devoted primarily to it. More detailed examination of the possible objectives of bank-supervisory and direct-lending policy are deferred until the later sections dealing specifically with those areas.

What Is Monetary Policy?

Monetary (or credit) policy is usually defined as control of the availability, cost, and use of money; it thus encompasses both "quantitative" and "qualitative" controls. But both experience and modern monetary theory suggest that this definition is too narrow to be of maximum use. There is no sharp line between "money" and a variety of other liquid assets, especially federal government securities. Moreover, many of the policy measures aimed at controlling the supply of money inevitably have offsetting or reinforcing effects on other types of liquid assets. "Monetary policy" may

be strictly limited to control of the money supply, taking into account, as a separate stage of analysis, the wide range of money substitutes. But for most analytical purposes it is more realistic and more useful to recognize the cross effects of federal monetary measures on a somewhat broader range of liquid assets.

Commonplace examples illustrate this point. If additional reserves are provided to induce new commercial-bank lending to business, resulting new loans will correspondingly increase the money supply in the hands of the public. But they will also increase the public's liabilities to the banking system. In contrast, federal governmental borrowing from the banks to finance expenditures also increases the public's money supply, but without any offsetting public liability to the banks.³ A third possibility is government borrowing from the nonbanking public to finance expenditures. This, like balanced-budget tax-financing, has no effect on the money supply, but it does increase the public's supply of liquid assets (government securities) by the amount borrowed.

In the first two cases there is an increase in the money supply; in the third there is not. Yet in the first case the offsetting private liabilities may mean that the public's future propensities to consume and invest may be increased less than in the third case where there is no increase in the money supply. Certainly this may be true where the convertibility of government securities

³ Except in so far as the public debt may be said to constitute such a liability. This, even if so considered, would be vastly different in degree from the preceding case, as seen from the individual or business viewpoint.

into cash at par is guaranteed, as at present. In many respects, the most significant figure for monetary policy may be the sum of currency, deposits, and federal government securities *less* private loan and investment liabilities to the banking system; this would give a *net* publicly held liquid-asset figure.⁴ In any event, it is clear that the total position of the nonbanking public on liquid assets and the composition of those assets are likely to be more significant for many purposes than merely the money-supply figure.

*Monetary policy, therefore, may be most usefully taken to cover those actions by the federal authorities that importantly affect the volume and composition of liquid assets (currency, deposits, and federal government securities) held by the nonbanking public.*⁵ This

⁴ For practical purposes, this is essentially federal government currency and interest bearing debt outstanding, plus those deposits produced in a 1 for 1 ratio by gold inflow. In other words, it is federal government debt liabilities to the public, including currency, plus deposits based directly on gold. "The public" is used throughout to mean the non-commercial-banking public, including state and local governments.

⁵ There is, of course, no necessary reason for stopping with government securities; other highly liquid assets could be included. But in all other cases, any privately held liquid asset is matched and to some degree offset by a privately owed liability (including state and local governments in the private sector). Moreover, as a practical matter, a good deal can be said for drawing the line after government securities, both because of the easy availability of data on this liquid-asset group and because government securities are probably about the only liquid asset considered as very near money by almost everyone in the population; nearly every other form of near money tends to be somewhat specialized to one group or another.

A strong case can be made for broadening the definition to include actions affecting the public's *demand for*, as well as supply of, liquid assets. In principle monetary policy can equally well work on either the demand or supply side. But again, as a practical matter, inclusion

implies focus on the public's liquidity position—on the relation between the public's demand for, and supply of, different types of liquid assets. Steps to increase the supply of such assets, *ceteris paribus*, will generally increase the public's propensity both to consume and to invest; a shrinking supply, *ceteris paribus*, will have the opposite effect. Measures to change the composition of the assets held can also have varied effects on the public's propensities to consume, save, and invest.

So defined, monetary policy obviously encompasses the usual Federal Reserve credit-policy operations—open-market operations, reserve requirement and discount rate changes, selective credit controls, and “moral suasion.” It also includes nearly all federal debt policy which, except for intragovernment transactions and direct refundings, necessarily affects the public's supply of liquid assets; and it includes the impact of federal cash deficits or surpluses. Lending policies of government agencies are also obviously encompassed unless government loans merely replace private lenders. Thus in contrast with traditional concern with the supply of money, what are usually called “monetary” policy and federal “debt” policy must be considered inseparable when the public's *total* position on

of the demand for liquid assets would so broaden the concept as to bring in a wide range of policy measures commonly considered far outside the monetary area (e.g., imposition or removal of price ceilings which would clearly affect business and consumer demands for liquid assets) and so lessen its usefulness in focusing policy responsibility. For strictly analytical purposes, inclusion of both the demand and supply sides would be advantageous.

liquid assets is taken into account. And the line between traditional "monetary" policy and federal "fiscal" and "lending" policies becomes highly artificial in many cases, because of the large liquid-asset effects of fiscal and lending policies. Similarly, effective fiscal policy, which aims directly at affecting the income stream, increasingly appears to require appropriate changes in the supply and composition of liquid assets.

*Absence of Statutory Objectives for
Monetary Policy*

There is no clear-cut mandate or set of standards prescribed by the statute as objectives for the exercise of the Federal Reserve's broad powers of monetary control. The Federal Reserve Act itself, replete with vast detail on the system's service functions, provides little information on what the system's monetary-policy duties are. This situation reflects partly the early emphasis on the gold standard and the commercial bills of credit doctrine of "sound" banking as quasi-automatic guides to Federal Reserve behavior. It reflects also the failure of Congress to specify standards or precise directives for monetary policy in the Banking Acts of 1933 and 1935; this congressional failure rested partly on the strong protests of Federal Reserve officials against any specific directives that would tie their hands. Outside of the original preamble and sprinkled admonitions against undue use of "speculative" credit and unsound banking practices, which suggest a policy

attitude rather than prescribing clear-cut standards, there is little in the way of a congressional mandate.⁶ Directives to help achieve full employment, prevent inflations, or mitigate business fluctuations are conspicuously lacking.

Until recently, the Treasury had even less specific guidance from Congress on the exercise of its debt management responsibilities. Treasury officials appear generally to have taken minimization of interest cost, together with protection of good will for possible future borrowing, as their major goals in the area, but clear-cut general policy statements are scarce. On fiscal policy (current taxes and expenditures) the Treasury has, for the last decade at least, consistently advocated policies oriented, in the judgment of Treasury officials, toward obtaining maximum output and employment with minimal inflation; but in the end it is Congress, not the Treasury, that determines taxes, expenditures, and the size of the cash deficit or surplus. Inconsistency between announced Treasury objectives and actual measures in the fiscal and debt policy areas has been repeated and conspicuous since the 1930's.

Under the circumstances, it is not surprising that Federal Reserve and Treasury officials have often differed about the proper exercise of their respective and joint monetary-policy powers over bank reserves, open-market operations, and debt policy. The directives to the various governmental lending agencies, moreover, are for the most part narrowly stated in terms of assist-

⁶The act includes a few scattered particular directives for the exercise of particular powers. See footnote 11, p. 18.

ance to some particular borrowing group (farmers, home buyers, veterans, and so forth). These provide no common bond for federal monetary and lending policies. On the contrary, they assure conflicting policies in inflationary periods if restrictive monetary policies are attempted by the Federal Reserve or Treasury. This failure of Congress to establish and apply generally a reasonably clear mandate for guidance in formulating monetary policy underlies in a very fundamental sense the continuing conflicts in the formation of credit policy by the Reserve, of debt policy by the Treasury, and of lending policies by the various lending agencies.

The Employment Act of 1946,⁷ which declares that "it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy . . . to promote maximum employment, production, and purchasing power," remedied somewhat this lack of directive. Nevertheless, the implications of the act for Federal Reserve policy are not prescribed, and the "quasi-governmental" Federal Reserve authorities have little specific statutory guidance or mandate in the complex field of monetary policy. Thus, sharp differences of judgment about appropriate monetary policies are still certain to arise, both within the system, among the various government agencies concerned with the problem, and between the Reserve authorities and such nongovernmental groups as the commercial bankers.

In judging the effectiveness of the Federal Reserve

⁷ Public Law 304, 79th Congress, 2nd session.

as a monetary policy-forming organization, therefore, we have virtually no usable legislative standards of reference. Under the circumstances, we may say provisionally⁸ that the prime objective of monetary policy should be to make its maximum contribution to continuing high level employment of men and of productive capacity without inflation. This statement would presumably be acceptable to most monetary experts, and, while it leaves unsolved many of the possible conflicts among goals, it will provide a general test of "good" monetary policy to bear in mind while investigating the processes and problems of the formation of monetary policy.⁹

Traditional Objectives and Methods of Monetary Control

It has been recognized for many years that commercial banks, acting in accord with their accepted goals of earning profits through lending and investing, may produce serious destabilizing effects on national in-

⁸ Pending more intensive analysis of possible conflicting objectives in monetary, as well as bank-supervisory and lending, policies in Part Four.

⁹ Writing in 1932, C. O. Hardy listed nine aims of credit policy: (1) Prevention of panics—"unquestionably the most important objective"; (2) stabilization of business conditions; (3) stabilization of the price level; (4) stabilization of the money market itself; (5) assistance to Europe in the establishment of stable currencies; (6) keeping money cheap for "legitimate" borrowers; (7) prevention of stock speculation; (8) helping the Treasury borrow on advantageous terms; and (9) reform of bank lending practices toward use of self-liquidating, short-term commercial loans.—*Credit Policies of the Federal Reserve System*, pp. 16-17.

come, employment, and prices. Lending and investing by commercial banks creates a corresponding volume of checking deposits on which borrowers may draw through writing checks; the borrower ordinarily takes his loan in the form of a checking deposit. In short, bank lending creates new money which can be spent and respent from one recipient to another as long as the loan and corresponding money are not wiped out by repayment to the original lending bank. The borrower gives his statement of indebtedness (promise to pay) to the bank, and in exchange receives the bank's promise to pay, which is acceptable as circulating money in the form of checks. The effect of the new deposits (that is, purchasing power) on the borrower's and the economy's propensity to spend may be partly offset by the borrower's corresponding debt to the loaning bank, but the economy's liquidity on balance is pretty clearly increased by such bank lending. This increased liquidity is wiped out by repayment to the lending bank of the loan outstanding.

This power of banks to vary the nation's money supply leads generally to an increased volume of money in boom periods and to a decrease in deflationary periods. Bankers are human beings. When business is booming, prices are rising, and the outlook is rosy, naturally many loans that might be (and will be) questioned in darker days look sound and profitable. Thus bank credit expands during expansionary periods—periods when purchasing power is often already outrunning the supply of goods available. Whether such bank lending is said to be a cause, or merely a contributory factor, in the

inflationary boom, its expansive role is clear, even though each individual banker acts with what seems at the time to be complete conservatism and propriety.

On the other hand, in a period of recession and general liquidation, the banker must look to the protection of his solvency and his depositors' and stockholders' funds. Loans that looked good in more prosperous times are called for payment instead of renewed as prices fall and business markets shrink. Each borrower in turn must endeavor to liquidate his assets (inventories, securities, accounts receivable, and so forth) to get money to meet his bank obligations, which in turn means withdrawals from other banks in the system as he collects from his debtors. Again, whether contraction of bank loans and investments is considered a cause or merely a contributory factor, the liquidation pressure on the economy is clear. And again, the banker is neither a scoundrel nor a fool. He is merely fulfilling the requisites of sound banking practice in an endeavor to keep his doors open and to protect his depositors and stockholders against loss from bad loans.

If commercial banks kept on hand one dollar of cash reserve for each dollar of deposits, the destabilizing effect of our present form of banking would be much less, since the banker then could always pay off his depositors without difficulty should they want their money. But in fact the commercial banking system operates on cash reserves equal to less than one-fourth its total deposits, with the remaining deposits offset primarily by the loans and investments whose exten-

sion gave rise to the deposits. Thus, continuation of this ratio means that each dollar of additional reserves can serve as the basis for over four dollars of new bank loans and investments, which means also a corresponding volume of new deposits.¹⁰

Viewed from another angle, the volume of reserves the banks have limits the volume of deposits they can legally hold, and thus the volume of loans and investments they can make. All banks must meet certain minimum legal cash reserve requirements—for Federal Reserve member banks these requirements are set by the Board of Governors, for nonmember banks by the state supervisors concerned.¹¹ Given any volume of reserves held by the commercial banks, an increase in these legal reserve requirements will restrict the potential credit the banks can extend. This is because the increase will wipe out part or all of any reserves the banks have in excess of legal requirements, which were previously available to back additional deposits. Without “excess” reserves no bank can increase its outstanding loans and investments. A decrease in legal reserve requirements has the opposite effect, since it provides new reserves for lending. Or the Federal Reserve may increase the lending capacity of commercial banks by

¹⁰ A simple explanation of this process is given in *The Federal Reserve System—Its Purposes and Functions*, Chapter 2. Similar explanations will be found in most money and banking textbooks.

¹¹ As of September 1949, the minimum reserve requirements for member banks against demand (checking) deposits were 22 per cent, 18 per cent, and 12 per cent respectively for banks in very large cities, large cities, and smaller communities; they were 5 per cent against time deposits at all member banks. Requirements are the same or lower for nonmember banks in the various states.

actually increasing the *volume* of commercial-bank reserves, through direct lending of cash reserves to the banks on rediscounted paper or through provision of cash reserves through purchases of government securities from the banks or the public ("open-market operations"). Similarly, reserves may be decreased by open-market sales of securities held by the Federal Reserve.

During the interwar period, the role generally assigned to credit (central bank) policy was that of mitigating economic instability by restricting inflationary commercial-bank lending and by encouraging credit extension in deflationary and depressed periods, primarily through controlling the volume of the banks' excess reserves. As indicated in the preceding chapter, the Reserve authorities had several instruments of credit policy, including some aimed at particular types of loans as well as the major ones aimed at controlling the aggregate volume of money. It was generally said that the Federal Reserve's powers to check credit expansion were substantial, since banks before 1930 typically had few excess reserves and had to borrow from the Federal Reserve to obtain new reserves to back additional deposits (except in so far as gold or currency inflows provided reserves). But the experts were much less sanguine about Federal Reserve powers to induce new bank lending in depressed periods. In such periods, the Reserve authorities could provide additional excess reserves (by open market purchases and reduced legal reserve requirements). But they could not be sure that new credit would be extended on these reserves, especially at times when bankers shared general pessi-

mism concerning the business outlook and credit-worthy loan requests dried up. Neither would lower rediscount rates help much, because member banks would not need or want to borrow additional reserves. About all that credit policy could do was to provide large excess reserves and encourage bankers to lend.

Certainly prior to 1930 and to an important extent even thereafter, the need for any substantial central-bank interference with the volume of commercial-bank lending was widely denied. The gold standard was thought to dictate the proper amount of money through international gold flows, which increased or decreased bank reserves in the countries concerned. This, coupled with restriction of bank lending primarily to short-term, self-liquidating commercial paper, was considered sufficient to guarantee that approximately the right amount of money would be forthcoming to meet "business needs" without inflation.

Gradual development of skepticism concerning this mechanism culminated in the discard of the gold standard in the 1930's. The dethronement of gold made immediately clear the need for conscious central-bank control over the volume of money. But it was still not until later, when the government debt began to swell, that much careful attention was paid to the cross-relations between fiscal-debt policy and credit policy. Until the mid-1930's, and to a large extent even now, monetary policy was viewed narrowly as it affected the supply and use of money *per se*, not broadly as defined earlier in this chapter to include the entire supply and composition of liquid assets. Nor was much considera-

tion given to possibilities of affecting the public's demand for money as a part of monetary policy, though this is correlative to the supply of money side of the picture.

The Current Setting for Monetary Policy

Prior to the 1930's the commercial banks rarely had large excess reserves, and rediscounting at the Reserve banks was a primary means of obtaining additional reserve funds. Under these circumstances variation of rediscount rates was a major tool of credit policy. But the huge gold inflow and the "easy money" policy of the 1930's gave the banks an unprecedented excess of reserve funds during the New Deal period of the 1930's.

Early in World War II expanding deposits and currency again tightened reserves. But since then the Federal Reserve has stood ready to buy United States government securities at or above par—at a 2.5 per cent interest rate on long-term bonds and lower rates on shorter term issues. Thus, for practical purposes, United States government securities held by banks have been substantially as good as cash reserves, since they could be converted into cash at or above par. Although excess legal (cash) reserves have been very low since 1943, bank-held government securities have constituted a huge *de facto* reservoir of excess reserves for expansion of loans and other investments by member banks. Guarantee of the market price of long-term government securities at or around par has thus precluded any

effective Federal Reserve action to restrict expansion of commercial bank credit to private borrowers.

Continuation of Federal Reserve support for government securities during and since the war has in effect assured the banks ready access to additional reserves, and there is no need for the banks to rediscount commercial paper. Member banks can meet increased reserve requirements within existing limits by sales of short-term government securities, which provide an insulating layer between Federal Reserve restrictions and member-bank lending policy. Thus Federal Reserve open-market operations (in effect the prices at which the Reserve stands ready to buy government securities offered for sale) have become not only the major, but virtually the only important, remaining instrument available to the Reserve authorities for restricting the total volume of money.¹² And utilization of open-market operations to tighten credit immediately meets the objection that it would permit government-security prices to fall below par (interest rates paid by the government to rise).

Since the war, short-term government securities have matured regularly at a rate of about \$50 billion per annum and have been largely refunded into new short-term issues. The question arose whether these issues should be refunded at the same low wartime pattern of interest rates— $\frac{3}{8}$ per cent for bills, $\frac{7}{8}$ per cent for certificates, and so on for longer maturities. Even

¹² Assuming no changes in the Federal Reserve's statutory powers.

though the 2.5 per cent rate was maintained on long-term government securities, it was possible to raise shorter term rates with much less objectionable consequences; the Reserve banks could stop buying short-term government issues at the lower interest yields or the Treasury could offer higher rates on refunding issues.¹³ This mildly restricted the tendency of the commercial banks to convert government securities into reserves to expand loans to business and personal borrowers, by raising the interest rate obtainable on short-term government securities. By using Treasury surpluses to retire Federal Reserve-held rather than public-held debt, it was also possible to obtain the maximum deflationary impact from the surplus, reducing both the public's money supply and commercial bank reserves correspondingly.

But in essence, Federal Reserve control mechanisms (reserve requirements, open-market operations, rediscount rates) have become largely useless against inflation because of the huge volume of government securities held by the commercial banks and the public, and because both Federal Reserve and Treasury authorities are committed (at least temporarily) to maintaining a low rate on government securities. Given this rate policy, Treasury debt policy is also largely immobilized against inflation. Only current fiscal policy (taxes, ex-

¹³ Since maturities are so near on such issues there is little problem of their market price dropping far below par. A higher interest rate (lower price) on such securities therefore raises no problems of severe price decline and possible "inequity" to government-security holders comparable to those faced in considering a higher interest rate for long-term issues.

penditures, and the relation between them) remains as a potent monetary-fiscal anti-inflation weapon.

The real issues on monetary policy in the postwar period have thus centered around the prices at which the Federal Reserve stood ready to buy government securities offered directly or in the open market, and around the interest rates at which the Treasury would borrow on new or refunding public debt issues. In fact, the two decisions have been inseparable. The Federal Reserve has changed its open-market policy (its pattern of buying prices for government securities) only after full consultation with the Treasury; and changes in Federal Reserve buying prices on short-term government securities have been closely coordinated with changes in the interest rates offered by the Treasury on refunding issues. The determination of open-market policy has thus been essentially a determination, in effect jointly with the Treasury, of the structure of interest rates on government securities. Treasury rate policy has no less been made in collaboration with Federal Reserve open-market policy, though there is little doubt that the Treasury has been the dominant partner throughout the period.

In short, the current setting for monetary policy is an unprecedented degree of liquidity, about which little can be done except by drastic statutory changes in monetary powers or by permitting inflation to erode existing liquid assets, and which may easily increase substantially if a strong demand for private loans recurs and the policy of supporting the price of government bonds is retained. In deflationary periods when

expansionary pressure is needed, the large volume of liquid assets is a welcome ally. But in either setting, such large liquid holdings provide a large and unpredictable cushion between current monetary-fiscal policies, whether expansionary or deflationary, and their impact on the current rate of spending. And in either setting, the pressures for joint action on monetary policy by the Federal Reserve and the Treasury are likely to prove irresistible, whatever their relation to current federal fiscal and lending policies.

PART TWO

Internal Policy Formation

IV

Open-Market Operations

As suggested by the previous chapter, Federal Reserve monetary policy is inextricably bound up with Treasury policy on closely related issues. In fact, during the past decade monetary policy has been essentially made in the frequent conferences of high-ranking officials of the Treasury and the Federal Reserve far more than in the Federal Reserve itself, especially with reference to open-market policy and Treasury financing—the core of monetary policy over the decade.

Thus, in many respects, analysis of interrelations between the Federal Reserve and the Treasury in monetary policy formation constitutes the crux of the problem. However, the next few chapters are first devoted to the Federal Reserve's *internal* policy formation, in so far as this can be separated from interagency relations. This leaves for Part III examination of the Federal Reserve's *external* relations in policy formation.

Formal Organization

The Federal Open-Market Committee is legally responsible for Federal Reserve open-market policy. Composed of the seven board members and five elected

Reserve-bank presidents, the committee meets at least four times a year in Washington, at the call of the chairman or at the request of any three members. The chairman of the Board of Governors is invariably elected chairman of the committee, and the president of the New York Bank, who is always on the committee, vice-chairman, by virtue of his special position in the nation's primary money market and the New York Bank's role as agent for the committee in its market dealings. No Reserve bank is permitted to engage in open-market operations except under the direction of the committee. Under the statute, the committee transmits its policy decisions to the Reserve banks through regulations comparable to those used by the Board of Governors in transmitting its formal policy and administrative rulings to the Reserve banks and others. The Open-Market Committee, however, has chosen to designate the Federal Reserve Bank of New York as its agent to execute its transactions through the "system open-market account." Purchases and sales, as they affect the aggregate Federal Reserve bank holdings of government securities, are then allocated among the twelve Reserve banks in accordance with a special formula agreed upon by the banks.

The Open-Market Committee designates annually an Executive Committee of five members. The chairman of the Open-Market Committee is its chairman, and its membership of five includes three from the Board of Governors and two from the Reserve-bank presidents. The full Open-Market Committee, meeting quarterly, determines the general pattern of policy for the suc-

ceeding quarter and directs the Executive committee to carry out this policy. The Executive Committee meets monthly, or more often if required, directs in more detail the operations of the system open-market account within the framework of the policy directives of the Open-Market Committee, and also keeps the full committee informed of important market developments. Day-to-day operations in the market are then handled by the manager of the system account, who is also a vice-president of the New York Reserve Bank and is designated by that bank, subject to approval of the committee.

The Open-Market Committee has a small official staff including its secretary, assistant secretary, general counsel, assistant general counsel, economist, and associate economists, who perform the duties indicated by their titles. In practice, these officials have been the officials of corresponding rank from the Board of Governor's staff, except that the associate economists have usually been chosen from among the Reserve bank chief economists. The committee is thus served by the staffs of the Board of Governors and of the various Reserve banks, and the preparatory staff work done for the Open-Market Committee on credit policy is generally indistinguishable from that done for the Board of Governors and the various Reserve banks in their non-Open-Market Committee capacities.

The Process of Policy-Making

As a practical matter the process of policy-making by the Open-Market Committee is in many respects a continuous one. The twelve members, in their individual capacities as board members or Reserve-bank presidents, are continually concerned with the operations of the money markets and with the credit situation in general. While committee meetings are held only quarterly, monetary policy questions represent the major interest of the board members in the interim periods as well, and to varying degrees the major interest of the Reserve-bank presidents. Thus the members of the Board of Governors have at any time, formally or informally, a position on current issues of monetary policy. This is the main concern of the board and its large staff. It is a subject of constant discussion at policy and staff levels.¹ Somewhat the same situation prevails for several of the individual Reserve-bank presidents. This is especially true of the New York president, who works in the nation's major money market and whose research and credit-policy staff is more comparable to that of the board than to the smaller staffs maintained by the other Reserve banks. But officers of the other Reserve banks as well have increasingly taken monetary policy as a major interest, in contrast to the primary interest in bank operating matters shown by numerous Reserve-bank presidents in the past.

¹ A more detailed description of internal Board procedures will be found in Chapters V and VI.

On the day preceding each Open-Market Committee meeting, it is customary for the twelve Reserve-bank presidents to meet separately in Washington to discuss common Reserve-bank problems and to consider development in credit policy. While the statute makes no formal provision for such a group, this conference of presidents, with its elected chairman and vice-chairman, is now a well-established though informal part of the system's organization.

In their preliminary meetings as a conference and in their informal discussions, the presidents may reach preliminary positions on appropriate courses of open-market policy and of other related types of credit policy. While little concrete evidence is available, it appears that there has sometimes been a tendency for the presidents to consider themselves as something of a "bloc" during periods of controversy with the board over open-market and reserve policy. But this has not been uniformly true and the Reserve Bank presidents often disagree. Often led by the president of the New York Bank, they have generally been inclined to favor more cautious, mild policies that would be less disturbing to the normal courses of banking and the money markets than have the board members.

This was apparently true, for example, at various points during the war when the possibility of raising reserve requirements was considered; following the war when board proposals to tighten up sharply on interest rates were under discussion; and when the Board recently proposed that additional special statutory reserve requirements (fulfillable by holding

government securities) be imposed on member banks to check loan expansion. On highly technical questions such as these, where no definitive criteria for action are available, it is only natural that the Reserve-bank presidents, whose daily work brings them into intimate contact with the commercial banks of their districts, should sense and appreciate fully the problems faced by the bankers. The board members, on the other hand, are further removed from the private banking community and are apt to place a higher evaluation on the possible "public" advantage (for instance, checking inflation) even at the cost of reducing private bank earnings or disrupting normal money procedures.²

In Open-Market Committee meetings, discussion typically ranges over the entire field of monetary policy, since open-market policy must realistically be considered in connection with Treasury financing policy and as an alternative to, or as supplemented by, other policy instruments such as charges in reserve requirements and rediscount rates. Meetings are relatively informal, with both reports by staff members on current

² An example is the contrast between the Board of Governors' views on postwar anti-inflation policy as presented by Chairman Eccles, and those presented by President Sproul of the New York Reserve Bank, before the Joint Congressional Committee on the Economic Report in 1947-48. The board sought added reserve-requirement powers to take active steps against inflation through checking bank credit expansion, while Mr. Sproul doubted the need for further action in the credit field and specifically opposed the vigorous, "clumsy" method of raising bank reserve requirements if any action were to be taken, favoring instead a more tentative, less "disruptive" approach. (Chairman Eccles' testimony was given on November 27, 1947, reprinted in the *Federal Reserve Bulletin*, December 1947, pp. 1455-63, and on April 13, 1948; President Sproul's testimony was on May 12, 1948.)

developments and proposals and free discussion. Those Reserve-bank presidents who are not at the time members of the committee also almost invariably attend and participate as freely in the discussions as do the committee members. This means in effect that meetings of the committee consist of a minimum of twenty-five to thirty persons (seven board members, twelve presidents, and ten or so staff members from the board and banks), the majority of whom feel free to participate actively in discussion.

A group of this size, even though only twelve are voting members, has not been found a highly effective deliberative or executive body. The Open-Market Committee thus functions in considerable part as a medium for general discussion and examination of issues; much of the role of open-market policy-making is, as is indicated below, in effect delegated to the Executive Committee, operating under general directives from the full committee.

When the vote is taken on a policy directive to the Executive Committee it is usually unanimous.³ This ordinarily represents a compromise to which unanimous agreement can be obtained, though in some cases there are no substantial disagreements to be compromised and the leadership of the chairman in establishing his views has been very strong. In cases of board-bank conflict, the majority of votes is with the board, which appears generally to have taken a

³ The last divided vote on a formal directive to the Executive Committee occurred in 1943. Unanimous votes were common during the earlier history of the committee, though less uniformly so.

position in close support of the chairman. It is apparently felt that a unanimous vote is desirable, possibly to present a united front against possible policy criticism from outside the system. This practice of unanimous voting obviously reduces the usefulness of the formal voting record for ascertaining actual issues and positions.

While directives issued by the Open-Market Committee to its Executive Committee vary depending on the market situation at which they are aimed, most directives have been broad in nature, leaving a wide range of discretion to the Executive Committee. Directives commonly state an objective, or general guide, to open-market operations, and set broad limits within which the Executive Committee must hold its purchases or sales, but prescribe no detailed operations to the Executive Committee. During the long period when open-market policy was, essentially, to maintain a fixed pattern of rates based on about 2.5 percent for long issues, the standard directive was to carry out such market operations as were "necessary, in the light of the general credit situation of the country, for the practical administration of the account, for the maintenance of stable and orderly conditions in the Government security market, and for the purpose of relating the supply of funds in the market more closely to the needs of commerce and business; provided that (the account's holdings) shall not be increased or decreased by more than three billion dollars." ⁴

⁴ The complete statement of a typical directive (December 9, 1947) is as follows: "The Executive Committee is directed, until

Actual open market dealings are conducted by the manager of the system open-market account (who is also a vice-president of the New York Reserve Bank), acting in close informal contact with the board chairman, the New York Bank president, and the Treasury. While in the broad, the role of the manager is a narrow and more or less mechanical one, in a very real sense it is he who must "make" short-run open-market policy as well as "execute" the directives of the full committee and of the Executive Committee. Even maintenance of an announced fixed pattern of Treasury yields is far more intricate than it sounds superficially, since the system account has consistently dis-

otherwise directed by the Federal Open Market Committee, to arrange for such transactions for the System open market account, either in the open market or directly with the Treasury (including purchases, sales, exchanges, replacement of maturing securities and letting maturities run off without replacement), as may be necessary, in the light of the general credit situation of the country, for the practical administration of the account, for the maintenance of stable and orderly conditions in the Government security market, and for the purpose of relating the supply of funds in the market more closely to the needs of commerce and business; provided that the aggregate amount of securities held in the account at the close of this date other than special short-term certificates of indebtedness purchased for the temporary accommodation of the Treasury shall not be increased or decreased by more than three billion dollars.

"The Executive Committee is further directed, until otherwise directed by the Federal Open Market Committee, to arrange for the purchase for the System open market account direct from the Treasury of such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the total amount of such certificates held in the account at any one time shall not exceed 1.5 billion dollars."

Directives, when published in the Board's annual reports, are usually accompanied by a brief explanation of the reasons for the action.

criminated between regular buyers and sellers and those who are merely trying to speculate at the expense of the account. In periods of strong market pressure or of shifting rates, the job of the manager involves substantial discretion in buying and selling large amounts of securities, mainly through a relatively small number of New York dealers and banks. This will be increasingly true under the new policy (adopted July 1949) of insuring "adequate credit" to the market rather than maintaining a fixed pattern of rates — in effect, permitting interest rates to fall though guaranteeing they will not rise through a fall in the price of long-term government securities below par. In carrying out this responsibility, the account manager consults a few officials of the board, the New York Bank, and the Treasury rather than the full Executive Committee. These three or four men in effect make open-market policy within only the broad restrictions of the full committee directives.⁵

This consideration of internal Federal Reserve open-market policy formation only hints at the crucial, often dominant, role played by officials of the Treasury. All major decisions about the rate structure of government securities are considered in informal conferences between Federal Reserve and Treasury officials, often only one or two from each agency. During and since the war monetary policy was adjusted to accommodate Treasury low-interest financing whenever this objec-

⁵ As indicated below and in Chapter IX, the same three men (excluding the account manager) have largely also made the broad policies enunciated in the full committee directives.

tive conflicted seriously with others, such as anti-inflationary credit restriction.⁶ More recently, with recession and moderate commodity price declines, this potential policy conflict vanished, but monetary policy continues to be made no less jointly.

Chairman's Leadership in Policy Formation

The importance of these joint Federal Reserve-Treasury discussions and decisions inevitably concentrates a high degree of Federal Reserve leadership in the major conferees, the chairman of the board and the president of the New York Bank. This leadership has been greatly strengthened over the past decade by the fact that both Governor Marriner Eccles at the Board and Presidents George Harrison and Allan Sproul in New York have been "strong" men who have exercised system leadership on other policies as well.⁷

There can be no doubt that during his chairmanship from 1934 to 1948 Governor Eccles made the role of chairman one of strong leadership for the board. There is no case on record in the board's formal reports during the entire fourteen years when a policy decision was taken against his vote, and in the large majority of cases votes were unanimous. Governor Eccles' leadership in the board *per se*, and as part of the Open-Market Committee, was exercised predominantly through informal discussion with other members rather than

⁶ This will be considered more fully in Part Three.

⁷ As this is written, Chairman Thomas McCabe has served so briefly as chairman of the board that there is no basis for generalization beyond Chairman Eccles's regime.

through obtaining formal voting majorities on issues that came to final vote in a controversial state among the board members. This situation was apparently supported by the desire of the board to take unanimous action on policy issues whenever this was feasible, and there was undoubtedly a substantial amount of internal cross-influence before many of the unanimous board votes were taken.

Governor Eccles' leadership in policy decisions of the Open-Market Committee appears to have been slightly less complete, but here again there is only one policy issue on record in his twelve years as chairman of the committee on which his vote was overridden.⁸ In the Open-Market Committee, however, divided votes were somewhat more common than in the board, and the president of the New York Bank in particular, it is generally agreed, often exerted marked influence in the molding of system open-market policy. Here again substantial persuasion and compromise in the pre-vote discussions was common, and the recorded policy votes possibly exaggerate somewhat the leadership exerted by the chairman. As the chief Federal Reserve representative in dealings with the Treasury, however, the chairman served as primary Federal Reserve official in discussions so complex and fluid that simple, completely prearranged positions were generally not feasible. He also served as the primary conduit

⁸ The question was one concerning the handling of short-term issues in the open-market account in early 1939. Three votes were taken on the same issue, on December 30, 1938, March 7, 1939, and March 20, 1939. In each vote, three board members voted with the unanimous Reserve-bank presidents.

to carry back to the Reserve authorities the complex attitudes of Treasury officials on the problems of debt-financing and interest-rate policy.⁹

Given the present intimate relations between the Treasury and the Reserve on debt and credit policy, it is almost inevitable that Federal Reserve leadership be substantially centered in one, or at most two or three, officials. In the Treasury responsibility on important issues is necessarily narrowed down to one man, the secretary, or at most to two, the secretary and undersecretary. As a practical matter, in intricate decisions involving many mutually interrelated variables a Federal Reserve Open-Market Committee of twelve members, or even a board of seven, cannot actively and equally share in discussions and "bargaining" with the single-headed Treasury. The nature of modern central banking, quite aside from the strong personalities of the recent board chairman and New York Bank presidents, has made almost inevitable strong system leadership by a very few officials if the system is in fact to

⁹ For reasons not officially revealed, President Truman did not reappoint Governor Eccles as chairman of the board when his term expired in 1948, nominating instead Thomas McCabe, previously chairman of the board of directors of the Philadelphia Reserve Bank. Unofficially, there was considerable agreement in the press and elsewhere that Chairman Eccles' demotion reflected the president's desire to obtain a new chairman who would be less out of harmony with the milder views of the Treasury on debt and credit policy, and who would thus be more acceptable to the secretary of the Treasury and to the large banking and financial interests who had long questioned many of Governor Eccles' views. The move was widely viewed as a triumph for the secretary of the Treasury in the monetary-fiscal policy-making area. It was also considered a step in the direction of less strong dominance of the board chairman in system policy-making.

have any real influence over the supply of money and the interest-rate structure, which represent the core of central banking and Treasury debt policy under present circumstances.¹⁰

Role of the New York Bank

In establishing the Federal Reserve System, Congress gave every Reserve bank identical statutory rights and powers. Aside from a 1942 amendment giving the New York Bank a permanent position on the Open-Market Committee, this statutory provision has remained unchanged. In practice, however, the New York Bank has consistently played a uniquely prominent role in the formation of system credit policy.

No one simple reason explains this phenomenon. Today it is in considerable part an established tradition, dating from strong leadership developed by Governor Benjamin Strong, head of the New York Bank during the 1920's. More fundamentally, New York is still the nation's central money market, and operations of the New York Bank as market agent for system open-market operations inevitably give it an inner-circle role with the Treasury and the board. The New York Bank is larger than any of the others and has among its members the largest commercial banks in the country with the most extensive correspondent relations; its prestige is great.

¹⁰ One result of this concentration of policy leadership has been a substantial allocation of some other board members' time to supervision of relatively minor administrative matters, such as individual staff-salary questions and Reserve-bank operating problems. Concentration of policy leadership is discussed more fully in Part Three.

The New York Bank's position in open-market policy, dealing intimately with the Treasury and the board, today probably plays the most vital role in assuring its position of special influence. The influential day-to-day role of the system account manager has already been mentioned. Beyond the continuous consultations among the board, the Treasury, and the New York Bank on Federal Reserve open-market policy, it must be remembered that the New York Bank also acts as chief fiscal agent for the Treasury in the money market. In this capacity, the bank is inevitably on the inside of Treasury fiscal activities. The account manager and Washington officials communicate by telephone several times a day when market developments are active; and the Treasury guards carefully from board interference its direct relations with the bank on its fiscal-agency and money-market affairs.

This special role of the New York Bank has been strengthened by its unique responsibilities as agent for the system and for the Treasury in international financial transactions. Most of the country's foreign-exchange transactions are centered in New York, most international gold transactions flow through New York, and it is in New York that many foreign financial institutions have their American correspondents. With the consent of the board, the New York Bank has long maintained correspondent relations with foreign central banks; and it serves directly as fiscal agent for the United States Treasury in the Treasury's foreign financial transactions. The New York Bank thus has direct financial relations with both foreign central banks, the

United States Treasury, and others outside the system.¹¹

The New York Bank early obtained a large staff of operating and research experts in both the domestic and international fields. It has maintained and developed this staff over the years. This in part reflects its special position and in part explains it. Its president has been accorded a position of prestige and influence in the New York banking community and his salary (\$50,000 annually) has been established by the bank's directors in the light of New York banking practices rather than of federal government standards which limit salaries of board members in Washington to only \$16,000 per annum. This salary, added to the prestige and power of the position and possibly reinforced by freedom from Senate investigation and confirmation on appointment, has attracted able, vigorous men who have made the bank a force to be reckoned with in system affairs.¹²

The statutory power of the bank relative to the board (with that of all Reserve banks) was sharply

¹¹ While the Treasury often calls directly upon the New York Bank for advice and consultation on matters of international finance, the strong New York Bank attitude in 1943 against the proposed Bretten Woods plan, supported jointly by the Treasury, the State Department, and the Federal Reserve Board, evidences the high degree of independence felt by the New York Bank authorities from any need for supporting official United States governmental positions. In this controversy, the attitude of the New York Bank was closely consonant with that of the New York commercial-banking community.

¹² The New York Bank has had only three chief executive officers since its inception—Governor Benjamin Strong from 1914 to 1928, Governor and President George Harrison from 1928 to 1941, and President Allen Sproul from 1941 to the present.

curtailed by the Banking Acts of 1933 and 1935, which in the eyes of many of their proponents, were aimed at lessening "Wall Street control" in national financial affairs. Certainly the New York Bank's influence during the 1930's and 1940's was substantially less than during the 1920's. This was probably attributable as much to the shifting balance of personalities within the system as to the legal change. During the 1920's President Benjamin Strong was by general agreement the dominating personality in the system's councils and in representing it before the public. His successor, President Harrison, serving in the difficult period of the early 1930's, was caught up in the nationwide New Deal tide, in which one primary emphasis was on curtailing Wall Street power over government affairs. In these circumstances, Governor Marriner Eccles, with the personal support of President Roosevelt, played a large role in the banking reform of 1935 and naturally assumed leadership of the system, both by force of personality and competence and in accordance with the bent of the times toward strong, positive action. There is, however, little evidence of strong internal policy cleavages in the system during the last half of the 1930's.

Under the leadership of President Sproul, the role of New York in system policy-making appears to have grown gradually since 1941. This was probably due in part to the increasingly dominant role of open-market policy and Treasury financing decisions in the field of credit policy where the New York Bank was almost certain of an important role because of its position in

the nation's main money market. In part, it was probably due to the vigor and competence of President Sproul.

Especially in the period after the death of President Roosevelt, and particularly since 1946, the voice of New York in Treasury financing decisions seems to have continued to grow. The Board of Governors, led by Governor Eccles, steadily pressed for new legislation, particularly the power to raise reserve requirements further to provide more effective credit-restriction instruments against inflation.¹³ President Sproul's attitude was much more cautious and mild. Testifying before a Congressional committee in May 1948, he doubted the existence of inflation requiring strong credit-restriction measures; he feared the possible deflationary results of such measures; he favored only experimental increases in short-term rates to check credit expansion; he opposed the granting of the new reserve-requirement powers requested by the board; and, though the matter was not within the immediate purview of the committee, he urged a reversal of the past tendencies to move policy-making power away from the semiprivate Reserve banks to the board.¹⁴ How closely President Sproul reflected the views of the other Reserve-bank presidents is not clear, but the

¹³ See, e.g., the strong statements of Chairman Eccles to Congress, reprinted in the *Federal Reserve Bulletin*, April 1947, pp. 402-4; and December 1947, pp. 1455-65.

¹⁴ Testimony before the Joint Congressional Committee on the Economic Report, on May 12, 1948. This was after the President had failed to renominate Governor Eccles as chairman of the board of Governors.

impact of his moderating force on Federal Reserve anti-inflation measures was evident, perhaps more through his influence outside the Open-Market Committee than through formal Federal Reserve channels. Clearly, the prestige and influence of the New York Bank exerted on the Treasury, on Congress, and indirectly through nongovernmental channels have long been and continue to be an important force in monetary policy-making, even though the internal balance of Federal Reserve power lies unmistakably with the board.

V

Reserve Requirements, Discount Rates, and Selective Controls

Major questions of credit policy are continuously under the scrutiny of board members and the board's staff. Absence of action is in many cases as important as decisions to act. While formal board meetings usually include on the agenda questions of monetary policy only when specific issues require attention, informal discussions among the board members and their staff are more or less continuous. Indeed, the board's monetary policy-making is probably done more in such informal discussions—in the board's private dining rooms and in the various members' offices—than in the formal board meetings. Board tenure is long and the governors become well acquainted with one another. They seem to have operated, at least in recent years, with comparatively little friction, a situation probably due in part to the policy leadership of the chairman, which minimized friction deriving from policy differences.

Though monetary policy is the major responsibility of the board, a substantial part of most of the board members' time is occupied with relatively minor, rou-

tine administrative matters, such as approval of salary and personnel arrangements at the board and Reserve banks, requests for admission to membership in the system, approval of applications for voting permits for holding-company affiliates, and so on. As an informal working arrangement each board member takes primary responsibility for certain of the board's functions, though individual members do not have authority to commit the board. These board assignments are determined informally and are varied from time to time.¹ On major matters, especially general credit policy, all board members maintain an active interest, although the chairman and vice-chairman have generally taken these as their primary assignments.

The board's staff is relatively small. Most board members maintain reasonably close personal contact with senior staff members, especially in the areas of their special responsibilities. Most basic staff work on monetary policy is done by the Division of Research and Statistics, which includes about one hundred professional employees on a budget well under \$1 million annually. Extensive written reports and memoranda and a mass of statistical data on general economic and financial conditions are regularly submitted to the board members, commonly in substantially summarized form. Like most other high government officials, the board

¹ For example, one member takes special responsibility for bank-supervision problems, another for margin requirements, a group of three for board personnel matters. The amount of time devoted to these special informal assignments varies from subject to subject and from time to time. On the average, it is well under half a board member's working time.

members are men of business, legal, financial, or other such background, not professional economists or statisticians. The material prepared for them through the senior staff must recognize this fact and the usual complaint of Washington officials—no time to study long, complex documents. Though most basic research is done in the Research Division, the Secretary's Office and Legal Division play important roles in preparing monetary actions for formal execution, and especially in work on new legislation. Where detailed rulings or regulations are involved—notably in selective controls and bank supervision—major operating responsibility shifts further toward the Legal and Examinations Divisions and the Secretary's Office, though the basic research function remains in Research and Statistics.

On the whole, staff cooperation is effective. The formation and execution of monetary policy generally represents a joint effort of economists, lawyers, and "operating" staff members, leading up to board action and working under varying degrees of board member supervision, depending on the particular problem involved. In periods of stress—for example, during the establishment of the original provisions of Regulation W providing for war-period consumer-credit controls—one or more board members may spend virtually full time working in detail with the staff members involved. This, however, is definitely the exception in more usual times, and most detail work is done by the staff for presentation in semifinished form to the board. Sometimes this is done on the basis of specific board direc-

tives, more often at the instigation of the senior staff in the Research Division for monetary-policy actions and in the various divisions for other actions. The Secretary's Office acts as general manager for the board, both in preparing internal materials for action and in relations with the public. But the direct, independent relation of the other divisions (notably Research) to the board has been steadfastly maintained on all policy matters, except where the board specifically directs some one senior staff member (in any division) to take responsibility for preparing some matter for consideration.

Beyond its major monetary-policy decisions, the board carries out its statutory responsibilities primarily through the issuance and maintenance of regulations, supplemented by direct examinations of the Reserve banks and of a few other institutions specified by the statute. The board has issued some twenty-three regulations, applicable to the Reserve banks, to commercial banks, to brokers and dealers in securities, and to other specified corporations and persons. Such regulations are more important in selective credit controls and bank supervision than is commonly recognized. The procedure by which they are formulated and maintained is summarized in the following chapter.

Reserve Requirements and Discount Rates

The statutory power to vary reserve requirements for member banks over a prescribed range was vested in the Board of Governors by the Banking Act of 1935.

Previously, fixed reserve requirements had been prescribed by the statute.² Apparently this power was placed in the board alone (in contrast with open-market policy) in part because even indirect member-bank participation seemed inappropriate on a matter so directly regulating the member banks. In part, the difference merely reflected the historical development of open-market operations as originally a quasi-independent Reserve-bank function. In fact, both reserve requirements and open-market policy are today clearly national, not regional, monetary-policy issues, and they are so closely interrelated that their consideration as separate issues is highly awkward and arbitrary.

Actual Federal Reserve policy-making reflects the facts of monetary interdependence. In practice, the separation between open-market and other monetary policy-making is less sharp than would appear from the statute. The board members constitute a majority of the Open-Market Committee. Possibilities of changing reserve requirements and discount rates are inevitably considered in Open-Market Committee discussions, as an alternative or supplement to open-market operations. With seven identical members of both groups and close informal relations between the board members and bank presidents, the decisions in the various areas are closely integrated. The Reserve-bank presidents generally have full opportunity to present their views on reserve and discount policy; since vot-

² Reserve requirements for nonmember banks are established by state law or state bank-supervisory bodies. They are generally lower than those provided by the Federal Reserve.

ing control on all policy issues ultimately resides in the board and since leadership of the board chairman has for some time been strong on all major policy issues, the relative roles of the board and the banks have not been greatly different for open-market policy and other monetary policy. In both, Reserve-bank influence is relatively informal, exercised through discussion and correspondence with the board members more than through formal voting strength.

Nevertheless, formal decisions on reserve requirements are made by the board, with only such influence from the Reserve-bank officials as the board members chose to accept. In this area, as in open-market operations, the board relies primarily on the work of its own staff. For example, the early versions of the board's "special reserve proposal" of 1947³ were developed by the board's Division of Research and Statistics during the early years of the war, utilizing suggestions originally advanced by nongovernmental economists. Variants of the proposal, a rather novel step in banking policy, were worked over in detail, and were discussed fully within the division and with other parts of the board's staff. As the need for additional instruments of credit control became stronger and as staff work progressed, discussion of the proposals was begun by the Director of Research with the board members. The first public suggestions concerning the possible need for such additional reserve powers were included in the

³ For a description, see *Federal Reserve Bulletin*, December, 1947, pp. 1458-65, and *Annual Report of the Board of Governors of the Federal Reserve System* for 1947, pp. 7-11.

board's *Annual Report* for 1945.⁴ Thereafter, the board strongly urged before Congress the enactment of such new powers, notwithstanding the continued vigorous opposition of the presidents of several of the Reserve banks (especially New York) and of the Federal Advisory Council representing the commercial bankers.

Board policy-making on matters of credit policy, such as changes in reserve requirements, is highly informal in the procedural sense. The procedure is similar to that of the Open-Market Committee. There are no formal hearings at which outside witnesses or experts present their views. The views of the Federal Advisory Council (formally representing the member banks) are obtained regularly through quarterly meetings. On major issues, the board also sometimes addresses written requests for views to the council between the regular meetings. When it considers additional information essential, the board conducts extensive surveys to ascertain the likely results of policy changes—for example, before raising reserve requirements it has commonly made a thorough statistical survey of the effects of the higher requirements on all member banks.⁵

Once a decision is reached to raise requirements, the affected banks have on most occasions been advised formally, or have already in effect informally anticipated the likely increase, so as to permit adjustment of

⁴ Pp. 7-8.

⁵ In the eyes of some observers this great care to avoid distressing individual banks has led the board as a general matter to be unduly slow and cautious in taking restrictive credit action.

reserve positions prior to the increased legal requirements. But on such matters, the advice of the affected commercial banks is not sought directly; there is no trace of the adversary procedures followed in arguing cases before most of the government's regulatory commissions.⁶

While commercial bankers and others have often vigorously criticized board decisions on credit policy, there has been little objection to the board's *modus operandi* in policy-making. Controversial public hearings on such technical yet far-reaching matters as open-market operations, reserve requirements, and rediscount rates could be highly disruptive to the operations of the economy, and would promise no appreciable advantage over the present practice. "Confidential" hearings with outside witnesses would open the way to personal gain from inside information, again without promise of major advantage to the ultimate policy decision. Often decisions must be reached hurriedly when special circumstances arise. Of necessity, the board relies mainly on its own staff, which in turn maintains contact with other recognized experts in the field, both within and outside the government. The absence of

⁶ Determination by the board of such technical matters as the exact definition of different classes of deposits subject to reserve requirements and the classification of banks into groups for reserve purposes is handled differently. In issuing regulations governing such matters, the board has typically taken great pains to assure that all competent affected parties have a hearing. Such board actions are more nearly akin to the procedure followed in setting bank-supervisory policy (described in Chapter VI) than to that in credit-policy formation.

criticism of the present procedure appears to indicate general satisfaction with the methods used.⁷

Board policy determination on rediscount-rate changes is similar to that on reserve requirements, though of less importance. In the eyes of the framers of the Federal Reserve Act, variations in rediscount rates were to be the principal instrument of credit control. When member banks had extended all the loans permitted by their reserves, they were expected to come to the Reserve banks to borrow additional reserve funds by rediscounting commercial paper. Higher rediscount rates would discourage such borrowing and limit credit expansion, lower rates would encourage both. Thus each Reserve bank was given the power to set regional rediscount rates for its district, subject to "approval" by the Federal Reserve Board.

During the 1920's, discount-rate policy was consid-

⁷ Many economists, however, have criticized the failure of the act to provide more complete precise directives for the policy-making of the Reserve authorities, both as placing undue discretion in the hands of the authorities and as failing to provide any test as to the adequacy or inadequacy of policy performance of the authorities.

The law requires that a record of all formal board and Open-Market Committee policy decision be published each year in the board's *Annual Report*. This is often the first formal public announcement of open-market policy decisions; for many other policies immediate publication is required for enforcement purposes (as in the case of increased reserve requirements). The published policy decisions are usually accompanied by a very brief statement of the reasons for action, which generally throws comparatively little light on the detailed issues involved. The general opinion, however, appears to be that this abbreviated form of public record is justified, since any attempt at completeness might well require a thorough exposition of the entire business and credit position, plus the credit-control philosophy of each individual board member, for each policy decision.

ered vital to preservation of prosperity. After some controversy, the board asserted its right to disapprove rate changes on various occasions, especially during the late 1920's. Finally, board power over rediscount rates was clarified by the Banking Act of 1935 which required that rediscount rates be submitted by the Reserve banks every fourteen days for "review and determination by the Board of Governors."⁸

Since 1933, gold inflows and Federal Reserve-Treasury policy have combined to produce a continuous easy reserve situation. Thus member banks have felt little need to borrow to obtain reserves, and, partly from a tradition against extensive borrowing, have generally adjusted their reserve positions when necessary by selling short-term government securities. Such force as discount changes now have comes through their impact on business and banker psychology. Yet according to the act, action on discount rates for each class of paper must be taken or reviewed at least once every fourteen days by the board of directors of each Reserve bank, or oftener if deemed necessary by the Board of Governors. Currently, each Reserve bank immediately advises the Board of Governors if it changes its discount rates. The board, acting in accordance with the general credit policies being followed at the time, generally approves or disapproves any change almost immediately; the issue has usually been considered in advance by all system authorities. In view of the board's

⁸ Section 14 (d). An opinion by the Attorney General has held that under the language of the act the board may inaugurate rate changes for the various banks as well as act on proposals submitted by the banks.

ultimate power, as a practical matter the special formalities prescribed for establishing rediscount rates are of little significance; rediscount policy is made in much the same way and on essentially the same considerations as is reserve and open-market policy. Since in recent years rediscount rates have been a very minor credit-policy instrument, few controversies concerning their use appear to have developed between the board and banks since the 1920's.

As in the case of open-market operations, reserve-requirement and discount-rate changes are considered with high Treasury officials before action is taken. Here, however, the board feels free to act somewhat more independently than in open-market operations, since government securities are only indirectly affected. During the war and postwar periods, Treasury advocacy of continued low-interest cost on the federal debt has made the Treasury position predictably one of opposition to generally restrictive credit-policy measures, such as substantial increases in reserve requirements. Thus the board's action in raising New York and Chicago reserve requirements on demand deposits from 20 to 22 and then to 24 per cent in early 1948 (even though the action was expected to have and had only a minor anti-inflationary effect) indicated the board's "independence" to take minor reserve-policy actions despite the Treasury's opposition. But the basic Federal Reserve preservation of bank reserves adequate to support long-term government securities at or above par indicates unmistakably Federal Reserve acquiescence on the major issue that no anti-inflationary credit policies

should be adopted that would endanger the market for (that is, the 2.5 per cent interest rate on) long-term government securities.⁹

Selective Controls

Aside from the question of their over-all monetary effectiveness, selective (qualitative) controls—over consumer credit and stock-market credit¹⁰—differ from general (quantitative) controls in two major respects. Selective controls affect widespread specific group interests (purchasers on consumer credit, installment sellers, stock-market speculators) in a direct manner which general, quantitative controls do not; thus use of selective controls raises special problems of dealing with these regulated interests. And selective controls by their very nature involve more detailed administrative regulative problems and procedures than do general controls. Federal Reserve policy-making in these selective areas reflects these two differences. Otherwise it is essentially similar to the case of the more general credit controls just considered.

In 1941 President Roosevelt issued an executive order¹¹ directing the Federal Reserve to control the

⁹ The question of Federal Reserve-Treasury relations is considered more fully in Chapter IX.

¹⁰ "Direct pressure" and bank examination procedures are considered in following sections.

¹¹ Executive Order No. 8843, issued on August 9, 1941, under the so-called Trading With the Enemy Act of October 6, 1917, as amended. The Federal Reserve's power to regulate consumer credit was ended by Congressional resolution in 1947, then temporarily restored, and finally permitted to lapse in 1949, in spite of strong pleas

extension of consumer credit with a view to lessening inflationary pressures and promoting the war effort by helping channel scarce materials and labor into war production. The problems faced in establishing and maintaining the regulation of consumer credit are indicative of the nature of policy-making in the selective control area.

In essence, the board's problem was to establish an administrative regulation that would single out for restriction those forms of consumer credit (by commodity loaned on, by type of loan, and/or by type of lender) that were (a) contributing most to inflationary pressure, (b) contributing most to bidding scarce materials and labor away from war production, and (c) susceptible to regulation administratively enforceable. The board had also to promulgate a regulation easily understood by the hundreds of thousands of lenders affected, legally defensible as within the powers granted by the executive order, and, while general, precise enough to stand up in court if violators should plead inapplicability to their own acts—all recognizing the undoubted opposition of thousands, even millions, of potential lenders and borrowers who would be curbed by the regulation. Should automobiles, sewing machines, and pianos all be covered and subject to the same loan restrictions? Should direct borrowers from financial institutions be required to file a "purpose of loan" statement to distinguish desirable "business" loans from undesirable "consumer" loans and this state-

by Federal Reserve and other administration officials that the power be continued as a regular peacetime counter-cyclical credit control.

ment be used to separate controlled from uncontrolled loans? Should there be a lower limit to loans covered? What about charge accounts in food stores, or in food departments of general department stores handling refrigerators and washing machines? What about "loan sharks" and individual lenders? What loan limit or repayment period should be set for each type of loan?

Working together and with extensive, though hurried, consultation with the major lending groups involved, all branches of the staff and the board prepared Regulation W, effective September 1, 1941. Within two months, two amendments had been issued, clarifying the terms of lending, requirements for borrowers, articles to be covered, and several other points. The many following amendments during Regulation W's eight years of life continued to hinge on two practically inseparable problems—determination of the degree of control to be exercised over various types of consumer lending, and provision of a workable, clarified regulation.

In this mixture of credit-policy formation and administrative clarification and application to more or less willing regulatees, lawyers, economists, bank-operations specialists, drafting experts, and others of the board's staff participated jointly in a sense not required by the formation and execution of general credit controls. Research and operating responsibilities were not sharply distinguished, but on the whole the role of economists was less than in general credit-policy formation. Development of the detailed regulatory standards was inseparable from the credit-policy issues involved;

the force and breadth of credit restriction depended as much on what commodities were covered and on the period of loans permitted on each, as on the cash down payments required and on regulation of cash-lending practices. With continuing amendment of the regulation the crux of the regulation process, credit policy also became inevitably intermixed with considerations of social reform (for example, of whether installment buying is "good" for low income groups) and of market practices (for example, some sellers *wanted* some governmental check on competitive granting of credit on durables). Monetary policy was by no means the only consideration, though the board tried to keep it uppermost.¹²

The formation and execution of margin-requirement policy on security transaction lies somewhere between general and consumer credit controls. During the 1930's the board's problems in establishing Regulations T and U to place security transaction under margin requirements in accordance with the Securities and Exchange Act of 1934 were comparable to those faced a decade later with consumer credit. But by the 1940's, margin requirements had become an established selective control from which the administrative "bugs" had been largely eliminated. While the technical job of defining exactly the classes of transactions, institutions, and individuals to be covered by the regulations continued to arise periodically, such questions had become

¹² Aside from the special pressures of the war period, establishment and amendment of regulations here followed the same procedures used for other regulations, largely in the bank-supervisory field. These are described in detail in the following chapter.

essentially subsidiary to the credit-policy issue of the *level* of margin requirements on regulated transactions. But this separation should not be overemphasized. For example, in 1944-46, when higher margin requirements were being considered, a major issue was whether the increase should apply only to future transactions or to securities already held on margin as well; obviously the latter regulation would be more restrictive and have a different effect on market practices.¹³

The longer establishment of margin controls undoubtedly accounts in part for their greater similarity to general credit controls in policy formation. In addition, the board does not have to police its margin-requirement regulations except for state member banks; the SEC Act gives this duty to the SEC for all brokers and dealers and to the various federal and state bank-supervisory agencies for their respective banks. But, basically, consumer credit is probably a substantially more complex and shifting field for selective controls. The number and variety of transactions is immense, and they do not center in a few well-organized markets. The more complex the area of transactions to be regulated, the more inseparable becomes the mixture of monetary policy, administrative problems, and social- and market-reform considerations in the formation and execution of selective credit controls.

A detailed account of the procedure followed in

¹³ This situation is somewhat similar to the case of reserve requirements, where requirements are established by issuing regulations governing member banks and where technical details of regulation as well as general requirement levels are involved.

agreeing on the policy of raising margin requirements in 1945-46 is included in Chapter IX, which considers the board's regulations with other government agencies in the use of its monetary-control powers.¹⁴

Direct Action—Moral Suasion

Direct action—the direct contact of Federal Reserve authorities with individual banks or groups of banks in an endeavor to check or stimulate credit expansion—is firmly established in the law, notably in directives to restrain speculative lending and to encourage loans on short-term, self-liquidating paper. Like selective credit controls, it had a brief and inconclusive trial, primarily in 1928-29 and to a lesser extent during 1947-48. Since utilization of this approach to credit control hinges substantially on Reserve authorities' direct contacts with bankers as individuals or in small groups, most of the activity must be carried on by the Reserve banks, which are in relatively close contact with the commercial banks through supervisory and local business channels. In a period of inflation, for example, Reserve-bank officials counsel the bankers to greater caution in the extension of loans. The dangers in the general business situation are expounded, in particular the dangers to

¹⁴ While the procedure followed in issuing and amending regulations is similar in selective credit control and bank-supervisory areas (see Chapter VI), it is interesting that the board has apparently felt much less obligation to provide a detailed hearing for affected groups in the case of margin than of consumer credit controls. In this respect, margin requirements are more similar to the handling of reserve-requirement changes (general credit controls).

the bank involved in marginal business, consumer, and real-estate loans at such times. An attempt is made also to show the banker the importance of credit restriction in checking inflationary developments. Lastly, the point may be emphasized that voluntary moderation by bankers may be a substitute for more "disruptive" government restrictions.

Most authorities are somewhat skeptical of the results obtained through such direct action, or moral suasion, when banks have adequate reserves to lend and when borrower demand is strong. Federal Reserve activity has varied widely from district to district. There is no special policy-making machinery in this connection. Board and bank officials generally agree fairly well about the basic trend of developments. It is left largely up to the individual Reserve banks to make such direct bank contacts as they decide are appropriate. Some Reserve banks—for example, the Reserve Banks of St. Louis and Philadelphia—have carried forward vigorously this sort of activity. Other districts have done very little. The more active banks have built up extensive field staffs, which both fulfill a general supervisory role and are available for use when the bank wishes to try to use moral suasion as an adjunct to credit policy. It seems clear that an examinations staff alone is not very effective along these lines.¹⁵ Other Reserve-bank officials must be prepared to participate actively in discussing problems with bankers individ-

¹⁵ Partly because many bank-supervisory officials question the propriety of combining credit-policy influence with the work of examination, arguing that examination should be purely fact-finding. See the following chapter for a fuller discussion.

ually or in small groups if results are to be achieved; and high officials of several banks as well as some board members have participated actively in this area. Several of the banks attempt to use for this purpose their monthly printed reports on business conditions. Probably the most effective suasion comes from the general atmosphere created by public pronouncements before Congressional committees and elsewhere by board members on the business and financial outlook, but the importance of this factor by itself is questionable. All in all, use and coordination by the system of this admittedly minor credit instrument is at best loose and informal.

VI

Bank Supervision

A survey of the relevant legislation on bank supervision leads to three broad observations.

(1) *The statutes provide no clear-cut statement of what bank supervision is or what its objectives should be.* Bank supervision is commonly said to consist primarily of bank chartering; bank examination; issuance of regulations and rulings; requirement of reports; provision of counsel and advice; and bank liquidation—with bank examination the core of the process.¹ But these activities have meaning or content only with reference to the objectives they seek to achieve. On this fundamental matter, the law is clear as to some supervisory areas and specific directives—elimination of fraud and self-dealing by bankers, enforcement of specific statutory provisions, minimum capital requirements for some types of banks, and so forth. But larger objectives can for the most part only be read between the lines, and such directives as exist (for example, the admonition to Federal Reserve officials against “unsound” and “speculative” bank loans) are so general

¹ Additional intermittent supervisory duties include granting of permits to exercise trust powers, granting of voting permits over holding-company affiliates, approval of consolidations and mergers, and so on.

that meaning is given only in actual supervisory practices.

Two broad objectives for bank supervision, aside from the chartering question, seem to be implied by the federal statutes: (a) Supervision should help keep existing banks operating for the welfare of depositors, the general public, and borrowers, particularly the former. This implies a function of limiting the risks to which banks are permitted to subject themselves; in the original Federal Reserve Act it appeared especially in repeated emphasis on the limitation of bank loans to short-term, self-liquidating paper. (b) Supervision should close and liquidate banks unable to meet their current obligations, so as to salvage a maximum of the available assets and to minimize the blow to the community involved.

(2) *The statutes are essentially silent as to any connection between bank supervision and monetary (credit) policy.* The problem of keeping the individual bank a going institution involves primarily the quality of its management and the kind of risks it individually takes. Even in good times, individual banks can fail; witness the 1920's. But the mass risks arising from general deflation and depression provide another, system-wide, danger against which investment wisdom of individual banks is of limited potency as long as the bank engages in any appreciable nongovernmental lending. It is this mass deflation risk that is of greatest danger to the public as well as to bank depositors at large. Bank-liquidation pressure in turn intensifies the downward spiral of deflation and depression. Similarly,

system-wide bank-credit expansion is both a cause of, and induced by, price inflation and income expansion.

Governmental responsibility for mitigating mass deflations is now widely accepted, and most students of central banking agree that the central bank's first responsibility is to provide ready liquidity for commercial-bank assets in time of financial crisis. Yet bank-supervisory legislation, largely enacted under the influence of the "real bills" doctrine,² largely looks to a restriction of the type of paper on which banks can lend for their basic protection against insolvency; there is virtually no recognition of the crucial central-bank (and Treasury) role in providing liquidity during crises to prevent mass bank closings of the traditional sort. Although much more specific attention is given in the statutes to prevention of inflation as a goal of bank supervision, in effect primary reliance is again placed on the "real bills" doctrine to assure that the banks do not make "unsound" or "inflationary" loans. This doctrine, however, is now widely recognized as inadequate to prevent bank lending and investing from contributing actively to price inflation.

*(3) Statutory responsibility for bank supervision is dif-
fused among three federal and forty-eight state authori-*

² That bank liquidity, as well as an appropriate volume of money, would be assured if banks loaned only on short-term, self-liquidating commercial and agricultural paper. With loans restricted to such collateral, the doctrine asserts, banks would be assured of prompt repayment. Since credit would be extended only to finance current production, moreover, only new credit to match new output would be forthcoming; this would provide just enough new credit to finance the increased output and would eliminate the danger of inflationary credit extension.

ties with unclear and overlapping jurisdiction and powers.³ On the federal level, responsibility is divided between the Office of the Comptroller of the Currency (a bureau of the Treasury Department), the Federal Reserve, and the Federal Deposit Insurance Corporation. The comptroller has the responsibility for chartering and closing national banks and primary responsibility for their supervision. The Federal Reserve Act gives the Federal Reserve power to supervise all member banks (which include all national banks), but each state retains supervisory power over all state banks. The Federal Deposit Insurance Corporation has supervisory power over all insured banks (which include all member banks), subject in some respects to permissive action by the Federal Reserve and the comptroller, and has exclusive federal supervisory responsibility for insured state non-member banks; in practice, however, the FDIC powers appear to depend in considerable part on persuading state supervisors to enforce the state laws that govern most of state nonmember banks' activities. Noninsured state banks are supervised only by state authorities.

The present chapter attempts only to outline the processes of bank-supervisory policy formation and execution within the Federal Reserve.⁴ The over-

³ As indicated above, a fourth federal agency, the Reconstruction Finance Corporation, retains contractual power to supervise those banks in which it still holds preferred stock or capital notes arising from its depression-period activities in reopening banks.

⁴ An official description of the Federal Reserve's attitudes and procedures in bank supervision is included in *Banking Studies*, pp. 187-227.

lapping legal and operation responsibilities of the various supervisory agencies are considered in Chapter IX, as they affect the problem of policy formation and execution. Most of the Federal Reserve's supervisory activities, as well as those of the other agencies, are carried out through the issuance of regulations and through bank examinations; the following description falls into these two sections. The issuance and maintenance of regulations is, as indicated in the preceding chapter, largely applicable to the process of selective credit-control policy formation as well.

*Issuance and Amendment of Regulations*⁵

The Federal Reserve Act and the Securities and Exchange Act of 1934 grant to the board and the Open-Market Committee wide powers to issue regulations. Section 11 (i) of the Federal Reserve Act authorizes the board to "perform the duties, functions, or services specified in this act, and make all the rules and regulations necessary to enable said Board effectively to perform the same." In addition, express powers to issue regulations on particular subjects are given at numerous points in the act, including, in Section 12A (b), the power of the Open-Market Committee to issue its own

⁵ An excellent detailed report on the administrative procedures followed by the Board in such matters as the issuance of regulations was made by the Attorney General's Committee on Administrative Procedure, Monograph 9, Senate Document No. 186, 76th Congress, 3rd Session (1940). There has been no important change in general procedure since the investigation of that committee in 1939; its report is recommended to readers wishing a more detailed account of administrative procedures than is given here.

regulations governing open market operations of the Reserve banks. In fact, most of the board's monetary and bank-supervisory policy decisions are implemented through issuance and amendment of regulations; in many cases (for example, selective credit controls) the essence of the monetary policy involved may be substantially influenced by the regulation-making process.

The board has issued twenty-three regulations, applying to the following groups:

1. The Reserve Banks (Regulations A, B, E, G, J, N, S, V)

2. Member banks (Regulations C, D, F, H, I, L, O, Q, R, some of which apply to all member banks and some exclusively to state or national member banks)

3. All banks (Regulation U)

4. Holding-company affiliates of member banks (Regulation P)

5. Brokers and dealers on national securities exchanges (Regulation T)

6. Corporations with banking offices abroad (Regulation K)

7. All persons and institutions extending consumer installment credit (Regulation W)

A complete list of the regulations, indicating the general purpose of each, is included as Appendix IV.

PREPARATION AND AMENDMENT OF REGULATIONS

Entirely new regulations have been issued in recent years only as an outgrowth of new board responsibil-

ities, bestowed by legislation or executive order.⁷ Action to amend existing regulations may arise from outside objections and suggestions, from the Reserve Banks, or from staff work; often these are interrelated and cumulative. Drafting of regulations and amendments thereto is only intermittent, and there are no special staff channels established for handling such cases.⁸

The most active regulation in recent years was Regulation W. Addition of new commodities to the controlled list, changes in terms, and a multitude of other questions arose both from day-to-day operations and from consideration of the broader credit-policy aims of the regulation. The legal, economic, and "operating" staff members responsible worked together almost constantly on new amendments. In a less active field, such as that covered by Regulation H (conditions of admission to Federal Reserve membership), contact between the responsible members of the Examination Division and the Legal Division is sporadic, although division directors are charged with responsibility for keeping regulations in constant review. In a few instances, such as Regulation D (member-bank reserve requirements), amendment *per se* is largely a routine

⁷ The only new regulations issued in the past ten years have been Regulations V and W, both pursuant to war-emergency executive orders.

⁸ Of the twenty-two regulations now in force, several have been amended only a few times and four have not been amended at all. Only a few are frequently amended in the process of effecting credit-policy decisions; Regulations D (bank reserves) and W (consumer credit) are examples.

matter reflecting credit-policy decisions to raise or lower requirements, although here too the details of the regulation are intermittently reconsidered by the staff (in this case, jointly by the Research, Bank Operations and Legal Divisions).

Preparation of the first draft of an amendment is ordinarily an informal process, usually instigated at staff level. The actual drafting is customarily done by an assistant counsel, who consults freely with the appropriate staff members in other divisions. Much internal staff work, cleared with the divisional directors involved, is likely to be done before a draft is presented to the board. Special information may be requested from the Reserve banks or from outside sources. If appropriate, staff members generally consult informally with affected parties or experts outside the Reserve System, either in Washington or elsewhere. In cases where extensive outside information is requested (as in the use of some 200,000 questionnaires sent out by the New York Stock Exchange for the board prior to issuance of Regulation T on margin requirements), formal board clearance is involved even at this preliminary stage. The board itself maintains close surveillance over formal outside contacts and inquiries on policy and important informational matters.

From this extensive staff work, a draft of the regulation or amendment is prepared for circulation among board members and staff. Following the discussion and comments on this draft, a revised draft is generally prepared by the assistant general counsel, or by the general counsel himself, working closely

with the drafting assistant attorney, the Office of the Secretary, any other senior staff members particularly concerned, and sometimes with a board member particularly interested in the problem. This draft is in no sense formally approved by the board, but is considered rather as a set of working papers.

CLEARANCE AND FORMAL ACTION

In some cases, a cross-section of outside views (both from other governmental agencies, nongovernmental experts, and the affected parties) has been obtained informally in the staff work of preparing the draft. Nevertheless, except where major credit-policy issues are involved or where there are comparable special reasons for avoiding publicity, the board commonly circulates the draft for comment, making clear that it has in no sense approved the regulation except as a draft for circulation and discussion. Ordinarily drafts have been submitted to four main groups: (1) the Federal Reserve Banks; (2) other interested government agencies such as the FDIC, Comptroller of the Currency, Treasury, SEC, and state bank supervisors; (3) the Federal Advisory Council; and (4) the American Bankers Association, or one of its committees. Regulations T, U, and W, applying selective credit controls outside the banking field, were submitted to other major groups affected. While such drafts are "not for publication," the Reserve banks and others are expected to obtain views in their banking communities unless the regulation is one on which publicity is specifically restricted.

Following this circulation, replies are received from the various groups concerned, stating approval, disapproval, or suggestions. These replies are carefully analyzed by the board's staff. Where they are thought desirable, informal staff discussions are held with the outside groups on the merits and disadvantages of proposed changes, and in some cases there are formal board meetings with representatives of the other groups. Although the board in principle stands ready to hold hearings on proposed regulations at the request of any concerned party, such hearings have been relatively rare. When held, they have been informal, in the procedural sense; witnesses are not sworn in and free discussion ranges over the problem at hand.

The Federal Reserve considers advantageous this conference method of obtaining suggestions and criticisms at both the staff and board levels. It often results in compromise of differences and almost invariably in a better understanding of the problem by all parties involved. The views of other parties are obtained in an informal, flexible fashion that throws light into hidden corners that could easily be missed in more formal proceedings. After such a procedure, everyone is almost certain to feel better about the regulation, even though some disagree with the ultimate decision of the board. The total process taps directly or indirectly the views of many financiers, businessmen, and professional economists, and there has apparently been relatively little criticism of the Board's *modus operandi* on such matters.

Following this extensive consideration, a final draft

is prepared by the appropriate senior legal-staff official and submitted for board action. By this time the board members' judgments are apt to be largely formulated, and final action can usually be taken with little further discussion or delay.

The amount of time consumed in drafting and approving regulations or amendments varies widely. Almost two years were spent in preparing Regulation U following the Securities and Exchange Act of 1934. Many amendments are drafted and approved with much less elaborate procedures than those outlined; this is true, for example, of amendments adopted merely to implement credit-policy decisions (Regulation D governing reserve requirements) or to alter details of a regulation (Regulation W). Regulation M, dealing with foreign branches of national banks, was issued only one day after consideration was initiated, in order to permit the temporary suspension of American banks' operations in Shanghai when that city was bombed by the Japanese in 1937.

RULINGS

In addition to formal regulations, the board frequently issues rulings, which interpret the Federal Reserve Act and the board's regulations and apply them to individual cases.⁹ These rulings have covered a wide range of questions, mainly of a technical nature.¹⁰ They

⁹ There is no statutory authority for these rulings. They are issued merely to help the banks and those enforcing the board's regulations to know where they stand.

¹⁰ For example, the board ruled that cottonseed may be classed as a "readily marketable staple" under the act (Ruling 13.1301); that

are to some extent decisions on individual cases, to some extent interpretations of the statute or regulations, to some extent general advisory opinions. Hundreds of rulings were issued in the earlier days of the system; the use of this method has become less common in recent years.

While the rulings have no legal force, they are generally followed by member banks and others, who dislike to run the risk of disciplinary action or of public conflict with the established bank-supervisory agency. Ordinarily rulings arise from the submission of questions by the Federal Reserve banks, member banks, or other interested parties.¹¹ Inquiries from member banks are invariably first referred to the appropriate Reserve bank for answer; a board ruling is made only if the matter is then referred to the board by the bank for decision. Questions so received by the board are referred to the appropriate divisions, usually the Legal Division and one other. The assistant counsel and other staff members concerned consult informally on the matter, and a draft ruling is prepared and submitted to the board member informally responsible for the area covered by the regulation. If the question is a minor one, the ruling may be approved by that member, circulated for routine concurrence by other members, and

a trust company is eligible for membership in the system even though it does substantially no commercial-banking business (Ruling 9.144); and that dividends declared but not disbursed do not constitute a deposit against which member banks must hold reserve requirements (Ruling 19.104).

¹¹ Ordinarily the board will not make a ruling on a hypothetical problem but only on an actual case.

issued by the secretary without being discussed in a board meeting. Otherwise, it is put on the agenda of the next board meeting.

EFFECTIVENESS OF PROCEDURE

The board's informal procedures in formulating regulations, amendments, and rulings appear, by general consensus, to have been on the whole efficient and satisfactory. Except on matters of monetary policy, where exclusive internal action is essential, participation by affected parties has apparently been extensive and real. The board's attitude in framing regulations has generally been to interfere as little as possible in the actual operations of the member banks or others regulated; monetary or direct banking-control objectives have been kept uppermost over "reform" considerations. The expressed intention has been to accept some reasonable risk of evasion rather than to exert the regulatory power to the full in order to assure complete compliance of every bank with every detail of the Board's regulatory intent.¹²

¹² On rare occasions the board has been involved in litigation concerning its regulatory activities. The most notable case of this sort in recent years arose from the board's controversy with the Bank of America and the Transamerica Corporation concerning the board's decisions on the granting of permits to vote the stock of holding-company affiliates in the Giannini-controlled chain of banks. In 1948, acting under Sections 8 and 11 of the Clayton Antitrust Act, the board issued an order to the Transamerica Corporation to appear at a formal hearing to show cause why the board should not order it to end certain monopolistic practices in connection with its control of a large number of banks in the West Coast area. Under this order, the hearing was as prescribed by the Clayton Act, and the board's decision may be appealed to the federal courts. The board's enforce-

Bank Examination and Counseling

Bank examination is perhaps the most important aspect of bank supervision. While the Federal Reserve has full power under the act to examine all member banks, as a working practice it examines only the 2,000 or so state member banks and accepts the examination reports of the Comptroller of the Currency for all of the 5,000 national banks. All the work of examining state member banks is allocated to the staffs of the Reserve banks; the board exercises only general coordinating supervision over this work. The Reserve banks in all cases share this supervisory power with the state supervisory authorities.

VARYING CONCEPTS OF BANK EXAMINATION

The purpose of bank examination, according to one of the board's chief examiners, is "to determine and appraise the facts with respect to the operation of individual banks. It involves verification and appraisal of assets, determination of liabilities as far as practicable, investigation of compliance with legal requirements, and appraisal of the ability and character of management."¹³ Thus the bank examiner is the eyes and ears of the supervisory authorities, so far as operations of the individual bank are concerned.

In practice, the role of bank examination can and ment power under this act, never before used, is similar to that granted the Federal Trade Commission, the Interstate Commerce Commission, and the Federal Power Commission in their respective spheres of supervision.

¹³ *Banking Studies*, p. 213.

does vary, depending on the interpretation put on its purpose. At the one extreme, examination may be viewed as merely a check upon the honest, legal operation of the bank. This involves verification of reported assets and liabilities, investigation of possible "self-dealing" by bank officers and employers, and checking for compliance with applicable laws and regulations of the examining or other agency. On this view, bank examination is conceived of as essentially a mechanical process; policy problems arise only when the supervisory agency must determine what action to take against violators of legal provisions. But this apparently neat concept begs the question of the real intent of the supervisory statutes—for example, the admonition to Federal Reserve authorities to encourage sound banking practices and to discourage speculative loans. The statutes are of little help in clarifying many of their general directives for supervisory policy.

A second, somewhat broader, concept of bank examination adds to investigation the right and duty of the examiner to counsel bank officials, at least upon request, on means of establishing sounder, more efficient banking practices, and to assess the quality of the bank's assets in the light of general economic developments and the individual bank's position. Under this concept, the examiner plays an educational and counselling role as well as a purely investigatory one. It carries into the examination field the function of limiting the risk to which banks should be permitted to subject themselves, applying accepted standards (usually unspecified except in general terms) to the multitude of varying

individual bank cases. Such a concept usually implies an attitude of the bank supervisory authorities, operating through the examiner, of informally working out plans and procedures for improving the quality of inadequate bank management and for handling potentially dangerous loan or investment positions in which the bank may find itself. This concept views bank examination as one important active device in the overall effort to maintain a "sound" banking system; it obviously raises more policy questions than does mere investigation.

A third concept adds to the other two a role for bank examination in the implementation of monetary policy. Not only may the examiner investigate the bank's operation and work with the management toward sounder, more effective banking, but he may endeavor to aid general credit policy in discouraging many loans in inflationary periods and encouraging more extensive lending in slack times. At least, he can be sure to avoid imposing further deflationary pressure in periods of severe liquidation when monetary policy is aimed at checking the decline. The direct pressure, or suasion, aspect of bank supervision may, of course, be quite separate from the examination process, but variation in examination standards can obviously exert some effect on lending and investing policies. If this broadest view is taken, the policy problems in bank examination are numerous and important; they become a close adjunct of general monetary policy-making. In any case, what constitutes "sound banking practices" is not easy to

separate clearly from questions of general monetary policy.

EXAMINATION POLICY-MAKING AND PRACTICE¹⁴

Bank-examination policy is made largely by examiners in the field. The role assigned examination by Federal Reserve authorities appears to be roughly the second of those listed above, with varying elements of the third. Board members emphasize strongly the close interrelation that should obtain between monetary and bank-supervisory policy. This view is reflected to a lesser extent in the board's Division of Examinations. On major issues, such as the use of the "intrinsic soundness" rather than the "current market" criterion in valuing assets, the Board of Governors, with the aid of its staff and in consultation with the Reserve banks and other supervisory agencies, directly establishes system supervisory policy. But decentralization is the cornerstone of Federal Reserve examination policy, and there is little evidence that this stated policy is applied effectively by the examiners in the field.

Members of the board's own examinations staff have no contact with the member banks. Examinations are conducted by the various Federal Reserve banks, whose examinations staffs appear to take a much narrower, more traditional view of the examination function. The field examiner examines the bank and makes a report to the chief Federal Reserve bank examiner, who reviews

¹⁴ For an official detailed account of actual examination procedures, see *Banking Studies*, pp. 219-27.

the report and recommends action if any seems to be needed. A copy of the report is then forwarded to the board's Division of Examinations for review, but the report is almost always accepted without criticism or suggestion of action different from that recommended by the Reserve bank.¹⁵ The function of board review is thus primarily one of loose general supervision. Such standardization, coordination, and implementation of policy objectives as are achieved come primarily through annual staff conferences of board and Reserve bank personnel, through influence over general standards established for examinations, and in rare cases through board influence in the dismissal of Reserve bank examiners deemed unsuited for their positions.

In an effort to coordinate and broaden system supervisory policy, periodic conferences are held between the board's examination staff and the senior members of examination staffs of the twelve Reserve banks. These meetings cover not only common technical and operating problems, but general economic and financial developments as well, with special reference to their implications for the conduct of sound banking. Developments in credit policy and related fields are usually scheduled for discussion.¹⁶ On some occasions the chairman of the board, or other board members, give talks or participate in the examination conferences. Emphasis has been placed on the need for avoiding supervisory

¹⁵ The board's staff for this review includes only about half a dozen men.

¹⁶ Although the staff of the board's Division of Research and Statistics is seldom called on to participate in these discussions.

policies that will, as they have at times in the past, actively counteract national fiscal and credit policy. For example, conferences have emphasized that stringent deflationary examination practices during an incipient depression may help to speed the deflationary spiral, that loans and investments that currently appear doubtful because of the general recession would be intrinsically sound if held through to maturity.¹⁷

While the periodic system conferences have some coordinating effect, each Reserve bank is essentially independent in the establishment of actual operating practices. The board furnishes a standard examinations report form but it sends few formal supervisory policy instructions to the Reserve banks. Reserve-bank chief examiners vary widely in the amount of latitude they in turn allow field examiners and in their policy on "counseling" as against "fact finding." Ultimately, application of any standards depends on the expert judgment of the field examiners in considering marginal assets and generally in dealing with the bankers involved. The field examiner is the crucial link between supervisory policy and practice under present arrangements where wide operating leeway exists, and it is by no means clear that he either understands or is basically sympathetic to the broader policy attitudes developed by the board and some Reserve bank officials. There is

¹⁷ This emphasis on intrinsic soundness rather than current market value was agreed on as joint supervisory policy by the three federal agencies and representatives of the state supervisors in a formal statement issued in 1938. For more complete discussion, see Chapter X.

evidence that some Reserve banks have made progress in counseling in recent years, but little evidence that examiners have any appreciable sympathy for the use of examinations as an adjunct of credit policy. Thus there is little evidence that the Federal Reserve has used bank examinations to any appreciable extent as an active instrument of credit policy. Such attempts at moral suasion as have been made—for example, in the direction of loan restraint during the postwar period—appear to have come primarily through speeches, statements, and informal contacts of board and Reserve-bank officials with bankers rather than through examiners.¹⁸

¹⁸ While attitudes in Washington headquarters on the role of bank supervision vary appreciably, there appears to be no sharp difference between the actual supervisory practices in the field of Federal Reserve, Comptroller, and FDIC examiners. See Chapter X.

VII

Direct Lending and Loan Guarantees

Direct lending to the nonbanking public by federal governmental agencies has obvious effects on the amount and composition of the public's liquid assets. Taking other cash outlays as given, federal lending either increases equally the public's liquid-asset holdings and its liabilities to the government (if deficit financing is used); or transfers existing money from taxpayers to borrowers while increasing the public's liabilities to the government (if no deficit is run). Federal guarantee of loans has similar effects. If the loans are immediately shifted to the guaranteeing government agency, the monetary effects are essentially the same as in direct government lending. But even if the guarantee is not used by the lender to obtain cash, it increases the liquidity of the paper on which the loan is made since cash can be obtained from the guaranteeing agency under terms of the particular guarantee. Direct or guaranteed lending by the Federal Reserve to the nonbanking public similarly has direct monetary effects. Since the Reserve has no power to go to the market for funds, its lending must correspondingly

increase the public's money supply, unless specific off-setting measures are taken, through here again there is an offsetting new liability of the public to the Federal Reserve.

In recent years, federal direct and guaranteed lending has swollen to billions of dollars, often overshadowing the more common forms of monetary policy. During the inflationary postwar period a moderate federal budget surplus (excluding lending operations) and slightly restrictive Federal Reserve credit policies were substantially overbalanced by unprecedented federal lending to veterans, farmers, home builders, and foreign nations. In spite of this dominant monetary effect, there was little evidence of intragovernmental efforts to coordinate lending with monetary-fiscal policy. Federal lending has developed largely on a purpose or recipient basis, with only secondary attention to overall monetary effects. Farm loans are made by the Department of Agriculture in connection with the government's farm program. Veterans' loans, handled largely by the Veterans Administration, are an integral part of the government's veterans' program. Housing loans are handled by the housing agencies, business loans largely by the Reconstruction Finance Corporation. Federal lending is thus "program" or "purpose" oriented and administered. Under the circumstances, monetary-policy considerations generally receive secondary attention; they are not the major concern of the agency planning and administering the loan program.

*Federal Reserve Participation in Government
Policy-Making*

The role of the Federal Reserve in the formation of federal lending policy has been two-fold: first, as a vocal, but not very effectual, advocate of the importance of the monetary-policy implications of federal lending programs; and second, as a minor participant in direct and guaranteed lending to business.

General recognition of the important monetary implications of federal lending programs came only in the postwar period, when such lending soared to unprecedented peacetime levels. All through the 1930's, the major issue on federal lending was whether this was an appropriate supplement to private lending agencies, or whether federal lending would merely supplant private funds. Little specific attention was paid to possible differential effects on the supply and composition of liquid assets. But with the obvious inflationary impact of the huge federal lending programs after V-J day, especially in the construction area where output limitations were largely real rather than financial, Federal Reserve authorities began to protest strongly against federal loan expansion. Both in statements to Congress and the public, and within the executive branch of the government, Chairman Eccles in particular repeatedly criticized the inflationary construction lending program.¹

¹ See, e.g., his strong letter to the Senate Banking and Currency Committee in 1946 (*Federal Reserve Bulletin*, March 1946, pp. 236-39). Washington opponents of the board's position suggested that the board's criticism was largely a cover for its own unwillingness to take monetary measures against the inflation.

On the other hand, the Federal Reserve itself made little use of its own anti-inflation powers, and appears to have made more of a point of publicly criticizing the lending agencies than of working through the clearance procedures of the Budget Bureau to obtain a coordinated anti-inflation program that would include restricted federal lending. Although the Budget Bureau and other presidential representatives have several times attempted to provide more effective policy coordination, no effective formal or informal mechanism has been established for coordination, or even effective joint discussion, of the continuing inevitably close interactions between federal lending and monetary-fiscal policy.

Federal Reserve Direct and Guaranteed Lending to Business

The Federal Reserve itself was first given power to make direct loans to business in 1933, in an effort to provide funds needed by business for recovery. Section 13 (b) of the act gave the Federal Reserve banks power, subject to authority granted by the board, to make "sound" working capital loans directly to business concerns that are unable to obtain accommodations from the usual sources on a reasonable basis, and to participate with other lending institutions in making such loans.

This power has never been used extensively. Two main interrelated policy issues have arisen: (1) What standards should be required of borrowers desiring ac-

commodations refused elsewhere; and (2) Should the system make an active effort to expand its activities under Section 13 (b)?

In practice, policy on the first question has been determined largely on an individual-application basis, though a general working agreement was reached among the system authorities. While system authorities discussed their attitude on loan applications, each Reserve bank has judged its own applications subject only to general board supervision, and on the whole rather strict "banker-type" standards of soundness appear to have been applied by all the Reserve banks. In most banks the standards have been sufficiently high that relatively few borrowers have received loans, except in the mid 1930's. This situation, generally recognized, has meant a relatively low volume of loan applications, particularly in view of the specific restrictions of the act.

Policy on the second question has also been determined largely at the Reserve-bank level, again in the direction of restraint. Aside from making their facilities somewhat known to the business community, apparently few banks have made extensive efforts to utilize the 13 (b) powers, except during the mid 1930's. Many potential marginal borrowers probably do not know of the existence of this lending facility. In contrast, the broader facilities of the Reconstruction Finance Corporation have been widely publicized, and most governmental direct lending to business has been carried on through RFC.

Early in the war shortages of funds threatened to im-

pede defense construction and production. Although this problem was handled partly through Army and Navy advance payments and through RFC loans, the Federal Reserve was authorized in 1942 by executive order to guarantee loans to holders of war contracts, acting as agent for the Army, Navy, and Maritime Commission. Under the board's Regulation V, war loans guaranteed by Reserve banks reached a total of over \$2 billion in late 1944, and authorized but unused guaranteed credits totaling an additional \$4 billion at their peak. Similar guarantees were made under Regulation VT to finance business reconversion during the contract-termination period.²

Administration of the loan-guarantee program was, like direct lending, largely in the hands of the Reserve banks, which already had extensive contacts with banks and businesses in their respective districts. Major policy decisions were reached jointly by officials of the Federal reserve, the Army, the Navy, and the Maritime Commission. Decisions on particular loans were made primarily by Reserve bank officials in consultation with War, Navy, or Maritime Commission field representatives. Available evidence indicates that the loan-guarantee program was executed expeditiously and efficiently, in consonance with the needs of the war and conversion periods, but on essentially a regular "banker" basis.

Since the war, different Reserve banks have followed

² For a detailed account of the procedure and experience with loan guarantees, see *Federal Reserve Bulletin*, March 1946, pp. 240-48.

diverse policies in the utilization of 13 (b) direct-lending powers. In a few districts, notably Philadelphia, active steps have been taken to make 13 (b) facilities available to worthy business concerns which can demonstrate an unsatisfied credit need that is legitimate though marginal for commercial-bank lending. The board, however, led by Chairman Eccles, has taken a strong stand for deletion of Section 13 (b) from the law and substitution of a guarantee power broader than the 13 (b) provisions and patterned somewhat on the war-time experience, to serve as a standby power in case of future need for government participation in lending to business.³

The board has consistently argued that it should be the major Federal agency making direct or guaranteed loans to business, and its postwar position on the desirability of guarantees rather than direct lending has been clear-cut. But since the mid 1930's the Federal Reserve has failed to utilize extensively its direct lending powers. The board's staff has intermittently concerned itself with objectives and programs for business lending, and new lending legislation was drafted in preliminary form on different occasions. But there was little evidence of a clear-cut board policy to "push" direct lending or even to encourage the Reserve banks strongly in this direction until the need for war-contract financing gave rise to Regulation V in 1942. Various

³ Federal Reserve statements advocating expansion of its lending or guaranteeing function have been numerous. Cf. the statement to the Senate Banking and Currency Committee on February 26, 1944 (*Annual Report for 1944*, pp. 61-64) and on April 17, 1947 (*Federal Reserve Bulletin*, May 1947, pp. 521-23)

Federal Reserve officials have argued that the legislative authority in Section 13 (b) is too narrow to permit extensive Federal Reserve direct-lending activities, but critics have considered this claim largely a rationalization of, rather than a reason for, inaction. This emphasis of the Federal Reserve on the need for new powers and its criticism of programs of other agencies rather than aggressive use of available powers parallels the position of the board in the postwar controversy over anti-inflation lending policy, indicated in the preceding section.

VIII

The System's Policy-Makers

Board Members

Between 1914 and 1950, there were thirty-one board members, exclusive of the secretaries of the Treasury and comptrollers of the currency who served *ex officio* from 1914 to 1936. At least since 1935 these men have been ultimately responsible for the system's policies, whatever may have been the influence of staff members, Reserve-bank officials, and others. Even before 1935 they played probably the major role, except for dominance of the New York Bank on credit policy during much of the regime of Benjamin Strong, which extended from 1914 to 1928.

The board members have been a diverse group.¹ Of the thirty-one, the background of thirteen was banking, of five business, of five agriculture, and of four law. Seven board members had held major appointive federal office before appointment to the board, but only one had ever served in Congress.² The bulk of the

¹ A table listing the thirty-one board members and briefly summarizing their backgrounds and board history is included as Appendix V. The appendix also includes a more detailed statement covering the background of each present board member and each governor or chairman of the board since its establishment.

² Edmund Platt, who was chairman of the House Banking and Currency Committee before his resignation in 1920 to accept appointment to the board.

appointees have had little or no prior public service. Since the act lists no requirements concerning political-party membership, the board maintains no record of the party affiliation of its members, but such evidence as is available indicates a rough equality between Republicans and Democrats.³ While in 1913 and in 1935 there was some discussion of requiring a formally bipartisan board, as a practical matter the issue of party politics in appointments has generally not been considered a major one, and the proposal for a statutory bipartisan requirement has received little support.

In view of the act's requirement that no two board members can simultaneously serve from the same district, all sections of the country have been represented, with some concentration on New York appointments. Of the twenty-four members whose service has terminated, nine left when their term expired, four left to become governor or president of a Federal Reserve bank (where salaries are higher), three died, and the other eight resigned to return to private life. Only seven were reappointed when their terms expired.

Board members' average age at appointment was 52. Only three men under 45 have ever been appointed, all by President Roosevelt in the 1930's, and most appointees have been in their 50's. Since the average length of service has been about six years, the average age of board members has been in the middle 50's, and

³ Though no official evidence is available, it appears that of the present (1949) seven board members four are Democrats, two were pre-Roosevelt Republicans who probably supported the Roosevelt Administration, and one is a Republican.

the average age at separation has been 58. These averages apply roughly to the board members now serving.

With few exceptions, appointees to the board have not been nationally recognized as public leaders or specially qualified by training or experience for determination of national monetary policy. Most board appointments appear to have been made on essentially the same basis as most other Washington administrative appointments—a combination of political connections and qualifications for the job. While “politics” has been essentially absent in the board, there is little evidence that the men appointed to the board have been, on the whole, any better qualified for their jobs than other, less “nonpolitical,” appointees to other high-level government jobs.⁴ Broad economic experience, understanding of the intricacies of the modern banking and monetary mechanism, awareness of the long history of domestic and international central-banking experience, and some knowledge of the executive processes of government—all important to the formulation and execution of wise credit policy—are qualifications possessed by few men. Most appointees, even those highly successful in other lines, have thus faced a long period of hard work and developing experience before they hope to understand fully the intricacies of monetary policy.

⁴ The same situation has prevailed in the other federal independent regulatory commissions, such as the Federal Trade Commission, Interstate Commerce Commission, and Federal Power Commission. In his study of these commissions, E. P. Herring concludes: “There is little evidence of training or experience that directly prepares our administrative officials for their duties.”—*Federal Commissioners* (Harvard University Press, Cambridge, 1936), p. 43.

Reflecting this situation, many board members appear never to have contributed importantly to the formation of monetary policy. Thorough understanding of the intricate monetary relationships involved has usually come only with years of service, if at all, and has therefore ordinarily been limited to a small proportion of the board members at any time. But neither background nor length of service explain satisfactorily the patterns of policy leadership that have developed. Most of the "strong men" in the board's history have come from banking backgrounds, but the proportion is not remarkably higher than the proportion of bankers to the total board membership. The only conclusion clearly supported by board experience to date seems to be that the only strong leaders have been men who were leaders in their respective fields before coming to the board, who have at least the tacit support of the president, and who are able to grasp reasonably well the essentials of monetary relation and policy.⁵ The comparatively rare occurrence of these conditions has combined with recent Federal Reserve-Treasury relations to concentrate leadership in the hands of the chairman of the Board, plus perhaps one or two other board members.

Chairman Eccles' dominant policy leadership from 1934 to 1948 apparently rested on this combination of factors. His leadership rested on strength of personality, support of President Roosevelt, and competence and insight into the problems of credit policy equaled by

⁵ The excellent research staff provides extensive information and analyses for board members on such matters.

few other system officials. But the two preceding chairmen were also strong leaders. Federal Reserve history provides convincing evidence that power within the system tends to be exercised where strong leadership is present, given reasonable leeway in the statutory allocation of authority. The lack of leadership qualities among the board members during the 1920's was an important factor permitting Governor Strong's dominance of system policy from New York.

Possibly reflecting the strong credit-policy leadership of the chairman and their own difficulty in "getting their teeth into" general credit-policy issues, many board members spend a substantial portion of their time on administrative matters. Even minor salary questions concerning the board staff must be cleared by the board, and detailed board consideration is given a variety of Reserve-bank administrative matters. On the whole administrative problems are permitted to take a remarkably large portion of board members' time. A substantial portion of each board member's time is spent on that area of the board's work for which he takes informal responsibility.

Board Staff

Because monetary relations are intricate and because many new Board members are relatively unacquainted with problems of monetary policy, the board's permanent staff has played an important role in policy-making. Most senior staff members have had long Federal Reserve experience and are well versed in the

intricacies of central-banking problems. The staff is selected on a nonpolitical, merit basis. Working conditions are excellent and salaries are roughly comparable to those prescribed by Civil Service regulations. The staff has generally been considered excellent, particularly in the Division of Research and Statistics. While staff influence has varied from time to time, the technical nature of the problems encountered has necessitated substantial reliance on staff work, and the board's utilization of its staff in policy-making has been on the whole reasonably close and effective. As in other government agencies, some high administrative officials have made active use of staff economists and statisticians; a substantial number of others have apparently distrusted such advice and have made little use of this portion of the professional staff.

The board's Division of Research differs in at least some degree from most government economic-research divisions in that it is relatively much larger and in that an appreciable portion of its staff is actually engaged in research rather than in analysis aimed directly at day-to-day operations. While probably well over three-fourths of the division's time is devoted to relatively current work, basic research and long-run analysis have been important (for example, on business financing practices and on the well-known index of industrial production). This characteristic is reflected in the outlook of the division's officials, in the type of professional staff members hired, and at least to some extent in the policy outlook of the board members.

Reserve Bank Officials

Reserve-bank presidents occupy a peculiar quasi-government, quasi-private position in the Federal Reserve System. They are elected by and responsible to their respective boards of directors, who in turn are elected primarily by the private commercial banks of the districts. Yet each president's election must be confirmed by the Board of Governors in Washington. The presidents' salaries, their local positions, and their other perquisites of office are much more like those of the private bankers of their districts than like the board members in Washington, and they are free of the trials and public exhibitions associated with Senate approval that the presidentially selected Board of Governors must undergo. Yet in the eyes of most citizens, who are only dimly aware of the Reserve banks' exact status, the presidents speak as representatives of the public interest—if not of the government itself.

Like the board members, Reserve-bank presidents have had varied backgrounds. A majority of them, however, have had extensive banking experience, either in private concerns or within the system, in keeping with their responsibilities as chief executive officers of large banking institutions; and on the whole their outlook is more that of bankers than is true of the board members. They are almost exclusively career men, who are reappointed to the presidency as long as age permits, or until they resign to accept preferred positions elsewhere. The presidents move largely in the banking and

financial circles of their communities and are looked upon by many bankers as the financial leaders of their districts. Their responsibilities relate both to the operating problems of the commercial banks in their districts and to questions of central-banking policy; and the attitudes and interests of most Reserve-bank presidents reflect this duality.

The competence of the Reserve-bank presidents as executive officers in operating their banks has seldom been questioned; this reflects in part the fact that competence in bank administration has apparently been a major criterion for selection. Variations in their participation in credit-policy formation have been greater. In recent years, increased emphasis has been placed on the general credit responsibilities of the system authorities, especially through the Open-Market Committee. The presidents' preparation for and participation in credit-policy consultation has increased, in contrast with their earlier concentration on Reserve-bank operations, but even today the participation of several of the presidents in policy-making is negligible. Reflecting his special position in the money market, the prestige of the position, and its high salary, the president of the New York Bank has particularly tended to be a man of broad interests and leadership potential. New York presidents have consistently been credit-policy, rather than bank-operating, men by interest and training.

Boards of directors of the Reserve banks are selected by the Board of Governors and by the banks of the district. The Board of Governors appoints three Class C

directors (one of whom is designated chairman) specifically to represent the public interest. Especially in recent years these men have been exceptionally prominent and well-qualified for the position. Prominent businessmen of intellectual stature and educational leaders have been chosen to fill many of the directorates and have served as an effective, cordial link between the Reserve System, the local business communities, and the public.

Class B directors, actively engaged in commerce, agriculture, or industry,⁶ and elected by the member banks, also have tended to be men of prominence and public spirit. These directors apparently view themselves as representing primarily the public interest or the interests of the business or agricultural groups from which they come, rather than of the bankers who elect them. Thus on issues involving Federal Reserve restraint on member banks there have been numerous cases where Class B and C directors have voted against the three Class A directors, who directly represent the bankers of the district. The caliber and public interest of the Class B and C directors is thus generally such that no direct formal banker domination of Reserve-bank policies is likely to occur, in spite of bank ownership of the Reserve banks' stock and election of a majority of directors. On the other hand, both Class A and B directors have generally been men of "conservative" outlook, whose policy preconceptions tend to be similar.

⁶ There is no formal representation of labor.

Federal Advisory Council

The board of directors of each Reserve bank selects annually one banker from the district to serve on the Federal Advisory Council, as prescribed by law. This council was intended to insure the bankers a channel through which points of view on any matter of interest could be brought to the board's attention, in its quarterly meetings with the board or oftener if desired. In practice, the Advisory Council has tended to represent the larger metropolitan banks of each district; members have been selected almost exclusively from such banks and are almost invariably prominent, influential financiers. Membership on the council has been extremely stable—several of the members have served for a full decade. The advice of the council has apparently played only a minor role in influencing board decisions. But the council has frequently and forcefully advanced its views before the board, Congress, and the public, acting as a group of well-informed, prominent representatives of the commercial banks.

PART THREE

External Relations in Policy-Making

IX

Monetary Policy: External Relations

The major policy determinations of the Federal Reserve are intimately bound up with the policies and practices of other government agencies. This is most notably true of general monetary policy evolved jointly with the Treasury, but it is hardly less true in the field of bank supervision. It is probably least true in the areas of selective credit controls, but even there board policy determination is subject to interagency clearances and restrictions.

The present "independent" status of the Board of Governors as a quasi-judicial body is the result of an intricate series of compromises in 1913 and in 1935 when major Federal Reserve legislation was enacted. The issue of the appropriate degree of independence for central banks is little changed today from what it has been here and abroad for the two centuries of their active existence, except that recognition of the interdependence of Treasury and central-banking policies is now far more widespread than it was prior to the 1930's. Although the legal independence of the central bank has been formally eliminated in most other major

western countries, American experience under conditions of war, deflation, and "normal" times has been, on the whole, comparable with that of other countries. A large portion of the major developments governing the legal and *de facto* independence, or freedom to act, of the Federal Reserve can thus be viewed as not peculiar to the United States and as reflecting general changes in the concept of central-banking powers and responsibilities.

Federal Reserve-Treasury Relations

THE MECHANICS OF COORDINATION

During and since the war, the most crucial part of Federal Reserve monetary-policy formation has been bound up with the discussions between high Federal Reserve and Treasury officials. As indicated in Chapter IV,¹ all major decisions about the rate structure of the government-security market are considered in these conferences. While meetings are usually called to consider major Treasury financing problems or proposed changes in Federal Reserve open-market policy, these questions generally also lead to consideration of related monetary-policy tools such as reserve requirements, discount rates, and selective controls, and sometimes to consideration of new legislation.

Covering the entire range of financing and credit policy, these conferences have been extensive and time-

¹ It is significant that internal Federal Reserve policy formation could not be described without emphasis on these negotiations.

consuming. Their size and formality vary. Recently, the board chairman and New York Reserve Bank president (chairman and vice-chairman of the Open-Market Committee) have frequently met informally with the secretary and undersecretary of the Treasury; sometimes the New York Bank is not included. Often a few senior staff members from both agencies are included, since technical details are of major importance in many financing decisions. Sometimes joint Federal Reserve-Treasury staff working parties develop agreed staff recommendations, but this rare. More commonly, each agency has developed its own program which it proposes for discussion, though the board chairman and the New York Bank president have not infrequently taken divergent positions, especially on minor financing matters.²

Out of these negotiations finally comes an agreed program, or at least an operational basis for nonconflicting policies. On Treasury financing the final decisions are made by the secretary of the Treasury, who may give more or less weight to Federal Reserve counsel. On credit policy the final decisions are made by the Reserve authorities, who seldom diverge sharply from the Treasury's position on major policy but feel freer to do so on policy decisions that do not involve open-market operations and do not directly affect the prices of government securities.

In such informal negotiations, the personalities of the various officials involved have influenced substan-

² Cf. the more detailed discussion, in Chapter IV, of the role of the New York Bank in the determination of system policy.

tially the nature of the negotiations and the relative strength exerted by the two agencies. The spirit of compromise has been more prominent and Federal Reserve influence greater since than during the war. This change has apparently reflected both the passing of wartime financing pressures and changes in personnel.

As indicated above, the importance of these joint Federal Reserve–Treasury discussions inevitably concentrates a high degree of Federal Reserve leadership in the major conferees, the chairman of the board and to a lesser extent the New York Bank president. Quite aside from the special personality factors which strengthened this tendency during Chairman Eccles' regime, the chairman must represent the entire Board of Governors in discussions with the single-headed Treasury which are so fluid that simple, completely prearranged positions are seldom feasible. And he serves as the primary conduit to carry back to other Reserve officials the complex attitudes of Treasury and other governmental officials on questions of debt financing, credit policy, and other related economic and political questions. In addition, he is the chief Federal Reserve representative in dealing with other major officials in the executive branch of the government and in Congress.

Between these Federal Reserve–Treasury policy meetings, the board's operating staff is in frequent touch with its Treasury counterpart and with the New York Reserve Bank on day-to-day market developments. Equally close operating relations prevail between the undersecretary of the Treasury or the assistant secretary in charge of fiscal operations and the manager of the

system open-market account at the New York Bank. The account manager is also viewed by the Treasury as its main point of contact with the money market, since the New York Bank acts as chief fiscal agent for the Treasury as well as for the Open-Market Committee. These officials are in touch by telephone several times a day when market developments are under special scrutiny; and, as previously indicated, the Treasury guards carefully from board interference its direct relations with the New York Bank on fiscal-agency money-market affairs. Much of actual open-market policy-making (the major part for short-run money-market developments) is done in the course of these day-to-day operations, within the broad limits established by the Open-Market Committee in the light of Federal Reserve-Treasury major agreements. Thus, in daily operations as well as in top policy conferences, Treasury participation in what is formally Federal Reserve policy-making is real and extensive.

THE EXTENT OF FEDERAL RESERVE INDEPENDENCE

Legally, the Federal Reserve authorities are now completely independent of the Treasury.³ They are responsible only to Congress and, through his designation of the chairman and vice-chairman, to the presi-

³ Though it must be remembered that the Treasury itself has under the law powerful instruments for controlling the level of bank reserves through the handling of its huge balances with the commercial and Reserve banks, through investment of government trust funds, through its policies regarding the nature of government securities retired or offered for sale, and through the handling of the foreign-exchange stabilization fund. See the following section.

dent. This situation reflects a combination of experience and intricate legislative compromise, both in 1913 and in 1933-35.⁴ In the discussions preceding the original act, there was a sharp controversy over the appropriate relation between the Federal Reserve and the Treasury. In general, the banking community urged complete independence for the board, which would be a "supreme court of finance," responsible to the rest of the government only as are the courts.⁵ At the other extreme, there was some sentiment for giving the coordinating role for the system to the comptroller of the currency, who heads a bureau of the Treasury and is responsible to the secretary, or to the secretary himself. The final compromise provided for five board members to be nominated by the president with the advice and consent of the Senate for ten-year terms, plus the secretary of the Treasury and the comptroller of the currency serving *ex officio*, in recognition of both the need for independence and the necessarily close ties with the Treasury.

In practice, the *ex officio* arrangement seems to have worked unsatisfactorily. One criticism of the arrangement was that the secretary was generally so busy with his own, more pressing, duties that his participation in board activities was sporadic and not well informed.

⁴ For a summary of these legislative maneuvers and compromises, see Arthur W. Crawford, *Monetary Management Under the New Deal* (American Council on Public Affairs, Washington, D.C., 1940), Chapter VIII.

⁵ Also included in this argument, however, was usually the proposal that bankers select all, or at least a minority, of the board members.

Neither he nor the comptroller attended board meetings regularly. Strong pressure to remove the *ex officio* members also developed in the late 1920's, when it was widely alleged that the secretary exercised excessive domination over the board's credit policy decisions.⁶ As a result of these pressures, spearheaded by Senator Carter Glass, Treasury representation on the board was abolished by the Banking Act of 1935, and has not been restored.

Though the legal independence of the board from the Treasury has been complete since 1935, formation of credit policy has been more, rather than less, consonant with Treasury financing needs and with government fiscal policy in general. This situation is explainable only by reference to kind of policy issues that arose during the period.

The nature of the Treasury financing problem *vis-à-vis* the banks and the impossibility of separating the effects of credit and fiscal-debt policy under modern conditions have already been emphasized. Particularly with an outstanding federal debt of \$250 billion, continuance of this intimate interrelation seems certain for years to come, barring important changes in the statutory powers of either the Federal Reserve or the Treasury. In periods of deficit financing, the sale of government securities to banks can be assured only

⁶ E.g., Adolph Miller, long a board member, testified that in 1929 the pressure from banking interests, exercised through the secretary of the Treasury and the New York Reserve Bank, made adequate steps to check unsound credit extension impossible.—*Hearings before House Banking and Currency Committee* on H. R. 5357, 74th Congress, 1st Session, 1935, p. 191.

through cooperative credit policy to provide adequate reserves; in periods of inflation, budget surpluses must be supported by credit restriction if over-all restraint is to be achieved. And Treasury desires for continuing low interest costs on the federal debt necessarily conflict sharply with credit-restriction policies in inflationary periods, given the large free volume of government securities in the hands of the banks and the public. Whoever is to dominate the policy decisions, fiscal policy and monetary (credit and debt) policy obviously must be considered jointly if lack of coordination and direct conflict between the two major monetary-fiscal arms of the government are to be avoided.

In this situation, credit policy since 1933 has been consistently sympathetic to Treasury fiscal and debt policy. During the 1930's there was little difficulty in establishing common policies. Except for a brief interlude in 1936-37 both the Federal Reserve and the Treasury were primarily concerned with increasing the monetary and fiscal inducements to recovery and re-employment, though there were some clashes over gold policy in connection with handling the Stabilization Fund. As the pattern of defense finance gradually developed, Federal Reserve-Treasury cooperation constituted no problem; the banks had adequate excess reserves to purchase all government securities not taken by the public at low rates, and no inflation had developed. But with the return of full employment, tightening reserves, and inflation early in the war, a conflict gradually arose between the Treasury's desire to borrow funds at a low interest cost and the traditional central-

bank policy of tightening up on bank reserves and the volume of money to restrain inflation. However, the gradualness of these developments provided no vivid issue on which the decision was sharply faced. In effect, the Federal Reserve officials appear to have drifted into the low-interest policy without foreseeing, or at least without appreciating the magnitude of, the inflationary problem of modern war. By 1942-43, Reserve authorities were advocating stronger anti-inflation measures in Treasury-Federal Reserve councils,⁷ but by this time the pattern of war finance was firmly established and the Reserve officials were unwilling to take action counter to Treasury insistence on the basic easy-money pattern.

This basic monetary-policy dilemma has continued into the postwar period. Tight credit to check inflationary loan expansion would imply withdrawal of the Federal Reserve war and postwar policy of supporting the price of outstanding government securities. As long as the Reserve stands ready to buy government securities at par, the huge bank holdings of government securities are as good as cash reserves and banks are essentially free to expand their loans to consumers,

⁷ For example, Reserve officials urged that bank financing be separated completely from "public" financing. This would have prevented banks from buying up securities originally purchased by the public in the war-loan drives and would have reduced the volume of money-creating bank security purchases. This step, however, would have made the war-loan drives less conspicuously successful, since the public could not have bought the large volume of securities it did buy for resale at a profit to the banks, and the Treasury refused to adopt the proposal. On the other hand, there is no clear evidence that even given a free hand the Federal Reserve officials would have in fact adopted a rising interest rate, nonbank financing policy.

farmers, businessmen, and other borrowers. With some \$50 billion of debt refunding coming due annually, the Treasury, from the point of view of its responsibility for handling the public debt, is understandably opposed to any policy of letting the price of government securities fall and interest rates rise. Yet a counter-inflationary rise in interest rates and tightening of bank loans apparently can be accomplished effectively only by depriving government securities of the status of "effective money" through removing Federal Reserve market support to hold them at or above par, unless new types of monetary controls are provided by Congress.

Confronted with this situation, the Reserve authorities took no important anti-inflationary action but they took a strong public stand on the need for additional power from Congress to check credit expansion without imperiling the 2.5 per cent interest rate on long-term government securities.⁸ They succeeded after long negotiations in getting the Treasury to agree to moderate increases in short-term rates, and some attempt was made to use direct suasion to discourage inflationary lending. Moreover, Federal Reserve and Treasury officials were agreed in using Treasury cash surpluses to redeem Reserve-held debt, the most anti-inflationary policy. But the Reserve authorities' repeated requests for new powers reflected their basic unwillingness to use their one powerful weapon—the withdrawal of market support for long-term government securities. Official

⁸ See the statement of Chairman Eccles before the Joint Committee on the Economic Report, on November 25, 1947.

Federal Reserve pronouncements during the period suggested a schizophrenic urge to justify low interest rates in inflation while insisting that all the logical concomitants of low interest rates must be avoided if disaster was to be prevented.⁹

In fact, therefore, the Federal Reserve has been far from independent over the past two decades. The pattern and volume of Treasury financing have provided the framework for credit-policy formation. Federal Reserve influence in the direction of stronger anti-inflationary measures has been exercised primarily *through* influencing the decisions made on Treasury financing, and *through* its repeated insistence to Congress and the public on the need for more positive action to stem the inflation—significantly *not* through direct Federal Reserve actions. With the present government-debt situation, Federal Reserve credit policy is no longer clearly distinguishable from Treasury debt policy. The two have been made jointly by Reserve and Treasury authorities, but there is little doubt that the ultimate decisions have so far been those of the Treasury. The Federal Reserve has willingly or reluctantly gone along with these decisions in its general monetary policy formation, while strongly urging Congress to grant it new-type powers to use in checking the inflation.¹⁰

⁹ See L. V. Chandler, "Federal Reserve Policy and Federal Debt," *American Economic Review*, March 1949, for a more complete description of the events of the period.

¹⁰ Traditionally, "independent" central banks have protested strongly against Treasury borrowing from the commercial banks and from the central bank itself to finance war costs, but in practice they have almost never refused accommodations. The transition from purely private to at least semipublic status for central banks abroad

Similar Treasury domination of Federal Reserve policy prevailed during World War I, when assistance to Treasury war financing was the avowed main, though unwelcome, Federal Reserve monetary objective.¹¹ During the peaceful, prosperous 1920's, however, there was little evidence of Federal Reserve subservience to Treasury fiscal needs; indeed in a few instances it appears more plausible that Treasury fiscal operations were timed to support Federal Reserve monetary policy, hinged on gold flows.¹² In historical perspective, however, this decade appears as a special case, probably of somewhat limited significance for the future in view of the small Treasury fiscal and debt problems of the time and of the dominant role accorded the gold standard as a determinant of monetary policy.

has lessened the sharpness of this conflict, and with nationalization in many countries any conflict of views is entirely within the executive branch of the government. In essence, this transition has been largely a rationalization of existing fact. Cf. M. A. Kriz, "Central Banking and the State Today," *American Economic Review*, September 1948, and B. H. Higgins, *Lombard Street in War and Reconstruction* (National Bureau of Economic Research, New York, 1949), pp. 71-73.

¹¹ For a summary of this period, see E. R. Taus, *Central Banking Function of the United States Treasury, 1789-1941* (Columbia University Press, New York, 1943), Chapter VII.

¹² The authoritative analysis of the period of the 1920's is C. O. Hardy, *Credit Policies of the Federal Reserve System* (Brookings Institution, Washington, 1932); see especially Chapter XIV on Federal Reserve-Treasury relations. H. Parker Willis, first secretary of the board and a staunch advocate of Federal Reserve independence, has repeatedly asserted that Treasury officials frequently distorted Federal Reserve policies to aid Treasury easy-money programs. See, e.g., his *The Theory and Practice of Central Banking* (Harper, New York, 1936) p. 91, where he states: "The history of the Federal Reserve System has been one of encroachment by the national government upon the functions of banking and gradual determination by that government to use the Reserve Banks as its instrumentalities for the political control of credit."

REASONS FOR TREASURY LEADERSHIP

The reasons for the Federal Reserve's acceptance of Treasury leadership, in spite of the complete statutory independence of the board, are no less real and understandable because they are largely intangible. At bottom they reduce to the facts that (a) the board is, and feels itself to be, a part of the government; (b) within the government Treasury and Federal Reserve policies are so inextricable that sharp operating conflict between them would yield a government financially divided and vulnerable to crisis and instability; and (c) in the resolution of conflicts into an operational program, the Treasury is almost invariably the stronger, basically because of its closer ties with the president and his executive officials but also because of its own potential powers over bank reserves.

Treasury rather than Federal Reserve leadership in the resolution of conflicting views apparently arises, anomalously, in substantial part from the very independence with which the board is vested. The Treasury is a crucial operating branch of the government. It is charged directly with the responsibility for borrowing any funds needed by the government. It recommends the tax policy. In the formation of fiscal and debt policy, the secretary of the Treasury is inevitably in close contact with the White House. At least during the past fifteen years, the secretary of the Treasury has been one of the president's closest personal confidants and advisers. This relation is probably not accidental; by the nature of his functions the secretary of the Treasury

will always be more closely associated with the president than most of the other cabinet members.

Federal Reserve stress on its "independence" from the ordinary executive branch of the government has placed it in strong contrast to the close operating responsibility of the Treasury in executive affairs. While the Federal Reserve board is appointed by the president, and the chairman apparently serves at his will,¹³ board relations with the president have, in accordance with the intent of the law and with practical operating responsibilities, always been much less close than those of the Treasury. The Secretary of the Treasury saw the President on virtually a day-to-day basis during the war. The board Chairman's visits were more on the order of one or two a year. Thus in the ultimate formation of major government financial policy, the Treasury has generally been in the "inner council" while the Federal Reserve has been a much less active participant.¹⁴

Policy conflicts between the Federal Reserve and the Treasury have seldom been taken to the president for resolution. This again has apparently reflected in part the Federal Reserve's unwillingness to consider itself

¹³ The exact legal status of the president's power to remove the chairman (as chairman though not as a board member) is not clear. In *Humphrey's Executor v. United States*, 295, U.S. 602 (1935), the Supreme Court held that Congress could restrain the president from removal of federal trade commissioners except for causes specified in the statute. The Federal Reserve Act merely states that the chairman and vice-chairman are to be designated by the president for four-year terms, and contains no specific restrictions on the president's power of removal during these terms.

¹⁴ Federal Reserve relations with the president are described in more detail in a later section.

similar to the regular departments in executive responsibility to the president, and in part recognition that the Federal Reserve was seldom likely to prevail. During part of the war, however, the process of over-all government economic policy-making was transferred in considerable part to the Office of Economic Stabilization in the Executive Office of the President. Meetings of the Economic Stabilization Board¹⁵ considered the relative roles of fiscal policy, credit policy, direct controls, and other measures in the war-period economic scene. Few Federal Reserve-Treasury issues on credit policy were taken to the Economic Stabilization Board, but in general the voice of the Federal Reserve Board (in effect, of the chairman) on economic policy appears to have been greater than before or since that period.

Aside from the question of ultimate presidential support, the Reserve authorities are always aware of the Treasury's own potential powers over bank reserves and the need for agreement if negation of each other's policies is to be avoided. The Treasury can reduce member-bank reserves simply through permitting its balances at the Reserve banks to pile up,¹⁶ through the

¹⁵ Composed of the director of economic stabilization; secretaries of the Treasury, Commerce, and Labor; chairman of the Board of Governors of the Federal Reserve System; director of the budget; price administrator; chairman of the National War Labor Board; and two representatives each of labor, management, and agriculture to be appointed by the president. Its role is described more fully in Chapter XI.

¹⁶ Payments of taxes to the Treasury withdraw funds (reserves) from the commercial banks, and if the Treasury holds these funds in the Reserve banks they reflect a corresponding net reduction in the reserves of the commercial banks. When the funds are spent by the Treasury they are returned to the commercial banks through

handling of its trust funds, and through Stabilization Fund operations. While the Treasury's powers to augment bank reserves are more limited,¹⁷ they are nevertheless considerable in view of the large cash balances now typically maintained by the Treasury. Utilization of these powers specifically to influence bank reserves would interfere with the normal course of the Treasury's fiscal or exchange operations, and credit-policy implications of the Treasury's fiscal management operations have ordinarily been a secondary consideration. Nevertheless the potential use of such powers is an additional consideration impelling Federal Reserve authorities to negotiate with the Treasury to reach working agreements on credit and fiscal policy. Indeed, Federal Reserve officials themselves have on various occasions emphasized the extensive controls over reserves available to the Treasury, and have asserted that the power of the Treasury to influence reserves outweighs that of the Federal Reserve.¹⁸

redeposit by the people and businesses who receive the government payments.

¹⁷ Since the Treasury can decrease its Reserve-bank balances only to the extent that it has balances on hand.

¹⁸ *Annual Report* for 1938, p. 21; and statements to House and Senate Banking and Currency Committees, reprinted in *Federal Reserve Bulletin*, May 1939, pp. 363-64. These statements may be subject to substantial discount. For one thing, the board was then apparently engaged in a campaign to augment its own powers. For another, it may have been engaging in a little "buck-passing" (a popular technique between the Treasury and the Federal Reserve), particularly in the light of the failure to prevent the sharp recession of 1937. Central bankers have long notoriously been inclined to protest their own impotence. Lastly, the Treasury's powers then seemed particularly large in connection with gold movements; this was the period of the gold-sterilization experiment.

Lastly, if the Federal Reserve should adopt policies in active conflict with those of the Treasury and the administration, the possibility always exists that Congress may alter or abolish the present system. Under crisis conditions of war or depression, the necessity for a unified government monetary-fiscal policy has been practically unquestioned. Under such circumstances, Federal Reserve insistence on exercising its legal prerogative of independence might well mean insistence upon extinction. Under less critical conditions, such as the recent postwar inflation, it is more difficult to predict what the result would be, but strong administration and Congressional pressure to fall into line seems likely, except possibly in periods when responsibility is divided between the executive branch and Congress. A recent off-the-record comment of the governor of one of the world's major central banks describes a situation apparently common among central banks for many years. The governor was asked: "Do you feel your bank has the right to defy the government?" "Oh, yes," he replied. "We value that right very highly and wouldn't think of exercising it." The power of the Federal Reserve Board is enormous and its legal right to exercise the power is unchallenged. Yet, as an operating matter, Federal Reserve policy has reflected keen awareness of the executive leadership of the president and the key role played by the Treasury in government financial affairs.

Selective Controls

Problems of interagency coordination have been much less time-consuming and troublesome in the use of selective credit controls—margin requirements and consumer-credit controls. Application or relaxation of these controls impinges on no other agency's major responsibilities. Application or relaxation of margin requirements directly concerns only the SEC, and this to a limited extent since the SEC is primarily responsible for individual security issues and market trading practices rather than the over-all volume of trading or new financing. Utilization of consumer-credit controls involved some potential conflicts with the Office of Price Administration, the War Production Board, and the War Food Administration, but on the whole consumer-credit controls supported the policies of these agencies by holding down consumer spending on scarce commodities. Treasury interest has been only secondary in both cases since neither control had any direct impact on the Government securities market. While the Federal Reserve Board has on various occasions publicly criticized the inflationary aspects of other agencies' policies, operating functions have not overlapped and serious interagency conflicts have not developed.

Clearance and coordination of selective credit controls with the policies of other agencies have been almost entirely informal, except during the war-period existence of the Office of Economic Stabilization. Many matters were cleared through informal meetings and telephone calls between the board chairman and other

agency heads. Senior staff contacts were of importance in some cases. Few matters in this area were brought to the director of economic stabilization for adjudication during the war, and apparently none have been referred to the president. A relatively detailed account of the formation of margin-requirement policy in 1945-46 may illuminate the interagency aspects of such policy-making.¹⁹

MARGIN-REQUIREMENT POLICY IN 1945-46

Following a reduction of margin requirements on security transactions to 40 per cent in the recession of 1937, requirements remained unchanged until 1945. During the late 1930's, the stock market was generally considered to be "in the doldrums." It began to rise gradually with the outbreak of war, and by 1943 and 1944 had reached levels substantially above the averages of the late 1930's though still below the peak of 1937. Under these circumstances, various staff economists in the government were paying some attention as early as 1943 to the position of the market in the whole inflationary picture. Apparently, however, the first suggestion by an important official that the long-standing 40 per cent margin requirement be changed was made by the board's senior staff.

This recommendation suggested that a moderate increase might be helpful in checking the steadily rising

¹⁹ This description is a condensation of a special case study made in the Hoover Commission study. The portions included here are substantially verbatim from the complete account included as Appendix III-B in the working paper, "Board of Governors of the Federal Reserve System," of the Task Force on Independent Regulatory Agencies.

market, which was using an increasingly large amount of credit, and that it would be in keeping with the board's general attitude of doing everything possible in the credit-policy field to moderate the generally recognized inflationary forces. At this time the board members, particularly the chairman, appear to have been opposed to the suggestion, partly because they doubted the efficacy of any such change in the entire inflationary picture and partly because they were not convinced that the stock market was out of line with the rest of the economy. The chairman, in particular, was on record as advocating a special capital-gains tax on war profits as a more important anti-inflationary measure, whose enactment at the time would have decreased the possible importance of margin-requirements policy.

Later in 1944 the staff of the SEC prepared a memorandum, which was circulated among government staffs in Washington, advocating that margin requirements on securities be raised immediately to 100 per cent. While the SEC commissioners made no formal public statements on the matter, the proposal reached the press and was widely discussed. In Washington, the entire problem was then raised in the policy discussions of the Economic Stabilization Board, then headed by Chief Justice Vinson. In these discussions the chairman of the SEC supported an immediate increase in requirements to 100 per cent. The chairman of the Federal Reserve Board apparently felt that a full increase to 100 per cent would be in keeping with the need for strong anti-inflationary action if any change were to be made,

but that the problem called for more basic measures to reduce total spending power and that little could be accomplished by charging margin requirements. Other major officials were apparently divided on the issue, as were the staffs concerned with the problem in Washington. There was general agreement that an increase in margin requirements could not be expected to play a major role in checking the inflation, but there was less agreement about how effective such an increase might be even in checking the rise in the security market.

By late 1944 the Board of Governors was informally considering the problem of raising requirements, and by early 1945 board discussion had reached a very active stage. The issues were complex and there were no clear-cut indications of the likely results of various policies. Under the circumstances the board members differed about the best course to follow. At this stage, the board received a letter from the Director of Economic Stabilization suggesting that consideration be given to raising margin requirements on securities and also to the possibility of establishing, by executive order, Federal Reserve Board supervision of margin requirements on real-estate transactions. This letter reflected previous discussions in the Economic Stabilization Board, which was concerned with the entire anti-inflationary program.

At this point, the Board of Governors was strongly opposed to the proposal to place real-estate transactions under margin requirements, with the power of regula-

tion vested in the board.²⁰ After further consideration of the problem, therefore, the board chose a compromise: it would not support the real-estate proposal but would immediately raise margin requirements on securities to 50 per cent, with the understanding that if this measure did not have appreciable effects and the inflation continued unchecked they would raise requirements to 100 per cent in only two jumps, first to 75 per cent and then to 100 per cent. Margin requirements were raised to 50 per cent early in February 1945.

This small increase in margin requirements had very little effect on the booming security market. The market paused only temporarily and then resumed its upward movement, still with extensive buying on credit. The matter was then under continuous consideration by the board and its staff, and was also frequently discussed at meetings of the Economic Stabilization Board. Over this period the Chairman of the Federal Reserve Board and the SEC were in frequent informal contact concerning the problem, and developed substantial agreement on the basic situation although not complete agreement on the precise steps to be taken at particular times. There was, however, virtually no contact between the economic staffs of the two agencies after the discussions of 1944 concerning the SEC staff proposal to raise the requirements to 100

²⁰ The reasons are not clear. Some board members expressed doubt whether such a regulation was administratively feasible, though experts in other agencies asserted that it would be and that the board merely lacked initiative to undertake the new major credit-control experiment.

per cent immediately. The reason for this limited inter-staff discussion appears to have been that the issues were thoroughly considered in the 1944 discussions and the staff differences were quite strong. Since there were few basically new developments in the whole situation after that time, the issues had to be resolved by policy-making officials. The board relied primarily on its own staff and on contacts with the Chairman of the SEC directly and with other high government officials through the Office of Economic Stabilization. Moreover, the fact that the SEC had been moved to Philadelphia made close staff contact difficult.

During this period the Chairman of the Board of Governors talked informally with the President of the New York Stock Exchange about the problem, though there was no formal request for the views of brokers and dealers or exchange officials. In these conversations, it was suggested to the president that the exchange voluntarily raise its margin requirements before the Board of Governors was forced to take this action. Possibly as a result of these discussions (although there is no clear evidence of a direct connection), the exchange did voluntarily take certain steps to reduce the trading in low-priced issues. While this action received widespread attention in the press, the board and its staff felt that the steps were very small, and in fact they apparently had little effect on the rising market.

As a result of these continuing discussions, and apparently of the favorable attitude of the Director of Economic Stabilization, the board determined in June

to raise margin requirements to 75 per cent, effective early in July. This increase was cleared informally with the Chairman of the SEC, who reported that his commission continued to be in favor of even more rapid increase in requirements. This increase in requirements clearly affected the market. Extension of credit for purchasing and carrying securities dropped substantially and prices fell somewhat. There was a lull that lasted for some time. It was not until autumn that the market again began to rise, and this rise was not accompanied by any increase in extension of credit to the market. There was general agreement that the July increase had had a fairly important and demonstrable effect in checking the market boom, even though this was of very limited importance in the entire inflation picture. Under these circumstances, there was no real objection to taking the second step of raising requirements to 100 per cent as the market continued to rise in the winter of 1945-46. Early in 1946, therefore, requirements were raised to 100 per cent.

Throughout, Federal Reserve policy decisions were cleared with other government officials primarily through the Office of Economic Stabilization. At least once information on a margin increase was conveyed directly to the White House before it was announced. But apparently the interagency conflicts involved were not strong enough to require any presidential adjudication, and the Director of Economic Stabilization effectively fulfilled the information and coordination function.

The President and his Executive Office

One of the primary fears of the drafters of the Federal Reserve Act was that the president might exercise excessive "political" control over the Board. These fears have never materialized. On the contrary, contacts between the president and the board during the last decade have been so infrequent and unintimate in comparison with those of the Treasury that the influence of the Treasury has almost always prevailed in the ultimate formation of government fiscal and debt policies, which since the 1930's have dominated monetary policy.

Aside from the appointment of new members and designation of the chairman and vice-chairman, the president has interfered virtually not at all in the board's policy-making. In 1915, President Wilson intervened to stop possible board action to reduce the number of Federal Reserve districts from twelve to three, a controversial step that would clearly have been in contravention of the intent of the framers of the legislation.²¹ President Coolidge is alleged to have attempted to influence the determination of rediscount rates in 1924. During various stages of the 1929-32 crisis, President Hoover received regular informal reports from board officials on discount rates, commercial loans, currency drains, and the gold situation—

²¹ This episode is described in detail by Carter Glass, *An Adventure in Constructive Finance* (Doubleday, New York, 1927), pp. 255-72.

matters that he apparently considered of crucial importance at the time. President Roosevelt played an important role in supporting the banking legislation of 1933 and 1935. But there is no evidence that either President Hoover or President Roosevelt interfered or attempted to influence directly the board's policies once legislation was adopted.

The reason for this "hands off" presidential relation appears to have varied with the passing of time. President Wilson explained his reticence on the matter in direct terms: "The moment that I should establish close relations with the Board, that moment I would be accused of trying to bring political pressure to bear."²² This philosophy apparently explains the behavior of Wilson's immediate successors. Certainly the explanation cannot be lack of presidential concern with Federal Reserve policies, for the 1920's and early 1930's represented the peak of prestige for central banking as a countercyclical and general economic-control weapon.

The banking crisis and general financial breakdown confronting the incoming Roosevelt regime focused interest on the Federal Reserve in the first few years of the New Deal. But with the continued depression and the gradual shift of emphasis to fiscal policy as the current panacea for unemployment, first among professional economists and then more generally in Washington, the Treasury gradually assumed a more prominent role in the monetary-fiscal picture. Federal Reserve policy was relegated to second-magnitude im-

²² Quoted in Glass, *An Adventure in Constructive Finance*, p. 272.

portance. This shift was speeded by war financing. While there is some evidence of a small shift back toward the prewar balance in influence within the executive branch, recent contacts between the Federal Reserve and the president have continued to be limited and it is not clear that the president has been directly concerned with Federal Reserve policies.

Presidential appointments to the board have tended to favor men of the president's political party and there have been numerous notable cases of minor political-debt appointments. However, bipartisan composition of the board has always prevailed, and negligible attention has been paid to party differences among board members after their assumption of office. There has been no evidence of board division along party lines. Most appointments have been of relatively uncontroversial, often comparatively unknown, men who have aroused little comment and who have received senatorial confirmation without serious quarrels if often with avowed lack of enthusiasm.

A somewhat similar nonpolitical situation has prevailed on designation of board chairmen and vice-chairmen. The governors designated during the 1920's were all Republican and President Truman's only designee is a Republican. Six of the board's eight chairmen or governors have been Republicans at the time of their designation, but the negligible criticism of this fact indicates the limited importance attached to it.²³ President Truman's failure to redesignate Gov-

²³ Governor Hamlin (1914-16) and Governor Black (1933-34) were Democrats. Governors Harding (1916-22), Crissinger (1923-27),

ernor Eccles as chairman in 1948 was, on available evidence, the only instance of a change in the chairmanship apparently aimed directly at replacing a chairman somewhat critical of administration (Treasury) policy and practices, and in this case the new chairman was a Republican.²⁴

EXECUTIVE OFFICE OF THE PRESIDENT

Beyond direct contacts with the president, most government agencies are more or less actively in touch with various parts of his Executive Office. In the monetary-fiscal area, these contacts in recent years have been mainly with the Office of Economic Stabilization (during the war), various special assistants to the president (most recently Mr. John Steelman), the Bureau of the Budget, and the President's Council of Economic Advisors (since 1946). The most regular of these contacts are in most cases with the Budget Bureau. The Office of Economic Stabilization, the center of war-period economic policy coordination, no longer exists.²⁵ Inter-

Young (1927-30), and Meyer (1930-33), and Chairman Eccles (1934-48) and McCabe (1948-present) were Republicans on appointment.

²⁴ So large a proportion of recent board history is encompassed by the administration of President Roosevelt, during which Chairman Eccles' influence, reputedly derived in part from the support of the President, was apparent, that generalization on presidential influence through designation of chairman is difficult. In fact, after the 1930's Chairman Eccles' frequent differences with the views of Secretary Morgenthau on financing matters appear usually to have been resolved in favor of the Treasury position, in spite of the widely held view of Mr. Eccles as a "New Deal" spokesman on fiscal and monetary policy.

²⁵ For a brief indication of the role of this office, see the preceding section on "Selective Controls."

mittent coordination jobs involving some aspects of monetary policy have since been handled by various special assistants to the president, and this continues to be the case, as it was under President Roosevelt. The extent to which the Council of Economic Advisors will assume a major role in developing and coordinating economic policy in the executive branch remains to be seen. Up to 1949 the council had remained essentially an advisory body, but recently it has moved in the direction of active policy participation. Neither special assistants to the president nor the Council of Economic Advisors have played any important role in recent Federal Reserve policy-making; the Federal Reserve has not solicited participation, and little or none has been forced upon it.²⁶

The Bureau of the Budget has contact with the various executive agencies in three major connections. (1) It reviews and coordinates for the president requests of the various agencies for appropriated funds and expenditure authorizations. (2) It attempts to help formulate a "program of the president" on matters of legislation, through a process of legislative clearance whereby each agency is expected to submit any proposed legislation or statements on legislation to the bureau before submission to Congress. The bureau then obtains the views of other agencies which may be concerned, and, after consultation with the president when necessary, informs the agency whether or not the legislation or statement is "in accordance with the

²⁶ More thorough attention is given these coordinating devices in Chapter XII.

program of the President.” (3) It carries through a somewhat similar clearance procedure on material being prepared for presidential statements and speeches, including the annual budget message to Congress.

Since the Federal Reserve receives no appropriated funds, it is not subject to Budget Bureau clearance or investigation on expenditure or administrative management matters. The board, moreover, has consistently maintained a status outside any Budget Bureau legislative clearance procedures. While the Budget Bureau asks the board's views on pending legislation and presidential statements where Federal Reserve interests are concerned, the board has consistently asserted its freedom to send its views directly to Congress without prior notice or clearance through the bureau and to dissent from “the President's program” when it chooses.²⁷

For example, after considerable interagency discussion, the President stated in his combined State-of-the-Union and Budget Message for 1946 that: “In the peacetime economy the Reconstruction Finance Corporation will take the lead in assuring adequate financing of small enterprises which cannot secure funds from other sources.”²⁸ Contrary to this stated policy, the Board of Governors actively supported the Mead bill, which would have placed this responsibility primarily in the

²⁷ The Interstate Commerce Commission is apparently the only other agency taking this position, though the attitude of the Federal Deposit Insurance Corporation is somewhat uncertain.

²⁸ P. xxxiv.

Federal Reserve. Again in 1947, the Federal Reserve actively supported the Tobey bill, which proposed a similar shift of power to the Federal Reserve, while opposing a competing bill to extend the RFC's powers in this field. A more conspicuous problem arose from the board's assertion of its independent status in late 1947 and early 1948. Following the President's ten-point anti-inflation message of November 1947,²⁹ the Board's Chairman was an early witness in the Congressional hearings. Without Budget Bureau clearance, he strongly advocated that Congress grant additional special reserve-requirement powers to the board as the means of implementing the monetary aspects of the program, in spite of interagency disagreement on the proposal and of uncertain presidential support. It was widely alleged that the board's aggressive action played a crucial role in lessening the chances of Congressional adoption of any substantial part of the President's program. Certainly a pronounced split in the executive branch did develop out of the Board's testimony.

Not unlike other agencies, in its relations with the Budget Bureau and other branches of the president's Executive Office the board has apparently wished to exert maximum influence in the formation of governmental economic policy and to minimize control over its own policies by other agencies and by the Executive Office.

²⁹ Delivered to Congress on November 17, 1947. The first point, arrived at after extensive interagency discussion was "to restore consumer credit controls and to restrain the creation of inflationary bank credit."

Congress

Continuous stress on the importance of the freedom of the Federal Reserve Board from partisan "political" pressures marked Congressional consideration of both the original act and the major reform of 1935. The intensity of Congressional interest in the Federal Reserve has varied with changing times and personalities, but for the most part Congressional relations with the Federal Reserve have accorded with these intentions. While Congress has frequently considered banking and monetary legislation and altered the structure of the system in 1933 and 1935, individual Congressmen and committees have since the early 1930's made few attempts to interfere in the actual process of board policy-making. The board has the usual minor, government-agency contacts with Congressmen—requests for information, visitors, and informal working contacts between the board's staff and Congress' staff. Except during the drafting or consideration of legislation, at least over the past decade, board relations with even the Banking and Currency Committees have not been particularly active. A few individual Congressmen have indicated special interest in Federal Reserve affairs and have made frequent inquiries of the board or have voiced repeated public criticism of board policies, but these cases have been rare exceptions rather than the rule.³⁰

³⁰ For most of the Federal Reserve's history, Representative, then Senator Carter Glass played a leading Congressional role in all matters pertaining to the system. Senator Glass' attitude was consistently and

The situation was strikingly different during the late 1920's and the early 1930's. During that period Federal Reserve policies were vehemently debated in Congress and a marked Congressional division developed on the issue of board versus New York Reserve Bank attitudes and policies. The changed experience of more recent years may reflect the lesser importance now generally attached to monetary as against fiscal policy, or increasing Congressional willingness to have credit policy determined administratively, or merely the absence of dramatic issues, such as arose in 1927-33, in which the board's role appears to be central.

Reflecting its wish to maintain its quasi-independent status *vis-à-vis* the executive branch of the government, the board has frequently gone directly to Congress with its requests and with comments on other agencies' programs which touch on board responsibilities, rather than following the usual Executive Office clearance procedures. Board representatives, usually the chairman, have testified freely before Congressional committees on tax, debt, lending, and general economic questions as well as on questions of monetary policy.

While evidence on the board's success in influencing legislation and Congressional attitudes is difficult to assess, the board's record does not appear outstanding. In spite of urgent requests from the board for new postwar powers (especially for authority to impose additional reserve requirements and permanent authority to control consumer credit and to guarantee loans to

strongly adverse to Congressional intervention in board and Open-Market Committee policy-making.

business), there have been few important changes in the Federal Reserve Act in the past decade. During the war period, the act was amended to lower gold reserve requirements against Federal Reserve notes and deposits to 25 per cent and to permit direct Federal Reserve purchase of government securities up to a maximum of \$5 billion. Both changes, however, were justified specifically as essential to expeditious conduct of war finance and there was no important opposition to either before its enactment.³¹ It may be that the board's greatest influence on Congressional policy has been indirectly through the impact of its statements and those of its staff on public sentiment and the views of the press. General public belief in the Board's expert, "nonpolitical" status as an advisor on monetary-economic problems undoubtedly remains, in spite of the recent decline in the power and authority of central banking.

³¹ Following enactment, both measures were vigorously attacked by critics outside the government. In 1947 the direct-purchase provision was repealed as having served its wartime purpose, in spite of Federal Reserve-Treasury agreement about the technical advantages of this limited power in money market management, though it was temporarily reinstated (until 1950) later in the year.

X

Bank Supervision: External Relations

Division of Statutory Responsibilities

Three major federal agencies and forty-eight authorities share the responsibility for bank supervision.¹ Supervision varies materially from state to state, and within the federal government there is extensive overlapping and confusion of jurisdiction. This complex jurisdictional pattern of statutory responsibilities is the product of eighty years of federal banking legislation which has included no complete overhauling of supervisory duties in spite of drastic changes in the national monetary and credit system during the period. New needs have been met by superimposing new agencies on old, largely in crisis-period legislation.

The Office of the Comptroller of the Currency (a bureau of the Treasury Department), the Federal Reserve, and the Federal Deposit Insurance Corporation share federal supervisory responsibilities. The comptroller is responsible for national banks. The Federal Reserve has power to supervise all member banks,

¹ In addition the Reconstruction Finance Corporation has contractual power to supervise banks in which it holds preferred stock or capital notes, purchased largely during the 1930's.

which include national banks, but each state also retains supervisory authority over all state banks. The FDIC has supervisory power over all insured banks, which include all member banks but here again each state retains supervisory power over state banks and in practice FDIC powers appear to depend in considerable part on persuading state supervisors to enforce the state laws which govern most of the state nonmember banks' activities.

The chartering and supervision of national banks is the only important function now performed by the comptroller. Under the FDIC Act, his previous function of appointing and supervising receivers for closed banks was in effect replaced by FDIC responsibility for liquidation of all closed insured banks. Simplification of the currency system and elimination of national bank notes, which the comptroller issued to the banks against legally prescribed backing, has in effect transferred the currency-issue function to the Federal Reserve. Federal Reserve notes now comprise nearly 90 per cent of all currency outstanding.

The FDIC has three major functions. (1) It handles the deposit-insurance fund, collecting assessments, investing the funds in government securities (under active *de facto* Treasury control, similar to that exercised over regular government trust funds), and making disbursements as required to pay off depositors or to prevent incipient bank failures. (2) It examines the nonmember insured banks and reviews the comptroller's and the Federal Reserve's examination reports for other insured banks. (3) It handles the liquidation

of all closed insured banks, and, cooperating with the other supervisory agencies involved, works out mergers and consolidations of weak banks to prevent threatened failures. In this latter procedure, which has become accepted practice rather than letting insured banks fail, the FDIC uses the insurance fund to purchase weak assets where necessary to effect the merger or consolidation.

Each state also has its own bank-supervisory system, often headed by a "political" appointee. State banking laws vary substantially, and the directives under which state bank supervisors operate vary accordingly. Turn-over among such officials is rapid. State bank-supervisory officials are commonly said to be more lax than federal supervisors; certainly most (though not all) state legislation is more lax than federal statutes where they cover comparable points.

Specific instances of overlapping responsibilities arise in many aspects of supervision. For example, the Federal Reserve has full authority to grant trust powers to national banks and to issue regulations governing their use, but supervision of the utilization of the powers is in the hands of the comptroller. The comptroller has power to close and appoint a conservator for any national bank (which is by law also a member bank), but he is required immediately to appoint the FDIC to handle the bank's liquidation. Organization of a new national bank, or reorganization or amalgamation to save a weak national bank, must be approved by officials of all three federal agencies, though the comptroller has final authority; for a state bank, three authorities are

also likely to share supervision. The comptroller issues regulations governing the purchase of investment securities by all member banks, which are enforced by him for national banks, and by the Federal Reserve for state member banks. Under the Securities and Exchange Act of 1934, the board issues regulations governing the extension of credit by *all* banks for purchasing or carrying listed stocks; the relevant regulation is enforced by the Comptroller for national banks, by the Federal Reserve for state member banks, by the FDIC for insured nonmember banks, and by the forty-eight different state authorities for noninsured banks. Much cross-clearance would be inevitable even if there were only one agency, and having more than one man's initials on an important action has advantages. But the present situation appears to go far beyond legitimate needs on these scores.

Beyond the overlapping of supervisory responsibility, important statutory discriminations exist as between the various groups of banks. In general, national and state member banks are subject to more stringent legal requirements than are nonmember banks. For example, member banks are required to remit at par on all checks, to meet prescribed minimum capital requirements, to maintain minimum cash reserves prescribed by the board, and to restrict investments to approved types of securities. In most states these requirements are stricter than for nonmember banks. The provisions of the Clayton Antitrust Act against interlocking directorates and other monopolistic practices apply to member but not to nonmember banks. National banks are sub-

ject to a variety of legal restrictions—for example, on real-estate loans and the exercise of trust powers—that apply neither to state member nor to nonmember banks.

Practical Operation of Supervisory Activities

In practice, federal bank supervision operates much more efficiently than would be expected from the confused state of statutory responsibilities. Banks are generally examined by only one federal agency—national banks by the Comptroller, state member banks by the Federal Reserve, and insured nonmember banks by the FDIC—as a result of cooperative arrangements under which each agency accepts the examination reports of the others where jurisdiction overlaps. And, as a result of intermittent negotiations among officials, most glaring cases of conflicting regulations and requirements have been softened or eliminated. Actual duplication of staff is a relatively minor problem.

Nevertheless, diffusion of authority has led to lack of uniformity in supervisory policies, to varying interpretations of even agreed-upon policies, to cases of the banks “playing off” the federal agencies against one another, and to time-consuming negotiations among supervisory officials in Washington. There has been a marked tendency for each of the supervisory agencies to identify its interests with those of the banks under its active supervision.² The well-known tendencies of

² This is indicated, in a formal sense, by the positions taken by the different agencies on legislation. Advocates of maintaining the present divided supervisory authority have made no secret of the fact that the various supervisory agencies are looked to as protectors of the

bureaucracy to protect one's own and to grow a little are not absent, as indicated by repeated squabbles over alleged efforts of one agency to steal banks from the supervisory area of another. The permanence of cooperative agreements depends on continuous acquiescence by the agencies involved, in the absence of statutory controls. *Most important*, with the present divided authority there is no assurance of prompt, unified action in case of another banking crisis. Uncertainty of decision and delay in action crucial to the public interest become increasingly likely as responsibility and authority are diffused among agencies.

The potentialities of delay and confusion from overlapping authority were dramatically illustrated by the recent conflict over a relatively minor issue. Federal law prohibits the payment of interest on demand deposits by all insured banks, but authority to enforce the law is granted to the Federal Reserve for member banks and the FDIC for insured state nonmember banks. In practice, this apparently simple prohibition has led to years of continuous and bitter wrangling between the Federal Reserve and the FDIC over what constitutes payment of interest, specifically over whether absorption of exchange charges on checks handled is permissible under the law. This disagreement has led to open quarreling in public statements,

interests of their respective banks. See, e.g., "National Banks Need a Spokesman," *United States Investor*, February 23, 1946. A former Deputy Comptroller of the Currency appears to have come close to accepting this position in a formal speech, "Independent Supervision of National Banks," *United States Investor*, December 29, 1945 (especially last paragraphs).

sharp denunciations of each other before Congressional committees, and active solicitation of support from affected commercial banks.³

At the Washington level, the mechanisms of coordination are informal discussion among the officials and senior staff members of the three agencies, and routine clearance arrangements on such matters as examination reports, applications for Federal Reserve membership, and circulation of regular statistical bank reports. These informal routine arrangements handle the majority of matters without serious controversy. There is no evidence in recent years, however, of systematic interagency work toward more effective coordinated bank-supervisory policy, and there is evidence of only sporadic attempts to develop a common policy in relation to the postwar monetary and economic situation. Washington supervisory officials of all three agencies have endeavored intermittently to educate field examiners to recognize the implications of the business cycle for bank management and supervision and of central banking and Treasury fiscal policy for the banking situation—but without striking success.

Though the evidence is limited, significant top-level supervisory policy differences seem to have existed between the three agencies in recent years. The FDIC has apparently been concerned primarily with protection of depositors and of the insurance fund, and with “working out” banks which are in financial distress or

³ The hearings of the House and Senate Committees on Banking and Currency on the subject in 1944 and 1945, and the corresponding board and FDIC annual reports give some indication of the bitterness of this controversy.

have actually closed. This is combined with a sharp awareness of the problem of the relations between supervisory and monetary policies; but the FDIC is skeptical about bank examination as a proper tool of monetary policy. The comptroller has apparently viewed supervision rather more as a job of enforcing the applicable statutes and regulations and of insisting on "sound" banking practices, a relatively traditional attitude. The Federal Reserve, whose largest responsibility is credit policy and the maintenance of general economic stability, places more emphasis on the need for supervisory policies in keeping with the general business situation, at least in the intent of its Washington officials; the board insists in its policy statements that examination procedures should not counteract government monetary policies aimed at mitigating economic instability and where possible should reinforce countercyclical credit policy.

But these differences in top-level policy outlook, insofar as they do exist, are in fact only slightly evident in practical supervisory practices during normal periods. Control by central policy-makers over day-to-day activities of examiners in the field is loose, and the Federal Reserve's announced supervisory policies appear to eventuate in much the same examination practices as those of other agencies' examiners. And the Federal Reserve has had no monopoly on forward-looking supervisory moves. During the late 1930's, for example, it seems clear that the path-breaking work toward re-examining supervisory objectives and methods was pressed mainly by the FDIC.

On rare occasions the federal and state bank-supervisory agencies have formally agreed on statements of supervisory policy. The most important of such agreements was reached in 1938, when an admittedly outdated but firmly established system of loan classification was modernized, and when stress was placed on "intrinsic soundness" rather than "current market value" as the basic test to be applied in valuing bank investments for examination purposes.⁴ This agreement, which marked a striking advance over previous examination practice in the direction of avoiding examination pressure to liquidate intrinsically sound assets in time of deflation, was widely hailed. But while federal officials still endorse the agreement the diffusion of federal authority and the short tenure of most politically appointed state supervisory officials raise doubts about the present force of this agreement. In 1947, the same group of supervisory authorities agreed on a formal statement urging banks to exercise restraint in the extension of inflationary loans.⁵ But the difficulties surrounding the adoption of even such mild agreements indicate the problems involved in obtaining prompt, unified supervisory policy.

When agreement on policy or operating issues cannot be reached, there is no established channel of ad-

⁴ The agreement, approved by the Board of Governors, the comptroller, the FDIC, and the National Association of Supervisors of State Banks, was published in the board's *Annual Report* for 1938, pp. 89-90. Approval of the agreement did not bind the various supervisors in any legal sense, particularly the state bank supervisors who only registered approval by a general resolution.

⁵ *Federal Reserve Bulletin*, December 1947, p. 1465.

judication. Few cases have been taken to the president, partly because both the FDIC and the Federal Reserve consider themselves quasi-independent agencies. As a result, many differences go unsettled for long periods of time; and ultimately they may have to be submitted to Congress for resolution. The conflict over absorption of exchange charges is the outstanding recent example.

In the field, interagency working relations appear to have been generally satisfactory, though the closeness of cooperation varies from district to district. In many districts, examiners of the three federal agencies see little of each other. Washington control is apparently somewhat closer for the comptroller and FDIC than for the Federal Reserve field staff. But examination procedures and attitudes in the field tend to be similar for all three agencies. Most examiners tend to view their jobs in the fairly narrow range of examining tradition. As one Reserve Bank chief examiner has put it, they like and understand something they can "get their teeth into" rather than general directives concerning policy and attitude. As a practical matter efforts to broaden the approach and knowledge of examiners to include the importance of economy-wide developments for the individual bank have moved slowly in all three staffs. It is doubtful if most examiners feel that bank supervision is properly attached in any way to governmental countercyclical monetary-fiscal policy; what their attitude would be on asset valuation in a future depression is uncertain.

PART FOUR

*Analysis: The Lessons of Monetary
Experience*

XI

The Impact of Organization on Policy

The impact of organization and procedure on policy is usually subtle and tenuous, always impossible to measure accurately. It is never possible to know for sure how things would have been had organizational arrangements been different. Thus supportable, objective conclusions are difficult to draw. In a study such as this one, evaluation of the impact of existing organization and procedures on policy is necessarily in considerable part a subjective evaluation of a mass of small pieces of nonstatistical, often nonreportable evidence, no one of which alone would be of much significance. It must rely in considerable part on attitudes, on unwritten and only partially articulated "traditions." But many areas of evidence are broader and more open, susceptible to more clear-cut statement as issues.

It is the purpose of this short chapter to focus attention on some of the key issues in the formation of Federal Reserve policy and on the relation of Federal Reserve policies to the broad sweep of government economic policy, and to suggest some tentative conclusions as to the impact of organization and procedures on the policies that evolve. Against this background and

that of the preceding parts of the book, the remaining chapters will endeavor to probe more deeply into these questions and into the lessons Federal Reserve experience may have for the future.

The Heritage of War Finance and Monetary Policy

War-period finance and its aftermath of debt and liquid assets have dominated the formation of monetary policy since 1941. It is commonly stated that no other governmental organization or allocation of responsibilities within the executive branch would have produced a substantially different pattern of war financing, that whatever the views of policy-making officials, it would not have been politically practicable to use less inflationary means of financing. Probably this assertion is true, though it is more difficult to defend under critical scrutiny than seems apparent at first glance. It is perhaps even more widely asserted that the huge war-period accumulation of debts and liquid assets, together with recent emphasis on fiscal policy, has permanently relegated monetary policy and central banks to third-rank importance. In this view, the recent subservience of monetary (Federal Reserve) to fiscal (Treasury) policy is seen as a natural, continuing situation that arises out of external circumstances. Organizational arrangements, either within the Federal Reserve or *vis-à-vis* other agencies, can be expected to have little effect on the policies actually followed.

This interpretation has a high degree of validity for the later war period and the postwar period to date. But too-ready generalization into the future is apt to

reflect historical naivete. The postwar period to date has been, after all, only a few years, heavily dominated by the particular stresses and ideologies of the war and the prewar depression decade. Even under these circumstances, there have been evidences of resurgence of monetary policy (in increasingly active short-term rate policies) and of the influence of the Federal Reserve. Abandonment of the entire system of fixed market "pegs" for the government rate structure in the recession of early 1949 was significant. While it left unchanged the basic policy of support of long-term security prices should they fall to near par, it marked a notable step away from direct ties between debt maintenance and monetary policy—away from the sole wartime objective of "maintaining orderly conditions in the government security market" toward the more traditional guides of general business and credit conditions. Already various ways have been suggested to get around the outstanding government debt and to reintroduce effective monetary policy. And history suggests that the powerful forces of today often fade in the light of the unforeseen developments of tomorrow. Who would have predicted in the 1920's the lowly state of central-bank policy or of the gold standard only one or two decades later? Many people—government officials, laymen, and professional economists—appear to be much less convinced than is the younger generation of economists that the supply of money is not a crucial factor in economic life and hence that monetary policy should not be accorded a major role.

History may show them to be right. At least the

possibility must be considered seriously. In more "normal" times, such as might be restored in the monetary field by immobilizing most of the bank-held government debt or by other developments, the issue of the appropriate status for the central bank could again become vital. Organizational arrangements internally and in relation to the rest of the executive branch could have a significant impact on the policies evolved. For this to occur, there is no need, of course, for a return to prewar arrangements and control techniques. On the contrary, historical change is a process of evolution—seldom an exact return to the past—and adaptability to new problems and changing conditions is a significant test of the virility of any institution.¹

Determination that monetary policy is not defunct would not, of course, necessarily mean that organization has any significant impact on policy. Would monetary and fiscal policy have been any different over the past decade had the central bank been merely a bureau of the Treasury Department, or if the central bank had been given substantially more authority in the formation of executive-branch economic policies? Would they be any different in the decade ahead? Would bank-supervisory policy have been significantly different had responsibility been centered in the Federal Reserve rather than diffused? Would Federal Reserve policy have been importantly different if there had been only

¹ On this problem in central-banking development, cf. R. S. Sayers, "Central Banking in the Light of Recent British and American Experience," *Quarterly Journal of Economics*, May 1949.

one governor instead of a board and the Open-Market Committee?

The answers to such questions are seldom clear, especially for the future. But the preceding descriptions of Federal Reserve policy-making, while they make no pretense to historical completeness, suggest that organization does influence the policy that comes out—under some circumstances a good deal, under others not very much. They suggest also that there is some advantage in distinguishing between types of policy—particularly between those policy areas in which the positions of agencies become identified with non-monetary operating responsibilities and those in which this is not true.

Congressional Directives and Monetary Policy-Making

The failure of Congress to establish reasonably clear-cut directives for credit, debt, fiscal, and bank-supervisory policy underlies fundamentally the continuing interagency differences and confusion which characterize these areas. The statute prescribes no clear mandate or set of legislative standards for the exercise of the Federal Reserve's broad powers of credit control or bank supervision. While various directives are scattered through the act with reference to the exercise of particular powers,² these are very general and tend to

² E.g., "Each Federal Reserve Bank shall keep itself informed of the general character and amount of loans and investments of its member banks with a view to ascertaining whether undue use is being made of bank credit for . . . any purpose inconsistent with the main-

prescribe a policy attitude rather than a standard of action. Treasury debt policy is equally, if not more, discretionary.

Passage of the Employment Act of 1946,³ which declares that "it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy . . . to promote maximum employment, production, and purchasing power," remedied somewhat this lack of directive. Nevertheless the implications of the act for Federal Reserve credit policy are in no way prescribed, and the Federal Reserve authorities have little statutory guidance or mandate in the complex credit-policy field. Under these circumstances, sharp differences of judgment concerning appropriate monetary policies are certain to arise, both within the system, among the various government agencies related to the problem, and between the Reserve authorities and such nongovernmental groups as the commercial bankers.

Congressional prescription of a clear-cut basic guide to monetary-fiscal policy,⁴ or merely of more specific guides to monetary-debt policy,⁵ could substantially

tenance of sound credit conditions; and in determining whether to grant or refuse . . . credit accommodations, the Reserve Bank shall give consideration to such information."—Sec. 4 (8) of the Federal Reserve Act.

³ Public Law 304, 79th Congress, 2nd session.

⁴ E.g., prevention of unemployment or stabilization of some price level.

⁵ E.g., stabilization of government security prices or prescribed subservience of government-security price stabilization to broader goals such as the avoidance of commodity-price inflation and deflation.

reduce the operating friction and uncertainty in Federal Reserve-Treasury policy-making. The more specific the Congressional directives, the less serious would be the problem of interagency differences and the less important the allocation of power between the agencies. At the extreme, precise legislative direction as to the exact policy guide to be followed and the exact steps to be taken in carrying out policy would completely eliminate interagency and intraagency conflict and would make insignificant the allocation of power and administrative organization.

Most economists apparently oppose elaborate, detailed Congressional specifications on economic policy, primarily because the rigidity introduced is apt to block adjustment to changing conditions, even if the specifications are sound at the outset. They also oppose the adoption of any simple, single "rule" or guide to monetary and fiscal policy, primarily because of the alleged inability of any one guide to mirror the multiple forces requiring attention and the inability of any such rule to adapt to changing conditions. Whatever the strength of these objections, it must be recognized that even adoption of a clear, simple monetary-fiscal policy "rule" (such as price stabilization or maintenance of "full" employment) would not eliminate the problems of interagency and intraagency differences and the importance of organizational allocation of responsibility, since the entire question of implementation would be open for discretionary differences. This might well be true even with quite detailed and elaborate Congressional directives; it certainly would

be true if any of the Congressional specifications were conflicting, as often is the case. "Built-in flexibility," in which legislation is drawn to provide automatic countercyclical effects, would be essentially self-administering and would go perhaps further than any other widely supported approach toward eliminating inter-agency economic-policy differences.⁶

The dangers of excessive rigidity in Congressional directives and of excessive Congressional day-to-day "meddling" in complex economic policies are obvious. Yet, ultimately, Congress must be responsible for the monetary-fiscal-lending policies of the government. Delegation of operational responsibility over such matters as the amount of money created, the size of the budget deficit or surplus, and the government's basic attitude on bank supervision to executive or quasi-judicial agencies has obvious administrative advantages. But it raises serious problems of potential conflict and of inaction through lack of focus of responsibility unless responsibilities are clearly defined and criteria for action specified.

In the absence of specific, discretion-eliminating Congressional directives, organizational arrangements are likely to continue to have some impact on monetary, fiscal, lending, and bank-supervisory policies. Some-

⁶ See Milton Friedman, "A Monetary and Fiscal Framework for Economic Stability," *American Economic Review*, June 1948. I have also endeavored to state more fully some of the main issues involved in the problem of Congressional directives in this area in "Monetary-Fiscal Policy Reconsidered," *Journal of Political Economy*, October 1949, and "Monetary-Fiscal Policy, Debt Policy, and the Price Level," *American Economic Review, Proceedings*, May 1947.

times this impact is likely to be significant. Unfortunately, these areas are all characterized by a high degree of professional and lay disagreement as to what constitutes "correct" or "good" policy. Beyond this basic problem with its strong tendency toward conflict and indecision, policy-making in all four areas seems to have suffered substantially in the past from three common organizational (bureaucratic) failings: (1) a tendency toward preoccupation with day-to-day, operating problems to the neglect of long-run policy considerations; (2) a tendency for each agency to develop and protect vested interests and "positions"; and (3) a tendency for each to look out for its own responsibilities with insufficient concern for the impact on possibly more important responsibilities of others. There is substantial evidence that altered organizational arrangements could markedly improve the government's policies in these areas, even given the present type of Congressional policy directives.

XII

The Problem of Policy Coordination

Modern government inevitably affects the tempo and structure of the nation's economic life at innumerable points. Taxes and government expenditures influence both the level and the direction of private spending. Monetary policies have similar effects. Agricultural lending and price-support programs reach beyond agriculture to the entire economy through their effect on farm prices and farm incomes. Government labor policies affect wage rates, prices, and incomes. Government guarantee of housing loans stimulates building and increases spending power. Many other government programs and policies have comparable effects. Avoidance of violent economic instability and maintenance of high-level employment and production are recognized by all as essential if the present type of American enterprise system is to survive. Yet no adequate mechanism exists for coordinating the impact on the economy of all these government measures. The government's economic policies are often conflicting, seldom well integrated and coordinated.

The recent postwar period provides obvious examples of such conflicts. The Treasury argued vigor-

ously against large-scale tax reductions but insisted on maintenance of the market for outstanding government securities which assured their easy convertibility into money. The Budget Bureau attempted to implement the president's ten-point anti-inflation program of November 1947. The Federal Reserve Board, although agreeing on the need for inflation control, insisted that its special reserve proposal was the way to approach the monetary side of the problem. On this score the President of the New York Reserve Bank offered contradictory testimony to Congress, and Treasury opposition was strong. The Veterans Administration and the housing agencies supported extensive, easy lending to veterans and others in spite of the general excess of spending power. The Department of Agriculture actively supported agricultural lending and price-support programs. A variety of other agencies pursued programs more or less in accord with the acknowledged need to restrain the inflation. Government economic policy at any time is a complex mixture of widely diverse programs, sponsored by different agencies and interests and aimed at a wide variety of objectives, some complementary, some contradictory.

The Place of Monetary-Policy Formation

Any practically useful consideration of monetary-policy formation thus must rest within the complex framework of the government's over-all policy-making. Often "economic" policy-making is indistinguishable from "political" or "military" or "international"

policy-making. Seldom are important decisions on monetary policy substantially independent of other governmental policy issues. The interrelations of monetary, debt, and fiscal policy are obvious. Realistically, however, decisions within this whole area are often conditioned, or even determined, by essentially noneconomic considerations, and there is little point in pretending that formal administrative arrangements will fundamentally alter this basic political reality. For example, in 1946-47 the need for monetary-fiscal policies to restrain inflation was clear. But housing was scarce and veterans' welfare stood high in the public mind. Easy credit for construction of homes was monetary dynamite, especially when the basic construction limitations were shortages of labor and materials. Yet government-guaranteed housing loans at low interest rates were supported by the housing and veterans agencies and were proffered to veterans with enthusiasm. The farm support-price program was a similar case in point. Most important quantitatively over recent years has been the huge defense and international-aid program. At this extreme, it is clear that monetary policy considerations are properly overridden by the need for appropriate measures for defense and for prevention of war. But this situation is removed only in degree from many others in day-to-day government policy-making.

Effective coordination of monetary, debt, and fiscal policy is thus only one phase of the larger problem of effective government policy formation. Monetary-fiscal policy becomes, in important areas, an incidental result of decisions on predominantly nonmonetary issues. It

is therefore more difficult than is commonly assumed to judge whether economic or monetary considerations have been given appropriate attention in the formation of government policy. But the evidence of the past decade, at least, suggests that integration of monetary policy into government economic policy has been substantially less than satisfactory. Coordination between the Federal Reserve and the Treasury (monetary and fiscal policy) has been reasonably close, but almost invariably through subservience of Federal Reserve to Treasury views on major issues. Between monetary-fiscal policy and government lending policy, there has been conflict as often as coordination during the past decade. Between the monetary-fiscal-lending area and other governmental economic policy, coordination appears to have been haphazard, with most issues decided on an *ad hoc* basis without adequate government-wide consideration of interagency implications of policies adopted.

Present Coordinating Procedures

ROLE OF THE BUDGET BUREAU

The Bureau of the Budget, a part of the Executive Office of the President, attempts to coordinate the formation and execution of economic policies of the executive branch of the government. In practice, the Bureau construes its function broadly and attempts to effect a reasonable degree of economic-policy coordination through its budgetary approval procedures over the programs and administrative expenditures of all

regular government agencies in the annual preparation of the federal budget; though legislative clearance procedures for "accord with the program of the president;" and through clearance procedures on presidential statements concerning the various executive agencies. These coordinating procedures have been helpful, particularly in getting a better flow of information between agencies about each other's policy proposals and in lessening conflicting testimony to Congress by the various agencies. Clearance and formation of "the president's program" on proposed legislation has helped to focus the views of the various agencies concerned, and on many minor matters, such as clearance of statistical surveys, considerable coordination has been achieved.

But the Budget Bureau has no official, or even generally recognized unofficial, status as an agency for coordinating top-level economic policies. In cases of conflicting views, secretaries of the various departments feel no compulsion to recognize such a role for the director of the Bureau of the Budget, and such quasi-independent agencies as the Federal Reserve participate only as they wish. The coordinating role of the bureau has increased greatly over the past decade, but its primary function continues to be budgetary and administrative in nature.¹

ROLE OF "ASSISTANTS TO THE PRESIDENT"

Recent presidents, faced with the enormous size and growing complexity of the federal government,

¹ See also the final sections of Chapter IX.

have relied increasingly on special assistants for help in discharging their executive duties. President Roosevelt asked and obtained Congressional approval of five "anonymous assistants" who acted primarily as his personal representatives and informants, and as informal coordinators on a wide variety of governmental matters. During the war he expanded the role of special assistants greatly. Some of these assistants were national figures, brought in for particular jobs; examples are Bernard Baruch and John Hancock. Others were essentially unknown outside government circles. On major economic problems of war time and postwar reconversion, President Roosevelt established more formal arrangements—the Office of Economic Stabilization and the Office of War Mobilization and Reconversion, which operated during their most active periods under the leadership of Fred Vinson and James F. Byrnes, respectively, both men of high prestige, long government experience, and outstanding administrative ability.²

President Truman has continued this use of special economic assistants, mainly on an *ad hoc* basis except for the Council of Economic Advisors established by the Employment Act of 1946.³ Mr. John R. Steelman, serving as assistant to the President and responsible directly to the President, has since 1946 operated largely as a "trouble-shooter" for the President on economic and other affairs. Many interagency policy conflicts are brought to his office, voluntarily or by invita-

² For a more complete account of these offices, see below.

³ See the following section.

tion, for discussion and adjudication. Because of his *de facto* status as representative of the President, he has been able to exert strong pressure toward resolution of policy differences. His staff is very small; his responsibility has apparently not been clearly specified; and he deals *ad hoc* with current problems as they become urgent. As a result, although many controversies have been compromised, many other less conspicuous policy conflicts have continued unresolved and little attention has been given to development of a systematic, long-range coordinated program.

In partial accordance with recommendations of the Hoover Commission and the request of President Truman, in 1949 Mr. Steelman's position was formalized by Congress as "Economic Assistant to the President." Not enough time has elapsed to tell whether this change will substantially affect his operations as economic assistant and coordinator, but so far there have been no indications of important changes.

ROLE OF THE PRESIDENT'S COUNCIL OF ECONOMIC ADVISORS

The Council of Economic Advisors was established in the Executive Office of the President by the Employment Act of 1946, which declares that "it is the continuing policy and responsibility of the federal government to use all practicable means . . . for the purpose of creating and maintaining . . . useful employment opportunities for those able, willing and seeking to work, and to promote maximum employment, production and purchasing power." The council consists of

three members, who must be "exceptionally qualified to analyze and interpret economic developments . . . and to formulate and recommend national economic policy to promote employment, production, and purchasing power under free competitive enterprise." The members are appointed by the president with the consent of the Senate. They have a small staff of trained economists, whose primary job is to collect data and analyses from other government agencies and from outside the government, and to focus the significance of these findings for the council members.

In practice the main role of the council to date has been to prepare extensive analyses of national economic developments and of the impact of the administration's various programs on current and prospective economic developments for the president's semi-annual Economic Report to Congress. From time to time, the council also makes special studies for the president—for example, on the impact of the foreign-aid program on the domestic economy and on the significance of the steel price increases in the winter of 1947-48. Beyond these research duties, the council has often been consulted by the president directly and by the Budget Bureau on questions of current economic policy and the economic implications of proposed legislation. The council has, however, so far played largely an advisory role; it has made only limited attempts to act as a policy-coordinating agency. By 1949 a sharp internal cleavage had become evident on this issue. The Chairman considered that the council should be essentially a staff economic advisor to the president and opposed any direct rela-

monetary policy seldom were specifically brought before the Stabilization Board. In general, however, the hearing received by the Federal Reserve (in essence, by Chairman Eccles) on the formation of government economic policy was substantially greater than previously; Mr. Eccles was throughout an active participant in the deliberations of the Stabilization Board.

Many wartime economic policies evolved through OES represented temporary *ad hoc* compromises, and little attention could be given to longer range considerations. But the success of OES in obtaining as much uniformity and interagency coordination as were achieved under the enormous pressures of wartime economic problems appears substantial in perspective. Whether these wartime successes were due to the wartime urgency of unified government action, to the competence and prestige of the first directors of OES, or to the inherent characteristics of the plan is impossible to tell accurately. Available evidence suggests that the existence of machinery fully recognized by the president, Congress, and the various government agencies, and the prestige of the director, used informally in obtaining working agreements, were of primary importance. The unusual formal wartime power of directive granted the director apparently played only a minor role. In any case, OES consideration of government-wide economic stabilization problems and the coordinating role played by the director as an informal arm of the president are suggestive for peacetime needs.

ROLE OF THE NATIONAL ADVISORY COUNCIL

Establishment of the National Advisory Council on International Monetary and Financial Problems in 1945⁸ formalized the procedures of interagency coordination in this field. The NAC is composed of the secretary of the Treasury (as chairman), secretary of state, secretary of commerce, chairman of the Board of Governors of the Federal Reserve System, and chairman of the Board of Trustees of the Export-Import Bank. It has the following major statutory powers and responsibilities:

1. To recommend to the president general policy directives for the United States representatives on the International Monetary Fund and Bank.
2. To act for the United States in approving decisions of the United States representatives on specified questions requiring formal government approval.
3. To coordinate, by consultation or otherwise, United States policies and operations on the fund and bank with activities of the Export-Import Bank and any other government agencies lending abroad.
4. To report and recommend to the president and Congress on United States participation in the fund and the bank and on related international financial problems.

In its few years of operation the NAC has, by general agreement, been an effective mechanism for de-

⁸ In the legislation approving United States participation in the International Monetary Fund and the International Bank for Reconstruction and Development, agreed on at Bretton Woods.

monetary policy seldom were specifically brought before the Stabilization Board. In general, however, the hearing received by the Federal Reserve (in essence, by Chairman Eccles) on the formation of government economic policy was substantially greater than previously; Mr. Eccles was throughout an active participant in the deliberations of the Stabilization Board.

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In its few years of operation the NAC has, by general agreement, been an effective mechanism for de-

⁸ In the legislation approving United States participation in the International Monetary Fund and the International Bank for Reconstruction and Development, agreed on at Bretton Woods.

veloping and coordinating United States policy on international finance. Meeting infrequently, it has operated with a very small, but highly competent, interagency committee staff.⁹ Extensive staff work, handled primarily by interagency working committees has preceded council meetings on important issues, and council meetings have apparently been efficient and productive of cooperative consideration of the issues involved. Effective agreement on many minor questions is reached through staff work. Many more important issues are resolved to an operating agreement by council discussions, and in fact the council has apparently in large part formulated the international financial policy adhered to by the various government agencies. On important issues where the vote is close, the question is referred to the president for resolution. While the Treasury and State Department have apparently dominated decisions on some issues, the council appears to have provided an effective mechanism for joint consideration on most questions.

The success of the NAC as a coordinating agency has apparently rested on four factors. First, the combination of statutory authority and specific responsibility to the president has been conducive to active continuing cabinet-level participation. Second, the responsibilities of the council are relatively well defined, with emphasis on instructions to United States representatives on the fund and bank and on the formation of United States foreign lending policy. Third, NAC

⁹ A secretariat for handling the administrative matters of the NAC is located in the Treasury.

members have been relatively free from the pressures of the economic interest groups that play so important a role in most domestic economic problems involving wage rates, farm incomes, industrial prices, and so forth. Fourth, the staff work has been unusually effective. Interagency working parties under the direction of the five-man interagency senior staff committee have been used; there is no large council staff as such.¹⁰

Main Issues in Policy Coordination

To count on each new president to set up adequate new coordinating procedures for economic policy is to refuse to see the lesson of history; there seems to be no reason to expect that future presidents will have wisdom and administrative genius beyond those of their predecessors. On the other hand, to establish a new permanent top-level "coordinating" agency which would have the ultimate responsibility for making all economic-policy decisions would merely add another layer to the bureaucracy. The policy issues involved in most instances are so diverse and so complex that separate agencies must take the primary responsibility for making and executing policies in each of the various fields (taxation, agriculture, banking, and so forth). In practice, most "policy" decisions can be made only in the context of the operations with which they are con-

¹⁰ Because it has not been concerned with the Federal Reserve or questions of monetary policy, the powerful National Security Resources Board, concerned with problems of defense and future war mobilization, is not considered here.

cerned, and essentially separate bureaus of any new single agency would merely replace the present several agencies in any major consolidation.

As a matter of practical government, a mechanism is needed to accomplish three purposes, whether attention is focused merely on the monetary-fiscal-lending area or on the entire sweep of the government's economic policy-making:

1. To assure full information on, and consideration of, the important interagency implications of proposed individual agency policies prior to adoption (for example, the monetary and fiscal implications of programs for construction of housing).

2. To facilitate compromise between the agencies concerned of as many interagency differences as is practicable, resulting in informally agreed on "operational" understandings or programs.

3. To focus up for submission to the president, and perhaps ultimately to Congress, those major interagency policy conflicts on which no working agreement can be reached.

In principle, the president has adequate power to establish in his Executive Office such officials and procedures as are needed to coordinate government policies on economic issues. Or he may choose to do the job himself. But, in practice, neither approach is likely to work very effectively. The president is too busy to be concerned with adjudication of all the interagency policy differences that need attention, and experience with an assistant informally delegated to achieve coordina-

tion on an *ad hoc* basis suggests that this is not an adequate answer.

The fruitlessness of overelaborate formal coordinating directives and of trying to coordinate too completely and too rigidly is obvious to experienced government administrators, even though it may not be to observers from without. The setting is the enormous complexity of economic, social, and political issues and interests involved in every major government economic-policy decision, and the tendency of each participant (agency) to stand up for his own people and the interests that are his responsibility. In this setting to attempt to do more than is suggested in the three points above is to court either cabinet-level explosion in the executive branch or to encourage by-passing of the machinery set up. In the last analysis, cabinet officers and heads of other major agencies cannot generally be ordered to conform to specific policies by anyone of lesser authority than the president, and not always by him. Government in a democratic society must work in considerable part on a voluntary basis, in spite of the formal authority of the President over other officials of the executive branch. While high officials can be fired for refusal to "cooperate" in policy formation and execution, frequent resort to this control is usually the mark of an ineffective administrative organization, in government as outside. Major issues must on the whole be compromised voluntarily among the heads of the agencies involved, or submitted to the president himself if voluntary compromise is impossible. There

is much mature wisdom in the Washington saying that one really good easy-going negotiator "gets more done than ten coordinating committees—and besides he quits when he gets through." Refusal to face the fact that mechanical coordination on many major economic policy issues is impossible and that such issues almost inevitably (and legitimately) involve vital political issues, is pointless and merely leads to oversimple answers.

Neither experience nor administrative theory provides an easy solution to this problem. If the three modest goals for coordinating procedures are accepted, establishment of (1) an "economic assistant president" or some comparable position equal or superior to cabinet rank to assume continuing responsibility as the president's right hand in economic-policy matters, and of (2) a loose economic-policy council, headed by the economic assistant, might provide a partial answer that would appear to combine the best experience of the war and postwar periods. In effect, what is needed is a regular mechanism to assure full interagency clearance of program information, and an informal but authoritative negotiating arrangement that provides the maximum opportunity for semivoluntary interagency agreement while at the same time focusing the unresolvable issues for ultimate handling by the president.

Any such peacetime partial counterpart of the wartime director of economic stabilization and Economic Stabilization Board would succeed or fail largely on the prestige and competence of the man heading it, though some progress could be achieved merely

through the establishment of formal deliberative procedures. To carry the necessary influence and authority, he would have in fact to be an "assistant president" in prestige and stature, whatever his title.¹¹ Statutory authorization of any such arrangement should permit extensive flexibility as to its membership and *modus operandi*, subject to the discretion of the President, to whom the Economic Assistant would need to be directly responsible.¹² Ultimately the President must be responsible for the executive branch's policies; establishment of an Economic Assistant would merely recognize the enormous load on the President's time and energy in modern government.

Coordination of Monetary-Fiscal-Lending Policy

In the absence of a general coordinating mechanism for all economic policy, a working program is needed in the monetary-fiscal-lending area to provide coordi-

¹¹ The parallel to a "minister without portfolio" or "minister of economics" in parliamentary systems may be suggestive. If the analysis is sound for the handling of "economic" questions, an equally good case might possibly be made for three or four other "assistant presidents" or "ministers without portfolio" in areas of major, cross-cutting importance, though the danger of merely superimposing another cabinet would be serious if many such officials were added.

¹² Obviously the agencies concerned vary widely from issue to issue within the "economic" area, though some agency heads, such as the secretaries of the departments of Treasury, Labor, and Agriculture, the director of the Bureau of the Budget, and the chairman of the Council of Economic Advisors, would probably be more or less regularly involved. If such an arrangement were established, attachment of the present Council of Economic Advisors as a major part of the staff of the economic assistant president might tie the present council into the policy-making process more effectively than at present.

nated, well-balanced policy-formation and execution in the government's monetary, fiscal, and lending activities, and to promote better coordination between these policies and government policy in other economic areas such as labor and agriculture.

Effective, continuous consultation, *on a basis of rough equality*, between the high monetary-fiscal and lending officials of the government is essential to balanced coordinated policy-making. For practical purposes, assuming continuation of existing agencies, these officials are the secretary of the Treasury, the director of the Bureau of the Budget, the chairman of the Board of Governors of the Federal Reserve System, and one (or perhaps two) representatives of the lending agencies.¹³ These four officials should be the president's chief advisors in the field of monetary-fiscal-lending policy. As close members of his official family they should be continuously aware of each other's plans, they should settle most policy issues in the area among themselves, and they should focus up major differences for consideration by the president. In short, together they need to form and put into execution the government's monetary-fiscal-lending policy, subject to the president's supervision and the ultimate conditions established by Congress.

To achieve these goals, establishment of a formal, but very flexible, National Monetary Council might combine the best experience of the war and postwar

¹³ Substantial consolidation of the government's now sprawling lending activities into at most three or four centralized lenders would markedly simplify this problem.

periods. Such a council might be composed basically of the four officials just mentioned, with flexibility to add others, in dealing with particular issues, at either the request of the president or the wish of the council members. Like the present National Advisory Council, it probably should be established by statute which would direct the several agencies to consult through this mechanism for the coordination of government policy to promote high-level employment and economic stability.¹⁴

The success of such a council, however, would depend directly on its recognized responsibility to the president, and he should possess extensive discretionary powers over its *modus operandi*. Ultimately, the chief executive must be responsible for the establishment and execution of the government's monetary-fiscal-lending policies, within the framework established by Congress. The usefulness of such a council would be to facilitate effective execution of this responsibility, not to prescribe and limit the president's disposition of his duties. As in the case of a broader Economic Policy Council, excessive statutory rigidity would lead to unnecessary inefficiencies or to by-passing the established formal machinery in dealing with new policy problems. Statutory status, on the other hand, would help assure continuity between administrations and

¹⁴ Such Congressional action might take the form of amendment to provide more effective implementation for the Employment Act of 1946, which has already established some mechanism in the economic stabilization policy field, both in the Council of Economic Advisors to the President and the Congressional Joint Committee on the Economic Report.

would provide each incoming president with at least a framework around which economic policy-making procedures could be organized in the difficult early period of the administration.

The coordinating and policy-forming role of such a council would depend basically on its standing in the eyes of the president, Congress, and others as the executive group responsible for the functions assigned to it. A National Monetary Council should not have formal statutory power of directive over the policies of the individual agencies. Such power would be out of keeping with peacetime needs and would in effect establish a new, powerful, top-layer agency rather than a coordinating mechanism for existing agencies. Such a council will "work" if it becomes an informal, integrated part of the president's official family. If it does not achieve this status, no amount of formal specifications can make it an effective mechanism for coordinating policy in an area of such vital importance to the president, to Congress, and to the nation.¹⁵

Establishment of such a council could not guarantee coordinated action by the monetary-fiscal-lending agencies, much less by them and the multitude of other government agencies whose activities directly or indirectly affect economic activity. There is no neat, simple road to coordination of the many government policies having conflicting economic implications, es-

¹⁵ A National Monetary Council might advantageously be combined with the existing National Advisory Council, which deals with international financial matters. Two members would surely be common to both councils.

pecially when the major issues involved are often in other fields. The most any formal or informal arrangements can do is to provide a maximum opportunity for well-considered, coordinated policy-making. If they guarantee that the interagency economic implications of important policies are fully considered prior to adoption, that the maximum pressure for coordination consistent with effective agency operations is applied, and that issues not subject to amicable compromise are effectively referred to the president, little more can be expected. On many problems, for example housing aids to veterans, noneconomic considerations will probably override economic arguments for restraint in inflationary periods. But if, for example, improved arrangements assure that the inflationary monetary-fiscal implications of such a loan program are carefully considered at the council level prior to adoption they have done all that is feasible to promote considered formation of government policy.

XIII

The Problem of Federal Reserve “Independence”

In 1913 the Federal Reserve Board was conceived of as essentially a quasi-judicial body, largely independent of the executive branch of the government though tied in slightly through the *ex officio* board membership of the secretary of the Treasury and the comptroller of the currency. The duties of the board were to be predominantly supervisory rather than policy-making; what credit policy there was was viewed as largely regional in nature. Sound credit policy was generally construed (almost without argument) to consist of (1) largely automatic adherence to the gold standard, with at most minor smoothing operations between gold flows and monetary conditions; and (2) restriction of bank loans and investments primarily to short-term, self-liquidating commercial and agricultural paper. The theory was that these two mechanisms would provide the proper quantity of money with only minimum central-bank interference, except perhaps to restrain marginal loans by higher rediscount rates in expansionary periods.

While some problems of the relations of the Federal Reserve and the Treasury in respect to monetary policy were argued bitterly, they were not of dominating importance. Much of the debate on the act is ambiguous as to from whom the Board was to be "independent"—the administration, the Treasury, Congress, and "the government" were all frequently mentioned.

Unreality of Legal Independence

By 1935, it had become clear that conscious monetary policy was required and that this policy function was so essential to economic stability and so nationwide in scope that central-bank independence from the government was no longer to be considered seriously. The real problem appeared to be the appropriate relation between the Federal Reserve and the executive branch (the president and the Treasury).

Complete freedom of the board from executive control threatened confusion and conflict in monetary-fiscal policy. Direct executive control seemed to threaten narrowly partisan political domination of central-banking and bank-supervisory policies.¹ The result was the Banking Act of 1935, which increased the Reserve authorities' formal independence from the Treasury, but recognized the national scope of credit

¹ Interestingly, no one seems to have expressed much concern, then or later, over the location under "political" control of the extensive Treasury monetary powers in connection with handling cash balances and managing the government debt. Traditionalism has played a major role in the controversy over Federal Reserve independence.

policy through establishment of the Open-Market Committee and grant of additional powers to the board.

The years since 1935, encompassing depression, war, and inflation, have demonstrated beyond reasonable doubt that no modern central bank can be truly independent of the executive branch of the government in times of stress, which are the times when monetary policy is of major importance. It is essential that the government have a unified monetary-fiscal policy. If the central bank asserts its right to "independence" through policies counter to those of the chief executive and Congress, it can be overridden or even abolished. As a practical matter, as is evident from the preceding detailed description of Federal Reserve policy-making, the central bank has acceded to the administration (the Treasury) on crucial issues of depression, war, and stabilization finance when their views differed.

The nation cannot brook a divided, obstructionist monetary-fiscal policy in crisis periods. The old concepts of central-bank independence, based on a narrow view of central-bank responsibilities, have been swept away by the realities of modern large-scale government financial operations in war and peace, and by recognition of government fiscal policy as a powerful countercyclical instrument. Only in periods of stability and normalcy is it realistic to conceive of Congressional and administration acquiescence in central-bank policies that are against the government's economic policies.

At bottom, it is the government's control over the money (liquid-asset) supply that is at stake. Viewed in this fundamental light, the Federal Reserve's continu-

ous responsibility to "the government," both Congress and the president, becomes obvious. Tied into every branch of government economic policy as monetary policy is, proposals to keep money and monetary policy "out of politics" and "out of the government" have no realism, except in the narrow sense of keeping monetary-policy formation as free as possible from narrowly partisan political pressures. In this sense, there is little ground for distinguishing between monetary policy and other basic government economic policies. The real problem is how to obtain the most reasoned, deliberative judgment as to the proper exercise of the government's power over the volume and composition of liquid assets so as best to promote economic stability and government financial strength in time of crisis.

Should the Treasury be the Central Bank?

A strong case can be made for combining in the Treasury responsibility for the government's monetary and fiscal affairs. The Treasury has traditionally been associated with control of the government's power of money issue and retirement; it is now charged with executive fiscal responsibility. Complete Treasury responsibility for both would guarantee a unified government monetary-fiscal policy in dealing with cyclical economic instability, war finance, and other problems. This would recognize the Treasury's inescapable monetary powers deriving from its fiscal activities. It should produce expeditious formation of policy and flexibility in dealing with crises. It should unmistakably fix re-

sponsibility, through the secretary of the Treasury, on the president, who must ultimately be responsible for formation and execution of such executive-type functions as monetary and fiscal policies. "Buck-passing" would be far more difficult.

The case against consolidation of the fiscal and money-creating powers in the Treasury is that it may lead to too easy reliance on money creation, to too easy inflation, to too little emphasis on sound fiscal policies when they require heavy taxation, restricted government expenditures, and deflationary monetary management. The Treasury viewpoint, as history demonstrates vividly, will almost invariably tend toward "easy money," very seldom toward effective monetary restriction. This tendency is greatly strengthened for the foreseeable future in this country by the huge outstanding national debt, the maintenance of which at lower interest rates and stable market prices will understandably impel Treasury preferences for easy-money conditions for many years ahead, in inflation as well as in depression.²

It should be clear that the case for a separate central bank thus rests largely on the conclusion that the Treasury *will* on the whole have an inflationary bias

²A strong Congressional directive to the Treasury to place commodity price and/or income stability above stable prices for government securities in carrying out its fiscal responsibilities would lessen the need for a separate monetary agency. But even such a directive could not eliminate the fact that the Treasury's operating responsibility for raising money when needed, coupled with the inevitable human tendency to "play safe," would probably lead the Treasury always to assure overly generous financing facilities to itself through its central-banking powers.

because of its operating responsibilities, and will *not* take the broader view of monetary-fiscal-debt policy that may be imputed to a central bank, freer of operating responsibilities and less susceptible to the pressures of organized groups in the economy. While this conclusion seems to me justified by the historical evidence and by the pressures foreseeably at work in the future, others may of course evaluate the evidence differently.

A cogent counterargument can be made on the ground that fixing monetary and fiscal responsibility on the secretary of the treasury would lead to more weight being given monetary-policy considerations, in spite of the secretary's conflicting fiscal needs, than could be hoped for from any formally independent central bank in an arrangement that divides responsibility. Not much evidence is yet available to evaluate this argument; I see little in United States monetary-fiscal history to support it. The experience of the several Western countries (for example, England and Canada) which have nationalized central banks is not directly relevant, since in these cases the central bank has been maintained as a separate entity, specifically responsible to the executive head of the government but not formally subsidiary to, or a department of, the Treasury. On the whole, the shift to nationalization (that is, government ownership) in most cases has seemed to be mainly a formalization of *de facto* situations and has made little difference in policy.³

³ This conclusion has been affirmed by several observers. See, e.g., M. A. Kriz, "Central Banks and the State Today," *American Economic Review*, September 1948; *London Economist*, October 20,

While a Treasury inclination toward monetary ease is unobjectionable in depressed periods, it precludes strong restrictive credit policies in periods of inflation, in war or peace. The dangers of excessively easy Treasury access to additional funds have been recognized for hundreds of years. They underlie the worldwide attempt during the past two centuries to check too easy government inflationary spending through establishment of "independent" central banks. But this experience has shown the unreality of the assumption that control over the money supply can or should be "outside" the government. It emphasizes that if a separate central bank is to play an effective role in the formation of sound monetary-fiscal policy, it must act *through* the government—through influence on the government's ultimate economic policies, not through obstruction and objection from outside.

The Case for a Separate Central-Banking Agency

Stated positively, the fundamental case for a separate central-banking agency is simply that it can contribute a viewpoint in government monetary-fiscal policy formation that is specifically oriented toward the maintenance of high-level economic and financial stability. A

1945, p. 570; and B. H. Higgins, *Lombard Street in War and Reconstruction* (National Bureau of Economic Research, New York, 1949), pp. 70-72. An interesting twist is given this problem by an observation of R. F. Harrod that nationalization of the Bank of England may well lead to *too much* attention being paid to the previously only moderately influential conservative financial views of the bank's officials.—*Are These Hardships Necessary?* (London, 1947), pp. 169-78.

strong argument can be made that only a separate agency, free from the Treasury's operating fiscal responsibilities, can be counted on to advance strongly the case for monetary restraint when restraint is needed. There is little to suggest that a central-banking bureau of the Treasury could hope to prevail in Treasury councils against the operational needs of large-scale fiscal policies, or that its views would rise through Treasury internal channels to be adequately heard in interagency economic-policy negotiations.

On the other hand, the banking agency cannot, and should not, be free to negate the Treasury's operating policies. What is needed is an *equal hearing* for the Treasury and central-banking points of view in the determination of government policy, and then unified action on what policy "the government" judges best. In the present situation the Federal Reserve is by law independently powerful but in fact subsidiary to the Treasury on credit policy. This arrangement provides neither the mechanical advantages of consolidation nor the policy-making advantages of equal attention to Treasury and central-banking approaches and objectives. And it is ideally suited to buck-passing by both the agencies concerned. The job of a separate central bank in government monetary-fiscal councils should be to argue the case for monetary restraint when restraint is needed, regardless of the narrower considerations of debt management that may dominate Treasury thinking; to argue for monetary expansion where that is required is to mitigate instability. If Federal Reserve-Treasury compromise between equals proves impos-

sible, the issue should be referred for informal adjudication to a senior presidential assistant, to some group like a National Monetary Council, or ultimately to the president himself. But once a government policy is determined, obstructionist action by the central bank would be disruptive and untenable. Only the right to raise crucial issues directly with Congress should remain, and it should be recognized clearly that this right could be exercised *only on very rare occasions* if the Federal Reserve is to maintain an effective role in government executive policy councils.

A decade ago, proposals to give the Federal Reserve (or central bankers generally) greater freedom to act or greater influence on government policy-making would probably have met strong opposition on the ground that central-banker "conservatism" would lead to excessively deflationary policies in recession periods. The painful 1931 experience, when central banks were of little help in checking deflation and apparently intensified it by following orthodox financial policies, was fresh in mind.⁴ But another decade of Keynesian, easy money influence has left little doubt that most central bankers, like other public servants, are highly sensitive to the danger of mass unemployment. The Federal Reserve's alacrity in removing credit restric-

⁴ See R. F. Harrod, *Are These Hardships Necessary?* pp. 161-63, and H. H. Villard, "The Federal Reserve's Monetary Policy in 1931 and 1932," *Journal of Political Economy*, December 1937. Harrod feels there may still be some danger of overdeflationary central-bank ("gold standard") thinking in such periods, a tendency which he puts down to misguided judgment rather than any aim to benefit special interests.

tions and cutting reserve requirements in the recession of 1949, after years of vigorous anti-inflation campaigning, speaks eloquently of their fear of depression. Indeed the central bank was the first major government agency to take major steps against the recession, when President Truman was still asking additional taxes and direct inflation-control powers. At least for another generation, government insensitivity to developing depression is unlikely; the problem seems to be far more that of restraining too expansionary government monetary-fiscal policies.

In principle there is, of course, no necessary reason why it should be a central bank that is responsible for arguing the "sound" monetary-policy point of view against the operating fiscal responsibilities of the Treasury. Any other agency or specific official could in principle do the job—the President's Council of Economic Advisors would be a logical choice. Certainly effective use of the council to represent a nonoperating monetary-fiscal viewpoint in governmental policy councils would substantially weaken the case for a separate Federal Reserve. On the other hand, tradition and considerable prestige in the eyes of the public provide a foundation for resurrected Federal Reserve policy responsibilities. And it is doubtful as a practical matter that the viewpoint of another agency (such as the Council of Economic Advisors) not specifically charged with monetary responsibilities could obtain a very effective hearing against Treasury counsel if monetary-fiscal operating power were concentrated in the Treasury. More effective over-all procedures for making and coor-

minating government economic policies would markedly simplify this problem.

*The Problem of Implementing Central-Bank
"Independence"*

The meaningful choice in the monetary-policy area thus lies between (a) consolidation of monetary-fiscal functions in the Treasury and (b) establishment of a more important, responsible role for a separate Federal Reserve. The present arrangement provides the advantages of neither alternative and the disadvantages of both. On balance, the duality and inefficiencies of separate Treasury and Federal Reserve organizations appear to me to be justified by the advantages of maintaining in the government an independent monetary policy-viewpoint. But greater Federal Reserve "independence" *from the Treasury* should be established and protected if a separate central bank is to be maintained. Equally, steps should be taken to *decrease* Federal Reserve "independence" from the president and to implement the role envisaged for the central bank in government policy formation.

This reasoning suggests that the potential contribution of a separate central bank, if one is to be maintained, might be better realized by (1) utilization of some sort of National Monetary Council or other top-level coordinating economic-policy group in which the Treasury and the Federal Reserve would be represented *with equal voice and more equal prestige*; and by (2) increased responsibility of the Federal Reserve to the President as one active major participant in the

formation of executive economic policy. Clear-cut definition of the chairman's status as such at the will of the president, and reduction in the number and length of terms of the members of the Board of Governors in order to lessen the likelihood of a prolonged intergovernmental policy split would help to assure greater Federal Reserve responsibility to the chief executive and fuller participation in government policy-making. Both these proposals are considered at more length in the following chapter.⁵

From the viewpoint of allocation of functions, most Federal Reserve-Treasury conflicts arise out of the handling of debt policy. The Treasury's desire to be sure of adequate debt-financing facilities at low interest rates leads to most of its conflicts with anti-inflationary central-bank control mechanisms. A direct, drastic attack on the monetary-fiscal policy problem might be made by giving the Federal Reserve specific responsibility for all debt management. Thus the Treasury

⁵ Re-enactment of the franchise tax by which excess Reserve Bank earnings were reclaimed for the Treasury would further emphasize the governmental nature of the Federal Reserve. Reserve Bank earnings are an incidental result of board and Open-Market Committee credit-policy decisions. The earlier franchise tax was repealed in 1933 when \$140 million of Federal Reserve surplus was appropriated to provide capital for the FDIC. With the surplus account rebuilt and virtually all Reserve Bank earnings now coming from interest on United States government securities, reinstatement of the tax would emphasize the governmental nature of the Reserve Banks' operations and would regularize return to the Treasury of the Federal Reserve's large interest receipts on government securities. Since the Federal Reserve, utilizing an obscure technical provision of the act, has since 1947 voluntarily been returning 90 per cent of its excess earnings to the Treasury, statutory requirement of such a return would merely confirm the Reserve authorities' current practice.

would borrow only, or largely, (at least during time of peace) from the Federal Reserve, and the Federal Reserve would have the power to issue and deal in its own securities *vis-à-vis* the banks and the public. This approach would utilize directly, simply, and visibly the government's (central bank's) power of money creation and destruction, while reserving open-market operations for control of the liquid assets held by the public. Coupled with adoption of a security reserve plan to restore Federal Reserve control over commercial-bank deposits, the plan might both restore the effectiveness of monetary controls and concentrate responsibility for monetary-debt policy in one agency so as to minimize simultaneously the opportunities for buck-passing, the chances of divided policy, and Federal Reserve-Treasury friction. It would result in a drastic reduction in traditional Treasury powers, probably too drastic to be tolerable to the government's chief financial agency. Exploration of this reallocation of powers and responsibilities, while not within the scope of this monograph, raises numerous suggestive questions for the implementation of the whole sweep of monetary-fiscal-lending policy.⁶

⁶ A similar arrangement is suggested by A. G. Hart in "Monetary Policy for Income Stabilization" in a forthcoming volume of the Yale University Committee on National Policy. Jacob Viner urged as long ago as 1936 ("Recent Legislation and the Banking Situation," *American Economic Review, Proceedings*, March 1936, p. 118) that the Federal Reserve should be permitted to deal with the market in its own securities, though he did not propose the further step of Treasury borrowing solely or primarily from the Reserve. Viner's suggestion was merely to give the Reserve a power already possessed by many other central banks.

XIV

Federal Reserve Organization and Policy-Making Procedures

Since the mid-1930's, the crucial elements in Federal Reserve monetary-policy formation have lain in the Reserve's relation with other parts of the executive branch of the government. On the whole, the internal structure and balance of power within the System has probably not been a very important consideration in general credit-policy formation given the external circumstances, though this has been less true for bank-supervisory policy. During the 1920's this situation was reversed; the balance of power within the Federal Reserve clearly had a good deal to do with the policies that evolved. The controversies of the late 1920's between the board and the New York Bank provide clear evidence on this point, as does the importance attached to the shift of executive power to the board in the legislation of 1933-35.

On the evidence of the last decade and a half, changes in the internal structure of the System are probably of secondary importance for Federal Reserve policy-making. Even so, arrangements more conducive to ef-

fective policy-making are suggested by Federal Reserve experience to date, and if the Reserve's role in government policy-making expands again they may become still more important.

Composition and Work of the Board of Governors

SIZE OF THE BOARD

It has always been generally agreed that a board, rather than a single official, should head the Federal Reserve System. This feeling originally reflected the concept of the board as a quasi-judicial supervisory and managerial group, insulated from political pressures, in charge of the volume of Federal Reserve notes (currency) issued, and generally responsible for the establishment of rediscount rates and rediscounting policy at the Reserve banks.¹ Today, none of these functions is of major policy importance, but the tradition of board control has seldom been questioned.

Whether this is because of inertia and the force of tradition in a field somewhat mystic to the layman, or because of real advantages of the board form is not clear. The board is charged with important responsibilities for monetary and supervisory policies, with wide discretion within the limits established by the statute—for example, on reserve requirements, open-market operations, margin requirements, and bank

¹ For an account of attitudes during the original framing of the Act, see R. E. Cushman, *The Independent Regulatory Commissions* (Oxford University Press, New York, 1941), pp. 151-61.

supervision. On such questions, where human judgment must play a large role in policy decisions, the advantage of deliberative, group procedures is clear. The board form provides important benefits in continuity and protection against arbitrary action. It makes possible a staggering of members' terms that restricts any president's power to control board policy. On the other hand, it is by no means clear that the discretion exercised by the Federal Reserve Board is any greater, or concerns more vital or difficult problems, than that of the secretaries of Treasury, Defense, and State, or of the single heads of any of a dozen other major government agencies. Fundamentally, the same arguments would appear to apply with equal force in these cases. Yet no one suggests a board to head the State Department, in lieu of a single, responsible executive head.² While board advantages are substantial and probably convincing in the context of public opinion, it is hard to escape the conclusion that the concept of Federal Reserve Board as "the supreme court of finance" rests in considerable part on the hazy, somewhat mystical aura surrounding "high finance" for the great bulk of the public. In fact, experience as well as administrative theory suggests that most of the major advantages sought could be assured through a single executive required by statute to consult with heads of the Reserve banks, his major divisional chiefs, and other respon-

² One obvious difference is the extensive operating responsibilities of most major government departments in contrast to the minor nature of such Federal Reserve Board responsibilities.

sible officials; and that important policy-making and administrative advantages might be obtained with a single executive head.

If, however, a board is to be retained (as seems almost certainly the case), reduction in the size of the present seven-man board is clearly suggested by three decades' experience. First, the board's main responsibilities necessarily involve close working relationships with Treasury and other government officials in the formation and execution of monetary policy. A large board simply cannot participate effectively in such negotiations. If some board members do not participate actively, they must either follow the recommendations and reports of the active participants or risk obstructing the efficient development of interagency agreements by refusing to accept the conferees' recommendations. A much smaller board could participate more actively and contribute more substantially to the formation of monetary policy.

Second, the present seven-member board is unnecessarily large for internal policy-making. Important policy differences have seldom arisen among the members, many board members have contributed little to policy formation, and there is little evidence that equally reasoned decisions could not have been reached more expeditiously by a board of three, or at most five. The board has only a negligible number of individual case problems, such as occupy the time of members of such quasi-judicial agencies as the Interstate Commerce Commission, the Federal Power Commission, and the National Labor Relations Board. As a result, with the

present large board and strong policy leadership by the chairman, an inordinate proportion of the time and energy of most board members has been devoted to various administrative matters that could be delegated to staff members and Reserve-bank officials.

Third, reduction in the size of the board would emphasize the importance of high-quality men for the positions. It would also enhance the attractiveness of the position. There is unanimous agreement, inside the Federal Reserve and out, that high-quality board members and senior staff are the key to future Federal Reserve success, and that many appointments to the board have done little to raise Federal Reserve prestige or performance. This need is emphasized by the unusual quasi-independent position of the board in the executive branch; board members must command especially great respect if the Federal Reserve is to play a major role in government policy formation. If a large board involves any danger of lower-quality appointees (and both logic and experience suggest that it does), reduction in size is of paramount importance to effective Federal Reserve policy-making.

If there is to be a board, the weight of experience appears to point to a three-man board as an optimum compromise between focus of leadership and responsibility and maintenance of the board form. This size would permit active participation by all members in most phases of policy and would force delegation of all except policy matters to competent staff and Reserve-bank officials, though it might raise problems in maintaining contact with the Reserve Banks throughout the

country if board members were frequently absent or incapacitated by illness. The gains from an increase in size to five members do not appear impressive.

With a three-man board, six-year terms (one to expire every second year) would provide a more responsible base for executive-branch policy formation than do the present very long terms, while assuring reasonable continuity and freedom from day-to-day partisan political pressures.³ Any incoming president would then be free to appoint immediately one new board member, whom he could designate chairman if he chose. On the other hand, direct presidential control of the board would be limited by the continuing terms of the other two members. The President could not appoint an outright majority for another two years, nor could he make all three appointments in any one term. Here again, reasonable balance between executive responsibility and continuity of the board form is the problem. Any greater responsibility through more frequent presidential appointment would eliminate formal guarantee of board continuity and freedom from narrowly political manipulation. On the other hand, greater emphasis on board independence and

³ With this shorter term there would be no objection to reappointment of board members. In practice, the present prohibition against reappointment after service for a full fourteen-year term has been repeatedly circumvented. This is accomplished by reappointing existing board members to new terms vacated by retiring members before the fourteen-year terms of the continuing members have been fully served. The new appointee to the board is then nominated for the unexpired portion of the continuing member's term and in turn is eligible for reappointment later to a full fourteen-year term.

continuity would probably threaten active Federal Reserve participation in executive policy formation.⁴

RESPONSIBILITY OF THE CHAIRMAN

Current isolation of the chief Federal Reserve official from the president and his executive family appears to be unrealistic and outdated. Once the incompatibility between central bank "independence" and active participation in executive policy-making in the modern economy is recognized, the necessity for cordial relations between the president and the chairman of the board is obvious. An effective, influential chairman is a vital need for major board stature and active participation in government policy-making. The chairman should serve, as chairman, at the will of the president,⁵ though it is probably desirable to protect his membership on the board in the same manner as that of other members is protected. Similar provisions should govern appointment of a vice-chairman. It is essential that the president, as the elected chief representative of the pub-

⁴ Nine-year terms, with one expiring each three years, would provide somewhat greater continuity, if this were considered desirable. This arrangement, however, raises serious problems in the light of the four-year presidential term, since only intermittently would a board appointment become available to a new president at the beginning of his term. Thus a newly elected president, presumably representing the wishes of the public, might easily have an entire board, and a chairman, out of sympathy with his program for as long as two years.

⁵ The realistic advantages of this arrangement are suggested by the fact that it is favored by both the chairmen of the board who have served since 1935.

lic, should not be saddled with a chairman completely out of sympathy with his program.

In practice, no president is likely to exercise lightly his power of executive dismissal of the chairman, and the present statutory four-year term for the chairman might easily produce strained relations that would negate the Federal Reserve's policy influence without providing any real independence. The present situation, where the chairman's four-year term begins in the last year of each presidential term, is indefensible. The arrangement of a protected six-year term for each board member but presidential freedom to remove at will the chairman *as chairman* appears to promise a workable compromise between the conflicting aims of board freedom from narrow political manipulation and policy responsibility to the president.

TREASURY REPRESENTATION ON THE BOARD

There is no serious problem of maintaining close contact between Federal Reserve and Treasury officials. This is assured by the intimate relations between modern credit policy and Treasury policy. The main problem in policy coordination, at least on major issues, is to locate the effective balance of power. Policy disagreements and extensive negotiations between these two agencies are to be expected. On the other hand, there can be little justification for secretive program development and policy-making. As an operating matter, unnecessary friction and waste of time have characterized Federal Reserve-Treasury relations, both at official and staff levels. Each agency has tended to

develop its own position and proposals in secret from the other. The attitude has been basically adversary rather than cooperative, at least during much of the past decade and apparently during much of the 1920's.⁶ While operating and policy relations have improved in the recent past, friction has by no means been eliminated.

Under these circumstances, various observers have suggested that reappointment of the secretary of the Treasury, or his representative, to the Federal Reserve Board would induce more effective working relations. They argue that this step would lessen the tendency of the two agencies to act as opposing "camps" and would keep each agency *au courant* with the other's policy thinking and operations.

While Treasury representation on the board might lessen the present adversary attitude and provide freer interagency communication, the wisdom of the change seems doubtful. Fundamentally, the problem of Federal Reserve-Treasury relations must be faced at the highest policy-making level. This basic problem cannot be solved merely by putting a representative of the Treasury on the board. Indeed, such a step might well make the present situation worse by increasing the control of the Treasury over the board without providing any effective channel for the board to learn of the policy plans and attitudes of the Treasury; the Treasury representative might in practice operate more as a "spy"

⁶ There is some evidence, though it is by no means conclusive, that the Treasury has been more responsible for this attitude than has the board during the past decade.

than as a real two-way liaison.⁷ If measures are taken to equalize the voices of the central bank and of the Treasury in government monetary-fiscal policy-making, maintenance of day-to-day operating liaison will become a relatively simple administrative problem. Without effective equality in high-level policy-making no mechanical arrangements for cross-representation can guarantee efficient inter-agency liaison if the top officials wish to circumvent the arrangements set up.

On balance, the case against re-establishing a Treasury representative on the board seems convincing. If policy-making equality is achieved by other measures, Treasury representation is an awkward and unnecessary way of assuring day-to-day operating liaison. If policy-making equality is not achieved otherwise, Treasury representation will only help strengthen the Treasury's relative position in policy-making. Only if the desire is to maintain a *separate but essentially subordinate* Federal Reserve does the case for Treasury representation on the board appear sound.

QUALIFICATIONS OF BOARD MEMBERS

With outstanding board members, the Federal Reserve will play a useful, important role in government

⁷ In practice, membership of the secretary of the Treasury and the comptroller of the currency on the board until 1935 seems to have been of dubious success. Neither official attended board meetings except infrequently, and the board members would not permit deputies to attend. Yet some testimony on the proposed banking acts of 1933 and 1935 stressed the "excessive power" given the Treasury secretary by his membership on the board. For an account of this controversy, see Cushman, *The Independent Regulatory Commissions*, pp. 165-77.

policy formation. Without them it will not, whatever formal arrangements are established by statute. If the board is to attract more outstanding men, board membership must carry prestige equal to that of other high government positions and must involve real responsibility for important national policy decisions. Men of the caliber needed can be attracted only by the opportunities for such public service. Generally they can obtain higher incomes in private life, and if they are willing to give up private positions they will have other opportunities for government service that do provide prestige and important responsibility. Such men will seldom accept appointment or continue long as board members if their major duties are merely administrative or if they feel they are without important influence on government policy. Only the office of chairman now is of really first-rank importance.⁸

⁸ Aside from increased policy responsibility, two other measures to improve the quality of board members may be mentioned. The first is the now commonplace observation that larger government salaries are necessary to make service economically feasible for any except those with substantial independent incomes. Second, there can be little justification, especially for a smaller board, for the representation of special interests. The act now prescribes (Section 10 (1)) that appointments must give "due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country," and that no two board members may come from the same Federal Reserve district. The law has been more or less ineffective, and it is doubtful that the provision has done any real harm. But, in principle, the requirement is objectionable. Monetary policy is national, not regional, in scope, and no board member should feel himself a representative of finance, agriculture, industry, or any other special group or area.

The Reserve Banks and the Board

HISTORICAL BASIS

The regional structure of the Federal Reserve System established in 1913 reflected the long-standing American tradition against centralization and authoritarianism. In particular, it reflected a widely prevalent fear that "Wall Street" and the eastern financial interests generally would dominate any single central bank. Moreover, the framers of the act saw the role of the central-banking organization as largely mechanical in adhering to the gold standard and prescribed banking standards, with the problems for the most part regional and rediscount rates the primary tool of credit policy.

In fact, during the 1920's problems of credit policy became the core of the Federal Reserve's functions. While the regional Reserve bank proved to be an operating success, the diffusion of credit-policy responsibility led to conflict and confusion, and the absence of strong Federal Reserve Board leadership from Washington permitted in fact the New York domination of system policy that the elaborate regionalism was intended to prevent.

Under the impact of historical change, the Banking Acts of 1933 and 1935 recognized the national scope of monetary policy by centering responsibility for most credit policy in the Board of Governors, and they acknowledged the importance of open-market policy by formally establishing a joint Board-Bank Open-Market Committee to replace the informal committee arrange-

ments developed within the system. Yet tradition and political resistances preserved a strong vestige of regionalism in the Open-Market Committee, which controls what has turned out to be the system's most important policy instrument. In practice, moreover, the importance of the open-market power plus the regular machinery set up for Policy determination by the Open-Market Committee has meant that all twelve presidents have participated actively with the board members in the consideration of all phases of credit policy.

Since 1935 the pressure of historical change has continued. The elaborate division of responsibility provided by the 1935 act has failed to eliminate friction and confusion or to provide visibly more effective protection to the public interest, toward which the complex division of authority was presumably directed. In the last analysis the system has had to have a head, and policy has been dominated by the board and its chairman. There is little evidence that the statutory division of authority has provided any benefits that could not have obtained with less friction and waste from a continuing consultative relation between the board as the statutory policy-making body and the banks as continuously consulted, operating arms of the system.

THE NATIONAL SCOPE OF MONETARY POLICY

The present anomalous statutory division of authority over credit instruments between the board, the Open-Market Committee, and the Reserve banks is badly outdated. Few informed persons would any

longer deny that ultimate control over the nation's monetary policy should rest with a national, governmental body. Money is no longer regional; currency and deposits flow freely from one region to another. Control of the nation's money supply is one of the most basic powers a government can and must have.

Effective monetary-policy formation calls for unified responsibility for all credit-policy instruments in one public body, and for coordinated use of all the instruments available—reserve requirements, open-market operations, rediscount rates, and selective controls. There is no more reason for formally entrusting open-market policy to a special body including the Reserve-bank presidents than for so entrusting any other credit instrument. No informed person any longer suggests that open-market operations are in an important sense regional problems or that independent policy decisions by the individual Reserve banks could be tolerated. Self-contradictory exercise of the system's various credit powers is unthinkable. Since the scope of all monetary policy is national and since unified responsibility for all credit-policy instruments is essential, responsibility for all credit policy should surely be lodged in the national, public board, rather than in the regional quasi-private Reserve banks. Control over the nation's money supply is constitutionally, and must be, a governmental function. It can be exercised effectively only if this fact is clearly recognized and if power and responsibility are focused accordingly by Congress.

On the other hand, continuous board consultation with the Reserve-bank officials in the formation and

execution of national monetary policy is essential. It can provide an invaluable "grass-roots" basis for policy formation. Such consultation should be specifically required by law, to assure frequent, formal consultation without the present indefensible division of responsibility and authority. Thus the present regional system provides an established channel of contact between the monetary authorities and banks, businesses, and the public, both for obtaining information and for effecting credit and supervisory policies. Operating advantages of decentralization on such service functions as check clearance and Treasury fiscal operations appear to be substantial. For policy-making the unique and invaluable function of the Reserve-bank officials is to channel information and attitudes from the many parts of the nation to the board, in which policy-forming responsibility is vested. To attempt to diffuse the policy-making responsibility over a large number of persons and institutions is to sacrifice effective policy-making without gaining any advantage not provided by policy-making centralization with full regional consultation.⁹

ROLE OF THE NEW YORK BANK

New York has traditionally been considered the financial center of the United States. The New York

⁹ Short of simple consolidation of policy-making responsibilities in the board, a modified plan might be worth consideration, whereby all policy-making responsibilities would be transferred to the board but one or more Reserve-bank presidents would serve as board members on a rotating basis. The number of bank presidents serving at any time would of course depend on the size of the board.

Reserve Bank is of necessity in many ways the most important of the Reserve banks. Its large role in system policy-making has already been described. Because of its central location in the money market, continuous New York Bank membership on the Open-Market Committee has long been considered vital. Certainly it is beyond argument that the constant advice and consultation of the New York Bank and the system account manager are vital for open-market operations, and in a large Open-Market Committee continuous New York membership has been almost unquestioned.

But responsibility for the Federal Reserve System's policies does not therefore devolve upon the New York district more than upon any other, even though New York banks are the country's largest and most government securities are traded on Wall Street. Open-market policy is national in impact, no less than reserve-requirement changes or rediscount changes. Recognition of this fact leaves little ground for special *voting* representation of the New York Bank on open-market policy issues, once the present large membership of the Open-Market Committee is reduced. The New York Bank should be a uniquely valuable *advisor* and *consultant* with whom the Board is in constant informal contact on all important policy decisions, open market and otherwise. But national monetary policy should be clearly recognized as transcending regional interests. There is no reason why special voting power should be accorded the president of the New York Reserve Bank and the financial center which his bank represents. But it would be indefensible not to take fullest ad-

vantage of the invaluable consultation and operating acumen of the New York president and his bank.

ROLE OF BANKER PARTICIPATION

Nature of the Federal Reserve's work. Contrary to common belief, the Federal Reserve *Board* conducts no banking operations. It is exclusively a policy-making agency, the primary responsibility of which is control over the size and interest cost of the nation's money and credit supply. The fact that most effective money is now bank deposits, so that control of the money supply involves indirectly control over bank lending and investing, does not alter the basically monetary responsibility of the board.

Adequate execution of this responsibility requires first of all a clear understanding of the role of money in the complex modern economic system. It requires a clear understanding of the complex impact of the various instruments of central-bank policy on the money supply and on the various sectors of economic activity. Only secondarily does it require a detailed knowledge of the techniques of commercial banking; this is of first importance only for the formation of bank-supervisory policy. The crucial question concerns the impact of monetary policy on national income, employment, and prices; the impact on the banks, while important, is largely incidental to the broader credit-policy aims. Previous experience in commercial banking cannot be considered essential to satisfactory service as a board member.

Activities of the *Reserve banks*, on the other hand,

include many technical banking operations. Check clearance, fiscal operations, and other such service functions are similar to commercial-banking problems; they call for operating, not policy-making personnel. Reserve-bank conduct of bank examinations also requires operating personnel well acquainted with private banking operations. Independent banking-policy decisions by Reserve banks are negligible; they arise only indirectly in bank supervision and in rare instances in review of bank assets offered for rediscount.

The policy-making role of the Reserve-bank president today thus lies primarily in his contacts with the board and the Open-Market Committee. Here his contribution is partly the reporting and evaluation of district banking, business, and agricultural situations as they comprise part of the national picture; it is partly evaluation of the impact of proposed policy actions on regional business and banker groups. In implementing credit policy, the Reserve-bank presidents serve as a primary link between national policy and local banking, business, and agricultural groups. For this role, experience in commercial banking offers advantages, particularly in smoothing contacts with district bankers, but such experience carries with it the danger of overemphasis on banking aspects of economic developments. Only for Reserve-bank operations does previous commercial bank experience provide overriding advantages to the Reserve-bank president who views his job broadly in the system's responsibilities.

Commercial Bankers and the Federal Reserve. In 1913 the bankers generally assumed without question

that they would be given substantial representation on any board established to supervise the Reserve System. Only the adamant opposition of President Wilson prevented direct banker control of, or at least formal minority representation on, the board. President Wilson's refusal to tolerate direct banker control is reported vividly by Carter Glass.¹⁰

Secretary McAdoo and Representative Glass had brought a group of prominent bankers to the White House to state the case for formal banker representation on the board. After they had done so with some vigor, President Wilson inquired quietly: "Will one of you gentlemen tell me in what civilized country in the world there are important government boards of control on which private interests are represented?" There was a moment of strained silence, and finally the President continued: "Which of you gentlemen think the railroads should select members of the Interstate Commerce Commission?" There was no reply to either question and, in spite of desperate banker efforts in the Senate for representation, the legislation contained no such provision.

While President Wilson's argument related primarily to the board as a supervisory agency, it states the case against banker representation. The same argument applies in the formation of credit policy. Restrictive credit policy involves restraint on bank lending and investing; banker representatives would seldom be likely to be sympathetic to such proposals. Acquaintance with bank operating procedures and prob-

¹⁰ *An Adventure in Constructive Finance*, p. 115.

lems is a valuable asset for a central-bank policy-maker; but direct representation of the banking community could hardly fail to produce excessive preoccupation with the impact of policy measures on bank earnings and operations.

Full presentation of the bankers' problems and arguments to the board before major credit-policy decisions are reached, however, is advantageous to both the board and the banks. Formally this is provided by the Federal Advisory Council and through the Reserve-bank officials, elected predominantly by the member banks. The present channels for Federal Reserve consultation with banks appear adequate. As a practical matter, there is little danger that the Reserve-bank presidents will fail to reflect adequately the interests of the commercial banks, by whomever they are selected. Every president's day-to-day business brings him in close contact with the bankers of his district. Most presidents place heavy emphasis on development of close, cordial relations with district bankers and businessmen. Inevitably, a Reserve-bank president becomes keenly aware of banker problems and attitudes. The system's history reflects this awareness of and even, in some cases, identification of Reserve banks with the commercial banks of their districts.

SELECTION OF RESERVE-BANK PRESIDENTS

Under present law the majorities of the Reserve-bank boards of directors are elected by the member banks, and apparently this procedure is productive of cordial relations between Reserve banks and commer-

cial banks. Each Reserve bank's president is chosen by its board of directors, subject to approval by the Board of Governors. In practice, the board has usually approved those nominees informally suggested by the Reserve-bank directors before formal election; it apparently feels free to disapprove only in cases of major objection.

In the end, the problem involved is one of providing means to take full advantage of banker advice and consultation and to maintain close, friendly relations with the bankers and businessmen of each district, and yet to retain policy formation in the hands of a specifically public body. If Federal Reserve policy-making is centered completely in the Board of Governors, continuance of the present procedure for selecting Reserve-bank presidents would be, as a practical matter, consistent with the objectives sought, though in principle all Federal Reserve officials should be publicly (governmentally) selected. If important policy-making powers were given the Reserve-bank presidents, it would become essential to assure their public selection (for example, by appointment of Reserve-bank presidents by the Board of Governors, subject to approval of the Reserve-bank directors, reversing the current practice). With the present limited monetary policy-making powers of Reserve-bank presidents the problem is not crucial. Closer board control over bank-supervisory practices in the field might be an important gain from closer Reserve-bank responsibility to the board, but it is doubtful whether this could be obtained merely by a different selection procedure for presidents.

In fact, the present system works reasonably well and any change would probably cause controversy and disruption out of proportion to likely gains.

OWNERSHIP OF RESERVE-BANK STOCK

Member-bank ownership of Reserve-bank stock is in principle no more justifiable than would be direct banker control of Federal Reserve policy. No other public supervisory body is owned by the industry it supervises. As a practical matter, however, the issue is not a major one. There has never been any serious question that the Federal Reserve has operated in accord with what its officials thought to be the public good, rather than to increase its own profits. The primary significance of the present private ownership of Reserve-bank stock lies in the indirect voting control it provides over Reserve-bank presidencies, its psychological force, and the payment of regular 6 per cent dividends to the banks. Since the Reserve banks do not need the capital funds invested, the dividend payments are in effect a government subsidy to the member banks;¹¹ and member-bank election of directors, if that is a desideratum, is of course not necessarily contingent on stock ownership.

When the change can be made without serious dis-

¹¹ In effect the federal Treasury pays these dividends since Reserve-bank earnings come almost exclusively from interest on United States government securities and since 90 per cent of Federal Reserve net earnings *after dividends* are now returned to the Treasury. Inasmuch as the Reserve banks have no real need for the member-bank invested capital, the dividend payments might be considered in essence a federal subsidy to the banks. They involve, however, only a relatively small sum—about \$12 million in 1948.

ruption, the Reserve banks themselves or the Treasury should buy up the Reserve banks' stock, making them explicitly public institutions, as they are now in substance. In the meantime, nominal private ownership and the 6 per cent dividend may be a reasonable price to pay for improved relations between the Federal Reserve and commercial banks. The matter is one of minor importance.

XV

The Problem of Bank Supervision

The present overlapping set of bank-supervisory responsibilities is a historical accident, the product of almost a century of federal banking legislation which has included no complete overhauling of supervisory arrangements in spite of drastic changes in the national monetary and banking system during that period. When the National Banking Act was passed in 1863, following several decades of wildcat banking, the intent was to eliminate state banks and subject all national banks to the supervision of the newly created comptroller of the currency. But although state banks nearly vanished in the following decade, they later sprang up again. When the Federal Reserve was created, Federal Reserve supervisory powers and responsibilities were superimposed on those of both the comptroller and the state authorities. In 1933 and 1935, the FDIC legislation required compulsory Federal Reserve membership for all banks receiving federal insurance, but the political pressures of the smaller state banks in Congress, under the banner of "states' rights," succeeded in having the requirement postponed and finally dropped in 1938 before it had become effective.

Again, FDIC supervisory powers were superimposed by Congress on those of all the other authorities.

No more progress was made in clarifying the purposes of bank supervision and its relation to monetary policy than in clarifying supervisory jurisdiction. In fact, there is little evidence of any carefully thought out basis for the steady expansion of direct bank-supervisory activities in the United States, even though comparable formal, direct supervision did not, and does not, exist in the other major Western nations. Neither supervisory authorities nor academic economists today appear to have been able to state clear-cut objectives for bank supervision that they feel are both right and practical. The problem of relations between supervisory and monetary policies is the subject of dogmatic assertions by numerous Washington officials, but apparently not of much carefully thought out analysis.

Under the circumstances, it is not surprising that tradition, rules-of-thumb, hear-say, and vested interests appear to have been dominant forces in the development of American bank-supervisory legislation and practice. There is a serious question whether bank examination in this country during the past quarter century has done more good than harm. The negative counts are reasonably clear during the 1929-32 debacle, and it seems clear that examination standards have generally tended to ease in boom times and to tighten in depression; thus, other things equal, examination policies may intensify rather than mitigate cyclical fluctuations. It is hard to find clear-cut evidence of benefits beyond the modest goals of restraining fraud, self-

dealing, gross negligence, and violation of clearly specified statutory provisions by bank officials; and numerous capable observers question whether present examination practices are very effective for even these purposes. Fortunately, the examination problem does not seem to be a major one for the economy except under crisis conditions, but under those conditions supervisory policies in conflict with broader monetary-fiscal goals may be of vital importance indeed.

The Problem of Simplification and Consolidation

Two organizational problems are involved in the present complex supervisory structure. One is the state-federal relation—should states continue to charter and supervise banks or would an all-inclusive national banking system be preferable? While monetary economists and central-banking experts are virtually unanimous in their support of a unified national banking system, the political issue is a bitter one of long standing and there is probably no chance of abolition of the existing dual state-federal system short of another major crisis such as that of 1932–33. Under the circumstances, action to abolish the dual state-federal system is not considered here, though this may be a practical requisite of the other changes considered. There would, however, be obvious, important monetary policy advantages in compulsory Federal Reserve membership for all banks, or at least in application of standard Federal Reserve reserve requirements against deposits

at all banks. Actually, Federal Reserve membership would be of secondary importance if common reserve requirements were made applicable, and this step could be accomplished for practical purposes within the limits of existing federal powers and without infringing on other aspects of state supervisory jurisdiction.

The second problem is the relation of the three federal supervisory agencies. There is no question as to the federal government's right to supervise all banks accepting federal deposit insurance,¹ and the exercise of this supervision need not necessarily be vested in the insurance agency itself. Thus Congress is free to allocate the present federal supervisory authority over all insured banks to any one of the three present supervisory agencies or to a new agency if it wishes, without in any way infringing upon existing state rights and without changing present requirements for Federal Reserve membership.

While the arguments against consolidation of federal supervisory agencies are seldom stated so impolitically, in substance they amount to the following:

1. The present system, while admittedly overlapping and cumbersome, works pretty well and seldom produces violent open clashes, so why upset things by a move toward consolidation.
2. The issue is a political hot potato. While states' rights are not actually involved in a mere reorganiza-

¹Though in practice FDIC supervision of state banks now apparently rests in considerable part on maintenance of good terms with state supervisors.

tion of federal supervision, any change will be viewed with suspicion by the ardent states' rights advocates, who will suspect an impending encroachment on state chartering and state supervision.

3. Most bankers like the present system. Its divided authority inhibits the exercise of vigorous supervisory restraint by any one agency since the bank is free to move to another agency's jurisdiction. Moreover, each agency views itself to an important extent as the advocate and protector of its group of banks on legislative and administrative matters. Bank supervisors are, in effect, in many respects similar to trade-association officers in other industries enforcing association rules and mores.²

4. We need numerous checks and balances in the federal government's bank-supervisory structure to prevent too much concentration of power in any one place.

Close examination reveals little substance in these arguments, except the very important consideration of political expediency. First, while the present system works reasonably well in "normal" periods, it is somewhat inefficient and overlapping even then. Second and more important, the difficulty of obtaining policy uniformity in "normal" times presages indecision and con-

² Thus the government in effect supports bank cartelization—by restricting admission of new units, by restricting competition for deposits through payment of interest on deposits, etc. This is in curious contrast to our governmental approach to many other businesses through antitrust and FTC activities, though it is in step with government-sponsored cartelization in coal, agriculture, and several other industries.

fusion in event of another banking crisis. Third, maintenance by the federal government of three bank-supervisory agencies which view themselves to a marked extent as protectors of the supervised banks against the other supervisors and vie for commercial-bank favor can hardly be defended. Fourth, while checks and balances in government are highly commendable, the principle can easily be carried to an indefensible extreme in any supervisory field. The same legislative-judicial-administrative checks and balances work in bank supervision as in other fields of government supervision, without any special need for multiplication of authorities. What the present multiplicity of bank-supervisory agencies provides is merely a diffusion of responsibility *within* the administrative branch. Few persons would advocate three separate federal Securities and Exchange commissions, with corporations free to select which they preferred to submit security issues to for approval, or three Interstate Commerce commissions. The very purpose of supervision is undermined by conditions conducive to competition among overlapping supervisors.

The Case for Consolidation

The case for consolidation and simplification in federal bank supervision rests primarily on the need for uniformity of policy, for more effective awareness of supervisory-monetary policy relations, and for supervisory arrangements that will be prepared for quick, unified policy determination in event of another bank-

ing crisis; not on personnel and direct dollar savings.³ In a field where actual operations are so scattered and so dependent on thousands of individual examiners' decisions and where "policy" has so little meaning outside these quasi-independent examiners' judgments, assessment of varying agency supervisory policies is inevitably difficult and imprecise. As indicated in Chapter X, however, significant policy (or attitude) differences appear to have existed among the three agencies at the Washington level. In general, Federal Reserve officials for at least the last decade or two appear to have been most cognizant of the cross-implications of bank-supervisory and monetary policies, the Comptroller's Office to have been most traditional-minded on supervisory policy, and the FDIC to have been somewhere between, with a keen eye to protection of the insurance fund as a (possibly the) major objective. On the other hand, field supervisory practices of the three agencies' staffs show little effect of these apparent high-level differences. Federal Reserve Board control over its field examiners is particularly loose, and actual examination practices appear to be largely in the traditional supervisory pattern.

It is by no means clear that bank supervision

³ There are some physical inefficiencies and waste in the present three-way federal system, but these are relatively minor. Consolidation of legal and research staffs would yield better results with fewer employees, and consolidation of examinations would reduce somewhat the number of head-office and field-office examinations personnel required, in part through reducing the time now spent on interagency coordination and negotiation. But if the present system worked well in policy formation and execution, these inefficiencies would provide a relatively weak case for change.

(mainly examination) either should or can be an effective adjunct to credit policy in inducing bankers to expand or reduce their loans and investments. Past efforts at "direct pressure" have not been convincing, and there is some danger that excessive preoccupation with countercyclical objectives would inhibit or even preclude effective exercise of the more traditional individual bank risk-restriction aspects of examinations. But the disastrous consequences of deflation-reinforcing examination policies are clear; if bank examination policies cannot help mitigate business cycles, they can indubitably intensify deflation.

It is essential that deflationary supervisory pressure be avoided in depression periods. Between 1929 and 1933, examiners' pressures on banks to liquidate "slow" and "doubtful" loans and investments intensified the general financial liquidation that was the core of the downward spiral. Thus the well-meaning efforts of the examiners to protect bank depositors and stockholders were a powerful force toward bank failures which deeply injured the very people that examinations were aimed to protect, and toward deepening the depression that every group in society sought to avoid. The most important characteristic of sound supervisory policy is that its impact on the banking system and the economy as a whole be salutary, rather than that each individual bank be considered in isolation as has been unfortunately customary among examiners.⁴

⁴For a careful, suggestive analysis of the whole problem of liquidity for financial institutions, in relation to the problem of economic instability, see Homer Jones, "The Flow of Savings," *Journal of Finance*, October 1948 and March 1949.

In the last analysis, even the present haphazard supervisory arrangements would probably work satisfactorily if the government (in effect, Congress, or the president together with the Treasury and the Federal Reserve, for this purpose) would agree on and adopt a monetary policy assuring liquidity to the economy in event of strong deflationary pressure. Comparable policy against inflation would also be important. It is the sound monetary-fiscal policy that is crucial. Sympathetic bank-supervisory policy, protecting against intensification of deflation, could undoubtedly be "sold" to the federal authorities concerned under those circumstances. The basic need is for Congress to provide either clear-cut monetary and supervisory directives or more effective means to assure adoption of sound governmental over-all economic (here monetary-fiscal) policies; if this is done bank supervisory administrative arrangements will become relatively unimportant.

Location of Supervisory Responsibility

Enforcement of applicable, well-defined statutes and regulations can be accomplished as well by one of the three agencies as another. Nor does any one agency appear better fitted than the others to carry forward the development of "sound" banking practices. The critical question in considering the best location for consolidated federal bank-supervisory responsibility is that of wise policy formation and effective policy execution, recognizing the fundamental objectives of supervision

in relation to both the individual bank and the problem of over-all economic stabilization.

The crucial importance of avoiding examination policies that contribute to economic instability suggests allocation of the supervisory function to the Federal Reserve, which has a direct responsibility for promoting economic stability and which seems most likely to consider fully the impact of supervisory policies on this responsibility.⁵ This conclusion is strengthened by the fact that the Federal Reserve will in any case have a regional system of Banks and branches that can serve as a framework for supervisory operations. The Reserve Board will also necessarily make many of the regulations which examinations must enforce. Exercise of supervisory powers fits in closely with Federal Reserve programs of banker-business "education" on credit-policy issues. This case rests not on superior Federal Reserve supervisory performance to date (for there is little to choose among the three agencies), but on the fact that the basic policy responsibilities of the Federal Reserve are probably most conducive to adoption of salutary supervisory policies.

The possible objections to Federal Reserve supervisory responsibility are three. Some observers fear that the Reserve authorities would subordinate supervisory standards to the dictates of credit policy, thereby losing the more orthodox benefits of careful bank su-

⁵ On the other hand, one should not forget that the comptroller is "in" the Treasury Department, which also has a strong responsibility for economic stabilization.

pervision. Others suggest that the Reserve authorities' time should be completely free for credit-policy decisions, and that any other functions should be placed elsewhere. Third, as a practical operating matter, Federal Reserve Board policy sometimes appears to be carried less effectively into actual field examinations than are the central policies of the other two agencies because of the high degree of decentralization in Federal Reserve examination procedures.

A reasonably good case can also be made for either the FDIC or the comptroller as the sole supervisory agency. But neither's basic responsibilities would conduce as strongly toward eliminating de-stabilizing supervisory policy decisions, and there are important positive objections to both. Consolidation of supervisory authority in either would involve maintenance of a second major federal banking agency alongside the Federal Reserve. Moreover with both there might be a serious danger that inadequate attention may be paid to "inherent worth" (more fundamentally, the need to maintain system liquidity) as the controlling valuation principle for bank assets in times of recession; some have urged that this would occur in the FDIC because of its natural desire to protect the insurance fund, though there is no necessary reason why this would be the case. A strong practical objection to the Comptroller's Office is that it has traditionally supervised only national banks, and any move to place it over state banks would undoubtedly face bitter states' rights resistance. Moreover, traditionally the comptroller has, technically at least, been quasi-independent of the sec-

retary of the Treasury, who is the Treasury official with broad responsibilities to combat economic instability.

Establishment of a new office in the Treasury, operating under an assistant or undersecretary and charged with all federal bank supervision as well as with all the other present Treasury banking, debt management, and monetary functions, would present perhaps the strongest alternative to centralization of supervision in the Federal Reserve. The choice here should depend in part at least on the outcome of the current reconsideration of the allocation of general monetary-credit responsibilities between the Federal Reserve and the Treasury.⁶

Deposit Insurance, Bank Supervision, and Monetary Policy

The intimate relation between federal deposit insurance and Federal Reserve credit policy strengthens the case for consolidation of supervisory authority over all insured banks in the Federal Reserve. The success of deposit insurance hinges on the prevention of most bank failures, not the payment of depositors after failure. Deposit insurance provides safety from loss primarily through public confidence in government guarantee of deposits, rather than through the technical ability of the insurance fund to cover losses. While deposit insurance has made a major contribution to economic stability by lessening the likelihood of severe

⁶ Any consolidation, wherever centered, should of course involve consolidation of the best personnel of the three present agencies rather than merely giving additional powers to one existing staff.

bank runs, in a major crisis it is only the Federal Reserve that can save the banks by advancing the cash needed to meet mass withdrawals—that is, by providing quick liquidity for sound but temporarily frozen bank assets. Failure of the Federal Reserve to provide liquidity would permit enormous drains on the deposit-insurance fund that could easily force it into bankruptcy unless rescued by the government. With adequate Federal Reserve policy, the FDIC need worry only about bailing out individual banks that have particularly weak assets or have experienced extraordinarily severe runs.

Realistically viewed, therefore, the insurance function of the FDIC is limited to possible failures of individual banks. Even here, provision of operating liquidity by the Federal Reserve and the FDIC have essentially displaced regular insurance procedures. Weak banks are now almost invariably merged with or absorbed by other banks to prevent the disruption associated with bank failure. In such mergers, the FDIC typically provides liquidity by purchasing the weak assets or otherwise advancing funds where necessary; as with Federal Reserve depression-period purchase of or lending on weak assets, many of these funds are recouped later through subsequent disposal of the weak assets. Thus the line between Federal Reserve provision of liquidity for the entire banking system and FDIC liquidity for individual banks is far from sharp.

Seen in this fundamental sense, the present FDIC insurance function is essentially only to collect insur-

ance assessments and to "work out" those banks that get into financial difficulties, supported by examination of nonmember insured banks and review of the examination reports of the other two federal supervisory agencies. Responsibility for the liquidity and continuous operation of the banking system as a whole rests ultimately with the Federal Reserve. Federal Reserve credit policy plays a far larger role in the protection of depositors' funds than can the deposit-insurance fund *per se*, even though technically only half the country's banks are members of the Federal Reserve as contrasted to 90 per cent in the FDIC.⁷ Under these circumstances, consolidation of bank-supervisory and "liquidation" functions in the Federal Reserve would be logical and realistic. Credit policy, maintenance of liquidity for the entire banking system, bank supervision, and maintenance of liquidity for individual banks facing closure shade almost imperceptibly into one another. Their separation among different agencies is arbitrary and inefficient. While the insurance fund should of course remain separate from Federal Reserve credit-policy operations, its status could be, as it is now as a practical matter on investment decisions, essentially that of a Treasury trust fund, comparable to the social-security trust funds, set aside for future beneficiaries.⁸

⁷ Although about 85 per cent of all insured deposits are held by member banks. Insured nonmember banks are mainly small banks.

⁸ While the insurance fund might logically be made merely a trust fund in the Treasury, its somewhat special status and potential liability to complex lawsuits over the rights of different creditors in closed banks might provide justification for maintaining it as a special separate Federal Deposit Insurance Fund, or Corporation, governed

The Problem of Bank Liquidation

At first glance, the case for unifying the function of liquidating closed banks with the rest of bank supervision seems obvious. On the other hand, a reasonable argument can be made that liquidation might be most effectively handled by the agency whose funds are at stake—namely the FDIC or the trust handling the insurance funds. But there are serious objections to this arrangement. An FDIC or trust reduced to primarily insurance operations would be ill-prepared to handle extensive liquidation activities. Second, bank liquidation has become largely the job of *preventing* failures through merger or purchase of assets, rather than of liquidating assets after banks have closed. Thus the closest working liaison between bank “supervisors” and “liquidators” is essential in handling weakened banks. Third, liquidation is ordinarily a minor function that requires only a small staff. The small staff required for ordinary liquidation work would be grossly inadequate in a serious crisis. By combining supervision and liquidation in the same agency, flexibility between the staffs could partially obviate the necessity for a standby liquidation staff at the same time that it assured intimate cooperation between supervisory and liquidation activities.

by a board of trustees or a board of directors. In this case, the governing board might appropriately consist of the secretary of the Treasury, the chairman of the Federal Reserve Board, and possibly one full-time member appointed by the president to be executive director of the Insurance Fund or Corporation, if there were enough work for a full-time major executive.

On balance, there is much to be said for consolidating liquidation with other supervisory activities in the Federal Reserve, or in a new expanded Treasury banking-monetary unit. Here, as with examinations, the need to avoid measures that will intensify economic instability needs to be given careful consideration. Endeavors to liquidate assets of closed banks in periods of low income and employment could only make things worse for everyone concerned. Liquidation of any substantial volume of frozen assets cannot avoid having important effects on national income, employment, and prices. The agency charged with liquidation responsibilities should be keenly aware of the need for counter-cyclical, or at least non-cycle-intensifying, exercise of this authority.

Still more fundamentally, the question can be raised whether all domestic liquidation activities of the government (housing, veterans' loans, banking, and so forth) should be consolidated in one agency. If, as is unfortunately possible, the government ever takes over in some future recession a large volume of assets (houses, businesses, agricultural commodities, and so forth) on which it has advanced or guaranteed credit, the impact of liquidation policy on the economy could be enormous. Complete consolidation of liquidation responsibility is not practical now; probably it never will be because of the important links between operating and liquidation responsibilities in the various fields of housing, agriculture, banking, and so forth, and it may not be desirable for the same reasons. But the need to assure that liquidation policies are at least

reasonably consistent with countercyclical considerations calls for coordinated policy-making; it might be construed to point toward moving individual liquidation functions to some central point (probably the Treasury) as possibilities arise.

Appendices

APPENDIX I

Statutory Responsibilities and Powers of Board of Governors

The following list of the main statutory responsibilities and powers of the Board of Governors of the Federal Reserve System is arranged by major functions rather than in the order in which they appear in the Federal Reserve Act and other legislation. Many of the board's powers and responsibilities specified by the act concern the board's control over the operations of the Federal Reserve banks;¹ these are not included *per se* in the present list. Although most of the operations of the system are carried out by the Reserve banks, the list refers directly to the ultimate locus of responsibility where it is in the board (for example, member-bank examinations are conducted by the Reserve banks under the direction of the board and are included in the list of board responsibilities). Statutory references are to the Federal Reserve Act unless otherwise specified.

I. *Regulation of the total supply and cost of credit, primarily through regulation of the volume of commercial bank reserves:*²

A. To prescribe reserve requirements against deposits held by member banks, within the range specified

¹Sec. 11 of the act lists many of these powers, including the power "To exercise general supervision over said Reserve Banks."

²Control of one major credit instrument—open-market operations in government securities, other securities, commercial paper, or gold—is vested in the Federal Open-Market Committee, on which all board members serve (Secs. 12B and 14).

- by the act, and to prescribe the methods of computing reserve requirements (Sec. 19).
1. To classify member banks as central reserve or reserve city banks for purposes of computing reserve requirements (Sec. 11e).
 2. To suspend temporarily reserve requirements against member-bank deposits (Sec. 11c).³
- B. To regulate the rediscount and advance policies of the Reserve banks, including the interest rates charged on discounts and advances (Sec. 4 (8), Sec. 12m, Sec. 13 and Sec. 14 (d)).
1. Discounts of commercial, industrial, and agricultural paper and acceptances for member banks (Sec. 13 (2) and (6), Sec. 13a, and Sec. 13 (b)).
 2. Discounts for individuals, partnerships, and cooperations (Sec. 13 (3)).
 3. Advances to member banks on promissory notes secured by government securities (Sec. 13 (8)) or other satisfactory security (Sec. 10b).
 4. Advances on unsecured promissory notes of groups of five or more member banks (Sec. 10a).
 5. Discounts for Government corporations (RFC Act. Sec. 9; Agricultural Credit Corporation Act of July 21, 1932, Sec. 201e; Farm Loan Act of July 17, 1916, Sec. 202).
- C. To suspend member banks from the credit facilities of the system for lending inconsistent with "maintenance of sound credit conditions" (Sec. 4 (8)).

³This provision of the act also gives the board power to suspend temporarily the statutory gold requirements against Federal Reserve notes issued by the Reserve banks and against deposits at the Reserve banks, but requires that the board impose a special tax against the reserve deficiency in such cases.

1. To remove officers or directors of member banks which continue unsafe or unsound banking practices after being warned by the Federal Reserve or comptroller (Banking Act of 1933, Sec. 30).
- II. *Regulation of the use to which bank credit is put (selective controls):*⁴
- A. To prescribe cash margin requirements for trading on national securities exchanges to prevent excessive use of credit in such trading (SEC Act of 1934, Sec. 7), and to make such rules and regulations as are necessary to carry out the purposes of the act (SEC Act, Sec. 3b and Sec. 23a).
 - B. To influence the types of loans made by member banks (see IB and IC above, and III below).
- III. *Supervision of member banks and others:*
- A. To issue regulations as required by the discharge of its responsibilities (Sec. 11i).⁵
 - B. To establish conditions of membership in the system (Sec. 9).⁶
 - C. To examine and require reports from:

⁴The Board's power to regulate consumer credit rested on Executive Order No. 8843, dated Aug. 9, 1941; it lapsed on Nov. 1, 1947, in accordance with a joint resolution of Congress passed on Aug. 8, 1947, was temporarily reinstated in 1948, and lapsed again in 1949.

⁵There are forty-six specific authorizations in the Federal Reserve Act for the board to issue regulations, including the general proviso indicated in Sec. 11i. Regulations so far issued are listed in Appendix IV. A complete list of the statutory authorizations was compiled as Appendix A to Monograph 9 of the Attorney General's Committee on Administrative Procedure, Senate Doc. 186, 76th Congress, 3rd Session (1940).

⁶Since all national banks are by law member banks, this includes in effect joint responsibility with the comptroller of the currency in the chartering of new national banks.

1. Member banks (Secs. 9 and 11).
 2. Holding-company affiliates of member banks (Secs. 9 and 21, and Banking Act of 1933, Sec. 2).
 3. Security brokers and dealers and all banks (SEC Act, Sec. 17b).
 4. Foreign branches of national banks (Sec. 25).
 5. Foreign banking corporations (Sec. 25 (a)).
 - D. To limit the rate of interest paid by member banks on time deposits (Sec. 19 (13)).
 - E. To suspend member banks from credit facilities of the system (Sec. 4 (8)), to remove member bank officers and directors (Banking Act of 1933, Sec. 2), and to expel member banks from membership (Sec. 9 (8)).
 - F. To grant permits to national banks to exercise trust powers (Sec. 11 (k)).
 - G. To grant permits to United States corporations to engage in banking abroad (Sec. 25a).
 - H. To grant permits to vote stock in holding-company affiliates of member banks (Banking Act of 1933, Sec. 2).
 - I. To enforce the provisions of the Clayton Act against banks, banking associations, and trust companies (Clayton Act of 1914, Secs. 8 and 11).
 - J. To grant permits where desirable for interlocking directorates between member banks and securities companies (Banking Act of 1933, Sec. 32).
- IV. *Direct loans to business concerns:*⁷
- A. To make short-term working capital loans to established business enterprises under exceptional

⁷ The Federal Reserve's power to guarantee loans to war contractors rested on Executive Order No. 9112, dated March 26, 1942; although it was interpreted to cover "termination" loans as well, its applicability has now lapsed.

circumstances where they cannot obtain credit through ordinary channels (Sec. 13b).

V. *Service functions:*

- A. To issue Federal Reserve notes against security prescribed by the act (Sec. 16, Sec. 10 (8), and Sec. 11 (d)).
- B. To provide an interregional clearing and collection mechanism for checks and to facilitate interregional payments (Sec. 13 (1) and Sec. 16 (14), (15), and (16)).
- C. To hold reserves of member banks (Sec. 19 (2)).
- D. To act as fiscal agent for the United States government (Sec. 15).

APPENDIX II

Organization of the Board of Governors

The staff of the Board of Governors at the beginning of 1949 was organized into seven major divisions, the head of each of which carried major staff rank of rough equivalence. Federal Reserve personnel are not under Civil Service, but the board has its own personnel system which operates along very much the same lines as does Civil Service. Regular staff members have essentially permanent appointments, as under Civil Service, and the influence of "politics" in the selection of staff members has been negligible. The staff totaled about 525 at the end of 1949.

OFFICE OF THE SECRETARY

The secretary of the Board, handling the Office of the Secretary, serves as chief administrative officer of the board. To some extent he acts as its general manager. On the other hand, the chief of each division reports directly to the board, and the role of the secretary as chief administrative officer is exercised with considerable informality.

DIVISION OF RESEARCH AND STATISTICS

It is the Division of Research and Statistics which is primarily concerned with the formation of credit policy. This division contains some 160 persons, about 30 per cent of the board's total staff.¹ Of these, about 100 are of professional rank. These employees are primarily economists and statis-

¹ As of early 1949. Other personnel figures are for the same date.

ticians; they are generally agreed to be objective and competent. The division keeps the board informed of the entire range of economic developments by statistical and other economic data and analyses. These cover developments in production and distribution of commodities, employment, income, expenditures, savings, and the course of prices, as well as in the banking and financial field here and abroad. The division is responsible for making policy suggestions and recommendations as well as for preparing the factual data upon which the board makes its determinations.

In addition to its staff work for the board and the Open-Market Committee, the division prepares a large volume of factual data and analyses for publication in the board's *Federal Reserve Bulletin* and its annual reports. It works closely with the research departments of the twelve Federal Reserve banks and with other policy advisers in the executive branch of the government (for example, the Council of Economic Advisers).

DIVISION OF EXAMINATIONS

The board is charged with the duty of examining the twelve Federal Reserve banks, and the twenty-four branches, and it does so as required by law through the Division of Examinations. The actual work of examining member banks is delegated to the Reserve banks. For reasons explained in the text, the Federal Reserve actually examines only about 2,000 state member banks, under an arrangement whereby the comptroller of the currency examines national member banks and makes his examination reports available for joint use. The Division of Examinations thus, in practice, carries out the following major functions:

1. Examines the Federal Reserve banks;

2. Analyses, for the board, requests for membership in the system, consolidations and mergers, requests of holding-company affiliates for voting permits, and requests of national banks to exercise trust powers;
3. Reviews reports on the examination of member banks, holding company affiliates, and other organizations for which the board has supervisory responsibility;
4. Makes recommendations to the board regarding supervisory policies and procedures, and maintains liaison with other federal supervisory agencies in this connection.

The division's staff consists of 30 professional examiners for the first function listed, and 12 professional examiners for the other three functions.

DIVISION OF BANK OPERATIONS

The Division of Bank Operations handles matters coming before the board relating to the operations of the Federal Reserve banks, and to the condition and expense reports of member banks. Since the board has relatively little *direct* contact with the operations of the banking system, its bank operations staff is primarily concerned with collecting and analyzing data reported to the board on the operations of the Reserve banks and of member banks; with attention to the related data on nonmember banks and related quasi-banking institutions; with reviewing the budgets of the Reserve banks; and with supervising the system's currency, check-clearing, and other similar operations.

LEGAL DIVISION

The Legal Division, headed by a general counsel and including ten attorneys, advises and assists the board on all

legal matters arising in the conduct of its business. Working in cooperation with other portions of the board's staff and other related parties, it prepares regulations, rulings, orders, opinions, and other documents of a legal or semi-legal character. It handles any litigation involving the board. It also prepares drafts of proposed changes in the law and keeps the board informed with respect to all legislative developments.

While the Legal Division is intimately connected with many phases of the board's work, it occupies a less dominant position than similar divisions in most of the government's so-called independent commissions because the board's major policy decisions do not involve primarily legal questions. Decisions on open-market operations, changes in reserve requirements, changes in margin requirements, and so forth must be determined on essentially economic grounds, where the Division of Research and Statistics plays the major role. Primary Legal Division responsibility arises in the handling of legislative matters and of those phases of credit policy and supervision that involve detailed controls through changing board regulations.²

²The other two Divisions are those of Administrative Services and of Personnel Administration.

APPENDIX III

Preparation of Regulation U by Board of Governors

Under the Securities and Exchange Commission Act of 1934, responsibility was vested in the board to establish margin requirements on security transactions on listed exchanges. The act prescribed certain initial requirements that would prevail until issuance of specific regulations by the board, but placed the general responsibility for establishing margin requirements on the board. In carrying out the act, the board was faced with the problem of regulating both banks and nonbanking individuals and businesses lending on or dealing in securities. It issued Regulation T (which covers loans by brokers and dealers) in 1934, as prescribed by the law. But because the general directives contained in the law for brokers and dealers could not be applied directly to bank lenders, more time was taken to formulate Regulation U, which relates to loans by any member or nonmember bank for the purpose of purchasing or carrying listed stocks. The board has described in detail the stages observed in preparing its Regulation U at that time. This description is as follows:

“(1) The staff, by direction of the Board, did a considerable amount of preliminary work on the legal and other problems involved in Regulation U, based in part on the Board’s experience with Regulation T

(which governs loans by brokers), and during the course of this preliminary work informal discussions were held with members of the staffs of certain Federal Reserve Banks and with operating officers of member banks;

“(2) A series of tentative drafts of the regulation were prepared and discussed until one was obtained that was considered good enough to submit to outsiders;

“(3) This tentative draft was then sent to all of the Federal Reserve Banks, which were requested both to forward their own comments and criticisms and to submit copies of the draft, for comment and suggestion, to member and non-member banks, representatives of securities exchanges, and other interested persons—and at the same time copies of the draft were forwarded by the Board to the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Secretary of the Treasury, and the president of the American Bankers Association;

“(4) Suggestions received from all of these sources, including special committees appointed by clearing-house associations in several different parts of the country, and a special committee of the American Bankers Association, were assembled, analyzed and digested;

“(5) Members of the Board and members of the Board's staff met with the special committee of the American Bankers Association to discuss the problems involved in the proposed regulation—and other discussions were held with individual bankers and groups of bankers with reference to particular prob-

lems, while close contact was maintained with the Securities and Exchange Commission and other interested governmental agencies;

“(6) A revised draft was then prepared in the light of the various suggestions and discussions;

“(7) Members of the committee of the American Bankers Association discussed this draft at a second meeting with members of the Board and the staff;

“(8) The Board, after careful consideration of the revised draft and the comments which had been received, and after making certain modifications, adopted the regulation to become effective about thirty days after adoption.

“The object of such elaborate procedure is not only to prevent the hasty promulgation of regulations but also to enable the Board to assure itself that its regulations, in addition to being effective, will be reasonable and workable from the point of view of the persons who are to be governed by them.”¹

¹ *Banking Studies*, pp. 362-63.

APPENDIX IV

Regulations of Board of Governors

(As of December 31, 1948)

- REGULATION A—Discounts for and Advances to Member Banks by Federal Reserve Banks. 1914.
- REGULATION B—Open Market Purchases of Bills of Exchange, Trade Acceptances, and Bankers' Acceptances under Section 14. 1915.
- REGULATION C—Acceptance by Member Banks of Drafts and Bills of Exchange. 1915.
- REGULATION D—Reserves of Member Banks. 1914.
- REGULATION E—Purchase of Warrants. 1915.
- REGULATION F—Trust Powers of National Banks. 1915.
- REGULATION G—Collection of Non-cash Items. 1940.
- REGULATION H—Membership of State Banking Institutions in the Federal Reserve System. 1914-15.
- REGULATION I—Increase or Decrease of Capital Stock of Federal Reserve Banks and Cancellation of Old and Issue of New Stock Certificates. 1914-15.
- REGULATION J—Check Clearing and Collection. 1915-16.
- REGULATION K—Banking Corporations Authorized to Do Foreign Banking Business under the Terms of Section 25 (a) of the Federal Reserve Act. 1920.
- REGULATION L—Interlocking Bank Directorates under the Clayton Act. 1916.
- REGULATION M—Foreign Branches of National Banks and of Corporations Organized under the Provisions of Section 25 (a) of the Federal Reserve Act. 1937.

REGULATION N—Relations with Foreign Banks and Bankers. 1933.

REGULATION O—Loans to Executive Officers of Member Banks. 1936.

REGULATION P—Holding Company Affiliates — Voting Permits. 1933.

REGULATION Q—Payment of Interest on Deposits. 1933.

REGULATION R—Relationships with Dealers in Securities under Section 32 of the Banking Act of 1933. 1933.

REGULATION S—Discounts, Purchases, Loans, and Commitments by Federal Reserve Banks to Provide Working Capital for Established Industrial or Commercial Businesses. 1934.

REGULATION T—Extension and Maintenance of Credit by Brokers, Dealers, and Members of National Securities Exchanges. 1934.

REGULATION U—Loans by Banks for the Purpose of Purchasing or Carrying Stocks Registered on a National Securities Exchange. 1936.

REGULATION V—Financing of War Production and War Contract Termination. 1942.

REGULATION W—Consumer Credit. 1941.

APPENDIX V

Members of the Federal Reserve Board

A. *Members of Federal Reserve Board, 1914-49¹*

MEMBERS (<i>in order of appointment</i>)	AGE AT APPOINT- MENT	LENGTH OF SERVICE	AGE AT DEPAR- TURE	CAUSE OF SEPARA- TION	BACK- GROUND	PREVIOUS GOVERNMENT SERVICE	RE- APPOINTED	STATE
Charles Hamlin	52	22 (yrs)	74	Term exp.	Law	Major fed. office	Yes	Mass.
Frederic A. Delano	50	4	54	Resigned	Railroad	Minor fed. service	No	Ill.
Paul Warburg	46	4	50	Term exp.	Banking	"	No	N. Y.
W. P. C. Harding ^a	50	8	58	Term exp. ⁴	Banking	No	No	Ala.
Adolph C. Miller	48	22	70	Term exp.	Economics	Major fed. office	Yes	Calif.
Albert Straus	54	2	56	Resigned	Banking	No	No	N. Y.
Henry Moehlenpach	52	1	53	Term exp.	Banking	No record	No	Wis.
Edmund Platt	55	10	65	Resigned	Editor	Congress	No	N. Y.
D. C. Wills	48	1	49	Term exp.	Banking	Fed. Res. Bk. chm.	No	Ohio
John R. Mitchell	53	2	55	Resigned	Banking	No record	No	Minn.
Milo D. Campbell	72	1 wk.	72	Died	Agriculture	State office	No	Mich.
D. R. Crissinger ^a	62	6	68	Resigned	Law	Minor fed. service	No	Ohio
George James Edward Cunning- ham	56	13	69	Term exp.	Business	Minor fed. service	No	Tenn.
Roy Young ^a	53	7	60	Died	Agriculture	State leg.	No	Iowa
	45	3	48	Resigned ⁴	Banking	No	No	Minn.

MEMBERS (in order of appointment)	AGE AT APPOINT- MENT	LENGTH OF SERVICE	AGE AT DEPAR- TURE	CAUSE OF SEPARA- TION	BACK- GROUND	PREVIOUS GOVERNMENT SERVICE	RE- APPOINTED	STATE
Eugene Meyer ^a	54	3	57	Resigned	Business	Major fed. office	No	N. Y.
Wayland Magee	49	2	51	Term exp.	Agriculture	Fed. Res. Bk. dir.	No	Neb.
Eugene Black	60	1	61	Resigned ^s	Banking	Fed. Res. Bk. gov.	No	Ga.
J. J. Thomas	64	3	67	Term exp.	Law	Loc. off.	No	Neb.
M. S. Szymczak	38	15	—	Still ser.	Professor	" "	Yes	Ill.
Marriner S. Eccles ³	44	14	—	Still ser.	Banking	Minor fed. service	Yes	Utah
Ronald Ransom	54	11	65	Died	Law	No	Yes	Ga.
John A. Broderick	54	1	55	Resigned	Banking	Bk. supervision	No	N. Y.
John McKee	44	10	54	Term exp.	Banking	"	Yes	Ohio
Ralph Morrison	53	5 mo.	53	Resigned	Business	No	No	Texas
Chester C. Davis	48	5	53	Resigned ^o	Agriculture	Major fed. office	No	Md.
Ernest Draper	52	10	—	Still ser.	Business	Major fed. office	Yes	Conn.
R. M. Evans	51	6	—	Still ser.	Agriculture	"	No	Va.
James K. Vardaman	51	3	—	Still ser.	Banking	No	No	Miss.
Lawrence Clayton	55	2	—	Still ser.	Banking	Fed. Res. Bd. staff	No	Mass.
Thomas B. McCabe ⁴	54	1	—	Still ser.	Business	Major fed. office	No	Pa.

B. Detailed Background of Current Board Members and All Chairmen¹

HAMLIN, Charles Summer: Member of the Board of Governors, 1914-36; Chairman of the Board, 1914-16; Special Counsel to the Board, 1936-38. Born in Boston, 1861. LL.B., Harvard, 1886. Law practice in Boston 1886-93 and 1898-1913. Assistant Secretary of the Treasury, 1893-97 and 1913-14. Member, executive committee, Indianapolis Monetary Convention, 1899. Industrial arbiter, 1907-1912. Died, 1938.

HARDING, William P. Gould: Member of the Board of Governors, 1913-23; Chairman of the Board, 1916-23. Born in Alabama, 1864. A.M., University of Alabama, 1881. Starting as a bank clerk in 1882, became president of the First National Bank of Birmingham, 1902-14. Managing director, War Finance Corporation 1918-19. President of Federal Reserve Bank of Boston, 1923-30. Died, 1930.

CRISSINGER, Daniel Richard: Chairman of the Board of Governors, 1923-27 (resigned). Born in Ohio, 1860. LL.B., University of Cincinnati, 1886. Prosecuting attorney, city solicitor, and president of national bank (1920) in Marion, Ohio. Comptroller of the Currency, 1921-23. Died, 1942.

YOUNG, Roy Archibald: Chairman of the Board of Governors, 1927-30. Born in Michigan, 1882. High School education. Starting as bank messenger, became vice-president of national bank (Michigan), 1913-17. President of the Minneapolis Federal Reserve Bank, 1919. President of the Boston Federal Reserve Bank, 1930-42. Now president of the Merchants National Bank of Boston.

MEYER, Eugene: Chairman of the Board of Governors, 1930-33. Born in Los Angeles, 1875, A.B., Yale, 1895.

Head of own firm and director of many corporations, 1901-17. Director of War Finance Corporation (later managing director), 1918-20, 1921-26. Member (later Commissioner) of Federal Farm Loan Board, 1927-29. Chairman of the Board, Reconstruction Finance Corporation, 1933. Editor and publisher, 1933-46. President, International Bank for Reconstruction and Development, 1946. Now newspaper publisher.

BLACK, Eugene Robert: Chairman of the Board of Governors, 1933-34. Born in Atlanta, attended University of Georgia. Law practice in Atlanta. President of the Atlanta Federal Reserve Bank. Died in 1934.

SYZMCZAK, Mene Stephen: Member of the Board of Governors since 1933. Born in Chicago, 1894. A.M., DePaul University, 1918. Instructor (later professor) in mathematics, history and economics at DePaul, 1916-33. Organizer and director of building and loan association, 1925-28. Vice-president and director of several state banks, 1929-31. City Comptroller of Chicago, 1931-33. Minister to Belgian Government-in-exile, 1944. Branch chief and later director, Economics Division, OMGUS, 1946-47.

ECCLES, Marriner Stoddard: Member of the Board of Governors since 1934; Chairman of the Board, 1934-48. Born in Utah, 1890. Student at Brigham Young College, 1905-09. Organizer and general manager of family investment holding company, 1916-29, and now president. President of national bank (Ogden), 1920-26; president of First Security Corporation, operating branch banks in three states, 1928-34. Assistant to Secretary of the Treasury, 1934.

DRAPER, Ernest Gallaudet: Member of the Board of Governors since 1938. Born in Washington, 1885. B.A., Am-

- herst College, 1906. Associated with chemical and food products firms, 1906-35. Member, New York State Commission on Unemployment, 1930-35. Member of National Labor Board, 1934. Member, Executive Committee on Commercial Policy, 1936-38. Member, Business Advisory Council, 1935; Assistant Secretary of Commerce, 1935-38. Member, President's Committee on Crop Insurance, 1936.
- EVANS, Rudolph Martin: Member of the Board of Governors since 1942. Born in Iowa, 1890. B.S., Iowa State College, 1913. Civil engineer and cattleraiser, 1916-33. Special assistant to Secretary of Agriculture, 1936-38; Administrator of AAA, 1938-42.
- VARDAMAN, James Kimble: Member of the Board of Governors since 1946. Born in Mississippi, 1894. LL.B. in Mississippi, 1914. Service in Army (1917-19) and Navy (1939-45); Naval Aide to the President, 1945. Former regional director, Reconstruction Finance Corporation. Former vice-president, First National Bank; and president, Tower Grove National Bank of St. Louis.
- CLAYTON, Lawrence: Member of the Board of Governors since 1947. Born in Salt Lake City, 1891. LL.B. Harvard, 1917. Service in Army, 1917-19. Associated with First National Bank of Ogden, 1924-34; vice-president, 1931-34. Assistant to Chairman of the Federal Reserve Board, 1934-45. President, Clayton Securities Corporation of Boston, 1945-47.
- MCCABE, Thomas Bayard: Chairman of the Board of Governors since April, 1948. Born in Maryland, 1893. A.B., Swarthmore, 1915. Associated with paper company since 1916, president since 1927. Director of Philadelphia Federal Reserve Bank, 1937-48; chairman of the board, 1939-48. Member of Business Advisory Council, Depart-

ment of Commerce, 1940-45; chairman, 1944-45. Deputy Lend-Lease Administrator, 1941-42. Army-Navy Liquidation Commissioner, 1945; Foreign Liquidation Commissioner, 1945-46.

¹ Excludes *ex officio* members; Secretary of Treasury and Comptroller of Currency served *ex officio* 1914-36. Data furnished by Board of Governors. A comparable summary of the members of the other so-called independent regulatory commissions up to 1936 is given in the appendix to E. P. Herring, *Federal Commissioners* (Harvard University Press, Cambridge, 1936). In Part B, all chief officials of the Board are referred to as "Chairman."

² Governor of Federal Reserve Board (title 1914-36).

³ Chairman, Board of Governors (title 1936-present).

⁴ Became Governor of Boston Federal Reserve Bank.

⁵ Returned to become Governor of Atlanta Federal Reserve Bank, from which position he was in effect on leave for 1 year.

⁶ Became President, St. Louis Federal Reserve Bank.

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