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Federal reserve control of bank credit

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BOSTON UNIVERSITY

College of Business Administration

THESIS

Federal Reserve Control of Bank Credit

by

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Federal Reserve Control of Bank Credit

I. Introduction

Bank credit, in such a highly developed economy as there exists in the United States today, is of utmost importance to everyone; the greater or lesser availability of money for spending is one of the major determinants of the entire level of economic activity and thus of whether we have inflation or depression.* Credit and its investment potential constitute a very dynamic force in the economic fiber of the nation.

However, the idea of bank credit, its construction, and administration is to many but a nebulous concept. Further, any discussion into its regulation only delves further into the abstract realms of economic theory. This should not be, and is not true; and since bank credit does constitute such a vital factor in our economy, and since it does concern so many both directly and indirectly, a study of bank credit and the Federal Reserve's policy is both timely, practical, and important.

Bank credit is a very potent instrument; it may be either a blessing or a curse, depending upon the way it is used. It is far from a passive element in the economy, contrary to what some may think; but it is, rather, a vital force upon which the prosperity of the nation is inextricably dependent. The concept of credit policy is an old one in the history of European banking, but is comparatively new in the United States.** With the organization of the Federal Reserve System in 1913,

* 3, pp. 29

** 1, p. 3

the first true credit policy was instituted in this country; and in the nearly two score years since its inception, the Federal Reserve has operated under many different conditions. One of the main duties of the Reserve authorities has been the maintenance of monetary and credit conditions favorable to sound business activity in all fields--agricultural, industrial, and commercial.* Therefore, it can be seen that the Federal Reserve control of bank credit through its several facilities is a very vital and current issue.

A good deal of material has been written on the subject of Federal Reserve control of bank credit; however it has never been limited to a strict consideration of the problem, nor will such be the case here. For it touches on too many issues, it being such a fundamental objective of the system, to be so restricted. Instead, this paper intends to touch on several ramifications of the subject which are of particular importance at the present time, especially the issue of Federal Reserve independence which is being challenged. The United States, along with the rest of the world, has witnessed a period of great change in the past ten years; it has not been restricted to the physical alone, but the thinking and perspective of many people have also undergone considerable alteration. In the light of this, it is well to reconsider such a vital issue as this and to explore its potentials and its problems.

* 8, p. 23

II. Early History

In order to study the problem of the Federal Reserve's control of the commercial credit in the United States, a brief sketch of American banking history and in particular the Federal Reserve System, is imperative. American banking, although it is comparatively young, has taken on many forms through the years; it has run the gamut from almost complete government control and supervision to periods characterized by an almost total lack of the same.

The first bank, in any modern sense of the word, was the Bank of North America, established in Philadelphia in 1782. Prior to this, banking functions were carried on in an informal manner by merchants and colonial governments. The Bank of North America and subsequent institutions were only a natural outgrowth of the merchants' activities in extending short-term credit among one another and were essentially, in character, commercial banks organized for the purpose of assisting the mercantile pursuits of their organizers.

However, with the advancing frontier inland and the growing percentage of the population engaged in agricultural and industrial labor, the number of banks increased tremendously with the constant demand for credit. But, they had no choice than to lend on the customer's condition, which was for long-term credit. This precipitated a break from the previous mercantile tradition of banking, although the latter still exerted great influence in banking thought. "In early American banking, the process of extending credit resulted in an enlargement of bank note circulation and not, as at present, in an enlargement

of deposits.** Bank notes were given for the amount of the loan and these constituted the greater part of the public's means of monetary payment. "Note issue was the outstanding function of banks in the earlier periods of American banking history; the deposit function became outstanding in the later periods.***

In 1791, the Congress chartered the first Bank of the United States, which continued in operation until 1811. Again in 1816, the Congress chartered the second Bank of the United States; and again its charter was not renewed in 1836. The Federal government held stock in these banks and they acted as fiscal agents for the government. The Banks were opposed notably on the ground that the Congress had no constitutional authority to charter them; this in spite of the fact that the Second Bank of the United States was constitutionally affirmed by the Supreme Court in 1819 and again in 1824. These banks marked the first entry of the Federal Government into the banking field.

"Controversy as to the constitutionality of a bank charter granted by the Federal Government was accompanied by controversy as to the constitutionality of bank charters granted by the States.**** The argument evolved from the Constitutional prohibition against States coining money or issuing bills of credit; if the States lacked this power, it was reasoned, they could not charter banks with the power to issue notes and bills. However, by 1836 there were over 700 banks with State charters and their notes constituted the larger part of the money

* 9, p.7

** 9, p. 7

*** 9, p. 8

in circulation. Meanwhile, a great number of unincorporated banking houses sprang up; they were frequently "private" banks because of their disassociation with any form of Government, either state or federal. The Supreme Court affirmed the right of States to issue charters in 1837. They were sometimes handicapped by their inability to issue notes, by State legislation, but as a class were as reputable as incorporated institutions.

In 1829, the first measure of regulation was enacted in the state of New York--the Safety Fund Act. It required banks to maintain a fund against the redemption of notes of banks which failed; it was very similar to the deposit insurance of today but was not nearly as comprehensive. The scope of the fund was diminished by a gradual decline in note issue and a rise in private banks to whose notes the fund was not applicable. Despite this, it served as an experiment in banking control, and proved to be a forerunner of present day practice. In 1838, New York again pioneered in banking legislation with the Free Banking Act. Prior to this Act, a charter could be obtained only through an action by the legislature, giving a somewhat monopolistic position to most banks. In addition, many banks were failing to honor their notes; both conditions giving concern to the general public. The Free Banking Act authorized anyone to get a charter who complied to certain general conditions, without a legislative act; it also required that certain securities be pledged with the banking authorities of the state against their circulating notes. This served to ease the pressure on the few banks and provide for a more reliable circulating medium.

Free banking spread rapidly through many states, particularly in the West. In many instances it degenerated into an outright swindle. Therefore, the banking business fell into general disrepute and was even outlawed in several states, whereupon it became the monopoly of the state; many state laws were enacted showing a general distrust of banks. Free banking was generally retained in most states but the "freedom" was greatly curbed; the authorities now retained the power of granting charters only to responsible management and only where there was a reasonable promise of a successful operation.

The first use of bank reserves, which today constitute such a vital part of the banking system, was in 1837. The Free Banking Act of New York required that a reserve be maintained against only circulating notes. Louisiana adopted legislation in 1842 which required each bank to maintain cash assets equal to one-third of its combined note and deposit liabilities and liquid assets equal to the other two thirds.* This was a very progressive step in banking legislation and was proven in the panic of 1857, when banks in this state survived against the general trend of bank failures. In 1858, Massachusetts adopted a 15 per cent reserve as a statutory requirement making these two states the only ones with reserves required by legislation.

During the period from the institution of free banking in 1834 until the National Bank Act of 1863, bank deposits became more and more important, even to surpassing bank notes. This fact corresponds to the ever widening scope and volume of business activity which demanded an

* 9, p. 11

easier and faster method of payment between distant areas. In 1855, bank deposits permanently took the lead over bank notes and, in 1935, the power of the banks to issue notes came to an end. Along with the preponderance of bank deposits, the function of extending credit through deposits became an important factor in banking.

When the Second Bank of the United States ceased in 1836, the government was left without a fiscal agent and again was left with the problem of decentralizing its activities with the public. In 1846, the first permanent Independent Treasury System was set up. At first it was the plan to carry all government funds in their vaults; but the constant problem of transferring funds and the expense of this operation proved too much. Therefore, the use of the banks was resumed before 1860 in conjunction with the Treasury System until the advent of the Federal Reserve System in 1920.

In spite of the fading importance of bank notes as circulating media, they still retained a significant role in our monetary system. Paper currency was comprised of issues from some 1,500 private banks, operating under charters granted by several states. The National Bank Act of 1863 was enacted in an attempt to limit circulating notes to banks chartered by the Federal government and secured by Federal obligations; with this legislation the government again entered the banking field as it had when it chartered the first and second Banks of the United States. The Act aimed at bringing all banks under Federal charter by imposing a prohibitive tax on State bank note issues. This succeeded in its purpose for the most part, but some State banks which were banks of deposit only continued under State charter.

National banks remained more numerous than State banks until 1892; since then State banks have retained a large majority. The reasons for the upsurge of State banks are several. Perhaps the most important is the fact of the increasing role played by bank credit in the form of demand deposits; thus the biggest curb on State banks, the tax on note issues, was relegated to relative unimportance. Another factor was the rights granted by State charters, for they tended to be much more liberal than those under the Federal charter. In some States, a bank could gain a charter with very small amounts of capital and they could make loans which would be prohibited under a Federal charter; in other States, the banks could act as trustees and operate branch offices. Supervision, as a rule, was less stringent under State charter and, all in all, much more freedom could be gained than under a Federal charter.

About this same time, the unincorporated form of bank began to be less familiar. The advantages of limited liability, corporate regulation, and the facility of raising capital made the corporate form more attractive to organizers and gave the institution an added note of strength and responsibility in the eyes of the public.

During the first hundred years of banking in the United States, the system took on many forms. And with these forms came problems. It can be easily seen that the banking system was weak and inefficient; it had not yet taken on a stable character capable of solving the many complexities of the nation's banking and currency needs. Credit was extended carelessly and at times when it was most needed, was unavailable; it also varied in availability depending on what section of the country you were in. The currency supply tended to break down completely when

any pressure was exerted on it. Bank suspensions were common, as were panics and crises. The Independent Treasury System was inadequate and even increased the deflating and inflating affects of the Treasury's collections and payments.

These defects were widely recognized and at the turn of the century a concerted effort of constructive reforms was begun. Three principal changes were advocated. One was that branches be more generally authorized to allow large banks to maintain offices not otherwise available and extend credit at low rates. The second was that an elastic currency be adopted that would be responsive to the changes in demand. The third was that central banking facilities be established to avoid the excessive expansion and contraction of bank credit. The first of these suggestions, i.e. branch banking, was accomplished through the liberalization of both State and Federal laws and since has found its place in the banking system. The other two had to wait for the enactment of the Federal Reserve Act of 1913 before they were finally realized.

It is obvious that the greatest need was for a central banking system; 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.* There were, however, several attempts to provide for some sort of central agency to meet these requirements in the past.

The Second Bank of the United States was organized in 1817 at a time when many banks were not redeeming their circulating notes.

* 2, p. 3

Paper money was available only at varying discounts which depended on how distant the issuing bank was from the place of transaction; credit obviously was unsound. This condition impeded both business and the government. The Second Bank undertook to get the banks to redeem their notes by exerting pressure on them because of its size and its position as the government's fiscal agent. Also the correspondent relationship of banks in large cities with those in the outlying territories; balances were kept in city banks which could be drawn on for currency, for transfer, or purchases of securities. In the latter part of the nineteenth century, these balances were permitted to be counted as legal reserves by the country banks. They were used extensively in the call-loan market in New York and the volume of reserves in New York City became an index of the money market. Banks could also borrow from city correspondents when balances became low; this worked well when only a few banks needed cash, however any large amount of borrowing made the situation different. In spite of this, the city banks could not create reserve funds, and they needed the power to expand reserves; the panic of 1907 proved their inability in an emergency, when they froze the funds they had and paralyzed the money market.

Another important factor in the present development of banking was the clearing house; it was a basic need that these be able to pay any checks drawn on it immediately. It was obvious, however, that the inability to make payment might result from a condition over which they had no control--a general insufficiency of legal reserves. They took action against this condition by creating certificates, issued in

exchange for notes and other obligations, to be used in settlement in order to protect these reserves.

The Treasury also exercised great influence on American banking and at times made use of central banking powers or gave rise to them. Occasionally it would transfer funds in order to alleviate a situation for which it was not responsible, and it tried to avoid sudden transfers of cash which might give rise to a shortage in one area. After the institution of the Independent Treasury System, there was a sharp segregation of government funds from the banks. However, it grew clearer that this situation could not exist for long and the Treasury again deposited money with the banks before the Civil War and used banking facilities more and more from that time on. In spite of this, the Treasury's sudden withdrawals of cash from the monetary stream and its forced idleness in the Treasury's vaults, without reference to the need for credit funds caused serious hardships on the public and the banking system alike.

Under different Secretaries, the Treasury made more or less use of central banking powers; the chief power which was aimed at was the regulation of credit. Some use was made of the ability to buy Government bonds on the open market, but by far the more common method was the deposit or withdrawal of deposits with the banks. However, the action of the Treasury was not an official activity so there was no regularity in these actions; frequently they had to be abandoned before the results were attained because the funds were needed for other purposes.

In spite of these efforts, the solution to the problem of solidifying the American banking system was still far from solved. The banking

system 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. 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.* Neither the banks nor the Treasury was in a position nor was either empowered to act to curb this situation.

Following the severe financial crisis of the panic of 1907, Congress created the National Monetary Commission to study the problem and recommend legislation. The report of the commission in 1912 recommended that a single institution be created to perform central banking activities; this was modified to a regional system of banks supervised and co-ordinated by a central board in Washington. It also proposed centralized reserves, which history indicated as a necessity, central note issue, and central facilities for the rediscount of commercial paper to provide for reserves in times of stress. There was opposition both from the general public and from the politicians; however, in December 1913, The Federal Reserve Act was passed as a compromise measure which contained substantially the provisions noted above.

The Federal Reserve System and its members was the first concerted effort to relieve the economy of the many shortcomings evident in the many previous systems. The twelve Reserve Banks acted as depositories

* 2, p. 3

for reserve funds of member banks, whether national or state, and assumed the duties of the clearing houses. The overall policy of the System was guided by the Board of Governors in Washington; this made it possible to serve the needs of the country as a whole without disregarding the needs of each section of the country. The Federal Reserve System also acted as the fiscal agent of the government and was empowered to issue Federal Reserve Notes, which would be elastic to the demand for currency.

The Federal Reserve System since its inception has undergone change, both formal and informal; it has changed through the process of administration, interpretation, and gradual acceptance of precedents.* The Act as passed was mainly interested in the service functions of the system, i.e. pooling reserves, clearing house functions, and serving as the fiscal agent for the government. It was felt that control as such would be more or less an automatic operation, not requiring any conscious effort on the part of the authorities. The establishment of "sound" banking practices was the directive which was to create the atmosphere of general control. In the early years of the system, the problem of control did not arise; but in the latter part of the 1920's, the large role played by the New York Reserve Bank under Benjamin Strong came into focus. The New York Bank dominated the open market operations of the system, then an informal operation, and sometimes acted in opposition to other policies of the system. The problem of unified action had not been solved, and the policy of passive credit regulation was open to wide debate.

* 2, p. 9

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.* To this end, the Banking Acts of 1933 and 1935 and the Securities and Exchange Act of 1934 were passed. In general, they accomplished two major changes. First, they gave the Federal Reserve new powers over the volume of bank credit and the uses to which it could be put; this was done by according the system the power to vary reserve requirements and margin requirements, and the ability to make loans directly to business. Secondly, control over the system's credit policy was vested in the Board of Governors in an attempt to achieve unity of policy.

Since 1935, little change has come to the system, but many problems have beset it which were not recognized by its founders. The chief among these has been its relations with the Treasury, which have so recently come into wide discussion. The system has made extensive use of its powers and has, on the whole, been successful in its endeavors to promote a stable credit policy; it has seen fit to use powers which are only implicitly granted it in the statute. It regulates the supply and cost of credit through open-market operations, reserve requirements, rediscounts rates, and moral suasion; it regulates the use to which credit may be put. A study of these operations will help to clarify the

* 2, p. 12

the function of the Federal Reserve System with regard to its credit policies and permit us to gain a better picture of where the system now stands.

III. Control of Bank Credit

Efforts to regulate the supply, the availability, and the cost of money, and to some extent the way it is used in extending credit, are the direct concern of governmental monetary and banking authorities. The principal monetary function of the Federal Reserve System is to see that banks have adequate reserves to supply the public's legitimate demands for money and to restrain banks from supplying excessive demands. Through the use of monetary and credit powers that influence the volume of reserves and the cost of borrowing additional reserves, limitations may be placed on the availability and cost of money, and through the use of various supervisory powers both the availability of money and the uses to which it may be put can be influenced.*

Probably the most direct power which the Federal Reserve has to control bank credit is the ability to vary the reserve requirements of member banks. Although only about one-half of the 14,000 banks in the United States are members of the system, these banks represent about 85 per cent of all commercial bank deposits;** this authority, therefore, can be used to an effective degree. The member banks are classified into three groups: central reserve city banks (New York and Chicago); reserve city banks; and country banks. They are required to have reserves deposited with the Federal Reserve Bank equal to a stated percentage of their time and demand deposits. There are maximum and

* 9, p.334

** 2, p. 29

minimum limits within which the Board of Governors can set the percentage rate; and the rates differ for each of the three classes of banks.

The rates for demand deposits are:

	Maximum	Minimum
For central reserve city banks. .	26%	13%
For reserve city banks.	20%	10%
For country banks	14%	7%

The rates for time deposits for all classes of banks are: maximum, 6%; minimum, 3%. At the present time, the maximum rates are in force for demand deposits for reserve city and country banks; for central reserve city banks the current rate is 24%. The maximum rate is also in force for time deposits.

The use of these reserve ratios is apparent. A bank in a reserve city needs a deposit equal to only one-fifth of its demand deposits; if, for example, it had \$200,000 in excess of the required reserve, it could loan out and create deposits of \$1,000,000. It is obvious that there is great potential in the credit expansion of the banks and for this reason, the Federal Reserve System was given control over the reserve requirements of its members.

Until the Banking Act of 1935, the reserve requirements were set by statute. In an effort to concentrate the responsibility for national credit policies, the Act placed the jurisdiction of these requirements in the hands of the Board of Governors. While this power would seem, in theory at least, a substantial tool in credit control, in practice such is not the case.

Member Bank Reserve Requirements *
(% of Deposits)

Net Demand Deposits				
Effective date of change	Central Reserve City Banks	Reserve City Banks	Country Banks	Time Deposits
1917 - June	13	10	7	3
1936 - Aug. 16	19 1/2	15	10 1/2	4 1/2
1937 - March 1	22 3/4	17 1/2	12 1/4	5 1/4
May 1	26	20	14	6
1938 - April 16	22 3/4	17 1/2	12	5
1941 - Nov. 1	26	20	14	6
1942 - Aug. 20	24	--	--	-
Sept. 14	22	--	--	-
Oct. 3	20	--	--	-
1948 - Feb. 27	22	--	--	-
June 11	24	--	--	-
Sept. 16	--	--	16	7 1/2
Sept. 24	26	22	--	7 1/2
1949 - May 1	--	--	15	7
May 5	24	21	--	7
June 30	--	20	--	6
July 1	--	--	14	6
Aug. 1	--	--	13	-
Aug. 11	23 1/2	19 1/2	--	5
Aug. 16	--	--	12	5
Aug. 18	23	19	--	-
Aug. 25	22 1/2	18 1/2	--	-
Sept. 1	22	18	--	-
1951 - Jan. 11	23	19	--	6
Jan. 16	--	--	13	6
Jan. 25	24	20	--	6
Feb. 1	--	--	14	-
1952 - In effect				
Apr. 1	24	20	14	6

* Source: Federal Reserve Bulletin

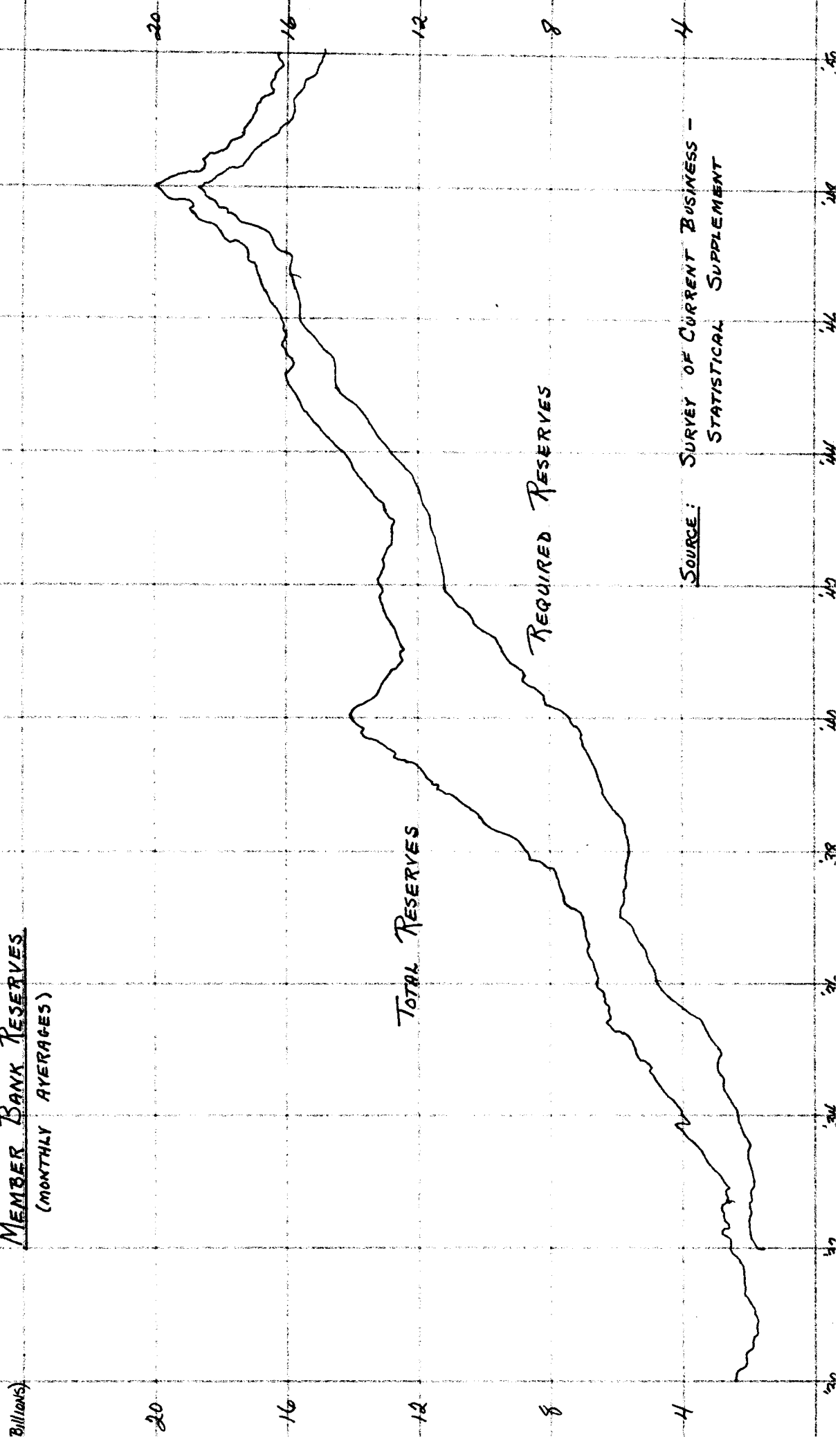
Since 1933, gold inflows and Federal Reserve - Treasury policy have combined to produce a continuous easy reserve situation.* The great inflow of gold, either from domestic production or the favorable balance of foreign trade, has made itself felt through the creation of reserve balances of member banks. These balances have consistently been in excess of the legal requirements. Another factor was the easy money policies of the Treasury necessitated by the financial crisis of 1932; this policy, jointly agreed to by the Federal Reserve, prevented any tightening of the reserve requirements or any curbing of the credit potential of the banks. With these two factors in combination, any attempt to exercise credit control through the use of reserve requirements was, as a practical matter, impossible and as an economic matter, in curbing credit expansion, unsound at that time. It is clear that at present reserve requirements do not act as an effective limitation on the expansion of bank credit and deposits. . . . It may be seen that, although bank reserve requirements provide a way of exercising an influence over expansion of bank credit, fixed and unchanging reserve requirements may not always be in accordance with economic needs. It is necessary to be able to vary the supply of reserves that banks have in excess of requirements.**

Another tool of credit policy which is closely allied with reserve requirements is the discount rate. This was to be the principal instrument of credit control intended by the framers of the Federal

* 2, p. 81

** 9, pp. 342-343

MEMBER BANK RESERVES
(MONTHLY AVERAGES)



SOURCE: SURVEY OF CURRENT BUSINESS - STATISTICAL SUPPLEMENT

FEDERAL RESERVE -

GOLD CERTIFICATE HOLDINGS
(MONTHLY AVERAGE)

Billions)

20

16

12

8

4

20

16

12

8

4

'38

'39

'40

'41

'42

'43

'44

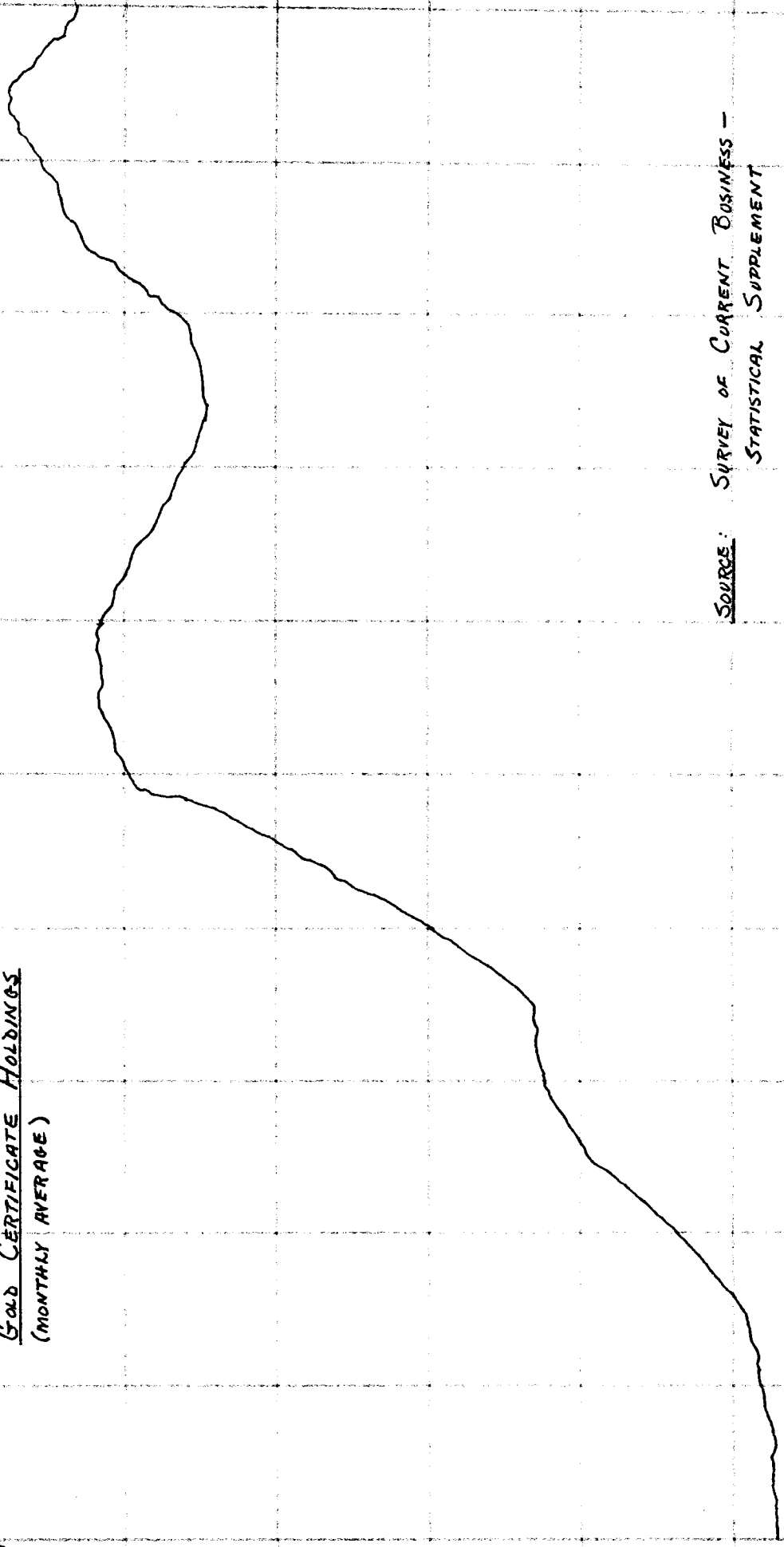
'45

'46

'48

'50

SOURCE: SURVEY OF CURRENT BUSINESS -
STATISTICAL SUPPLEMENT



Reserve Act; because when additional funds were needed by the banks, they would borrow from the Federal Reserve Bank. Therefore, the authorities would be in a position to either encourage or discourage the expansion of credit through the lowering or raising of the discount rate.

In the first years of the system's operation, changes in the discount rate were the only means of expressing credit policy. Excess reserves were not to be had and the power to regulate reserve requirements had not yet been accorded to the system. It was not until World War I that extensive use was made of this power, however. With the government selling large issues of Victory Bonds, a low rate had to be maintained to insure that enough money was available to make these issues successful. This low rate was maintained until the end of the war financing in 1919. Then the Federal Reserve authorities took steps to stop this tremendous expansion of credit and the upward spiral of prices; the discount rate was raised until it reached 7 per cent in 1920. By 1922, discounts at Federal Reserve Banks had been cut to less than one-quarter of their war-time high. With this entrenchment accomplished, the rates were then lowered until 1925 when they were then raised to try and check, to some extent at least, the terrific expansion accompanying the boom period. They hit a peak of 6 per cent in 1929 and then were drastically reduced in an effort to stimulate the depressed state of the economy. They have continued to be moderately low through the war years, again because of the terrific problem of financing it.

The discount rate, as a rule, must vary closely with the fluctuations in the rate of short-term paper, and must very closely approximate this rate. If this were not the case, then banks would go into the

open market for funds rather than the Federal Reserve Bank and thus circumvent the controlling influence of the Federal Reserve System. In recent years, the use of the discount rate as an instrument of credit control has lost much of its potency. As was the case with reserve requirements, the member banks have accumulated and have been able to maintain large excess reserves; this has made the need of borrowing funds to replenish reserves virtually non-existent. Such force as discount changes now have comes through their impact on business and banker psychology.*

A third and probably the most useful instrument of direct credit control is the open-market operations of the Federal Reserve Open-Market Committee. This committee is empowered to go into the open market and buy and sell government securities in an effort to either relax or restrict credit. If the committee buys securities, it pays for them with a check on a Reserve Bank; when this check is cleared, some member bank has additional reserves against which it can make loans. Conversely, if the committee sells securities, it receives a check on some member bank; and when the check is cleared, the member bank's reserves are depleted by the amount of the securities sold and its credit capacity is correspondingly reduced. In view of the situation with regard to reserve requirements and discount rates and the excess reserve position of member banks, open-market operations constitute the most direct control of bank credit presently in the hands of the Federal Reserve authorities.

* 2, p.81

It was not until 1922 that the Reserve Banks began buying government securities; this was done on the initiative of each individual Reserve Bank in order to supplement their earnings, which had dropped with the decline in discounts. Such independent and unorganized action by the Reserve Banks had a disorganizing influence on the government security market; furthermore, such regional activity without the guidance of an overall, national policy by the system failed to exercise any control over the nation's credit situation. It might, in fact, be injurious in some cases.

Recognition of this fact led to the organization of a System Open Market Committee consisting of five Governors of the Reserve Banks, for the purpose of co-ordinating open-market purchases. In the spring of 1923 this Committee was reorganized and a broad principle for the conduct of open-market operations was adopted.* An orderly government bond market was to be maintained and open-market operations were to take account of existing credit conditions, with a view to accommodating commerce and business. The Banking Act of 1933 took formal recognition of the Committee, as were the principles under which it should operate. The Banking Act of 1935 reformed the Committee to consist of the seven members of the Board of Governors and five representatives of the Federal Reserve Banks elected regionally. This enactment constitutes a complete recognition in law of the national significance of open-market operations and the need of national control over them.** Since New York is the principal money market in the United States, The Federal Reserve

* 9, p. 398

** 9, p. 398

Bank of New York carries out most of the system's open-market operations. Because of this fact, the New York Bank was given a permanent position on the Open-Market Committee by an amendment to the Act in 1942.

The operations of the Open-Market Committee were not very extensive until the depression of the 30's. At that time the committee instituted a policy of buying government securities in an effort to stimulate the economy; by 1938, Federal Reserve holdings totaled over two and one-half billions of dollars. Up to this time, the Federal Reserve acted in accordance with the act, i.e. it acted to maintain sound business and credit conditions. In 1937, the system agreed with the Treasury to maintain a stable government bond market and to help in the determination of interest rates. This was a voluntary agreement and was strictly extra-legal; there is no provision for such agreements in the Federal Reserve Act. This relationship was further increased during the war; with the immense problem of financing the war, the Federal Reserve further agreed with the Treasury to peg the price of government bonds towards a gradually lower interest rate. This situation prevailed even into the post-war years until March 1951, when the Federal Reserve reverted to an orderly market and stopped pegging the price of government bonds. When this occurred, the price of government bonds took a sharp drop; this proves that these actions provide an artificial influence in the market.

The Federal Reserve - Treasury relationship can be appreciated as a very important one; to have these agencies operating at odds with one another would only bring chaos to the financial system of the country. However, there must be a balance struck between them; one cannot act as

the servant of the other and still retain and live up to the purposes of its existence. More on this subject will be presented later in this paper.

While the foregoing instruments are the most direct controls of bank credit available to the Federal Reserve, it also possesses other powers with which it may exercise an influence over the credit situation. These are mainly selective controls which regulate the uses to which loanable funds can be put and affect specific groups, rather than the actual quantity of credit funds. These methods are supplementary to methods of general regulation, and their merit is that they make it possible to restrain the flow of money into certain fields at times when conditions in the economy as a whole are such as to make general restraints on the growth in the volume of money undesirable.*

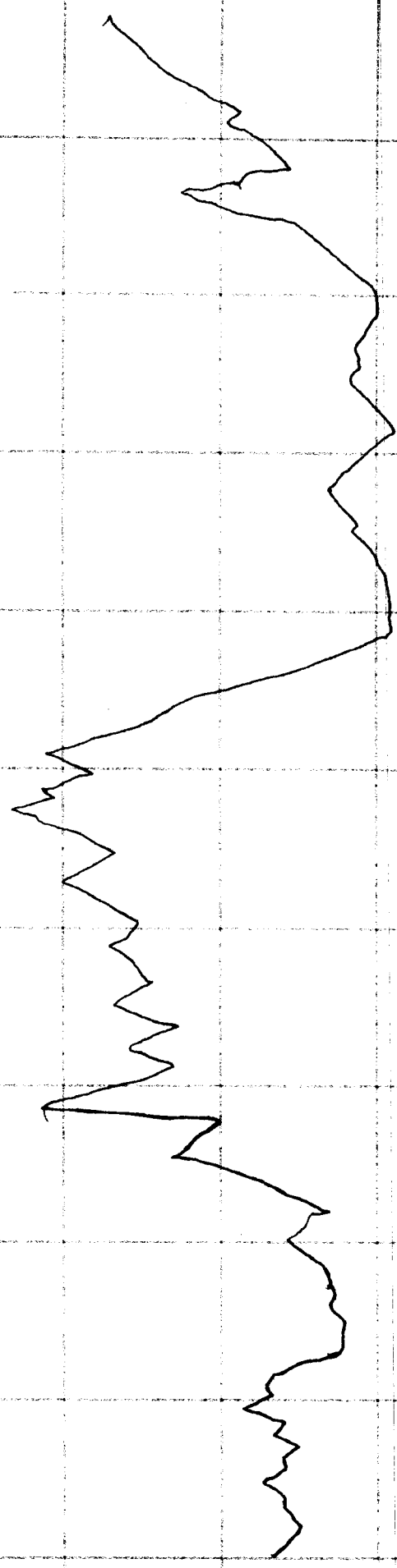
One of the first of these controls is the regulation of margin requirements; this power was given to the Federal Reserve by the Securities Act of 1934. This law directs the Board of Governors to determine the amount of collateral that shall be required on loans made by brokers and dealers for the purpose of purchasing or carrying registered securities, and authorizes the Board to make similar determination with respect to loans made by banks and other lenders and in addition to prescribe margin requirements for short sales.** For several years before World War II, the margin requirement was 40 per cent. During the war, the requirements were raised until they reached a peak in 1946 of 100 per cent; this was an effort to curb the inflationary potential which was

* 8, p. 38

** 9, p. 405

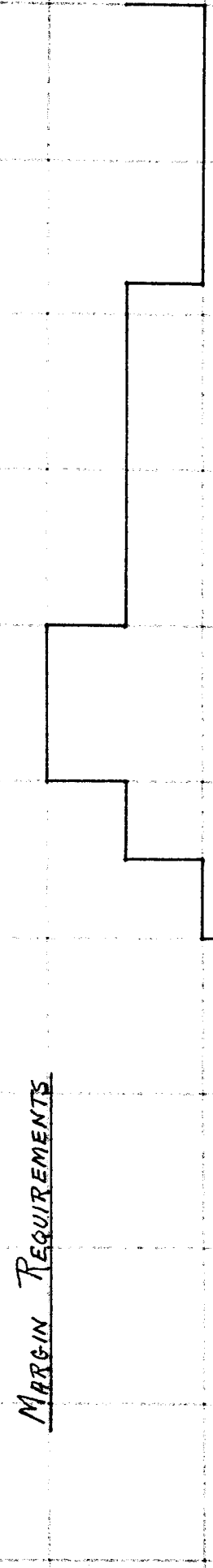
Millions

STOCK MARKET CREDIT —
MONEY BORROWED FROM BANKS



MARGIN REQUIREMENTS

SOURCE: FEDERAL RESERVE CHARTS ON MONEY RATES, BANK CREDIT, AND BUSINESS.



1000

500

0

100

50

1000

500

0

%

100

50

1929

1931

1933

1935

1937

very strong and any increase in available stock market credit would only serve to abet it. It was reduced in 1947 to 75 per cent and to 50 per cent in 1949 and back to 75 per cent in 1950. In conjunction with this, the Federal Reserve has adopted an informal limit of approximately one billion dollars on this type of credit. This instrument is effective restraining the demand for credit from the borrower's standpoint and preventing a great increase in pyramiding that can take place in a rising market. By the control of margin requirements excessive use of credit in the stock market, which has caused serious disturbances to the economy in the past, has been placed under control. The danger of a stock market boom financed by credit and followed inevitably by a disastrous collapse has been largely eliminated.* Margin requirements do not constitute a significant factor at the present time in view of the high margin requirement and the informal limit on the amount of this credit.

Another very powerful instrument in the control of credit was given to the Federal Reserve by an Executive Order of the President in 1941 directing the system to control consumer credit; this was done under the conditions issued in Regulation W of September 1941. The regulation prescribed the terms under which credit might be granted, the amount of the down-payment and the length of time for repayment; this restriction was limited to a certain number of listed items. Later the scope of the regulation was broadened to include more items and to cover charge accounts and single-payment loans. This was all done again in an effort

* 8, p. 42

Billions

14

12

10

8

6

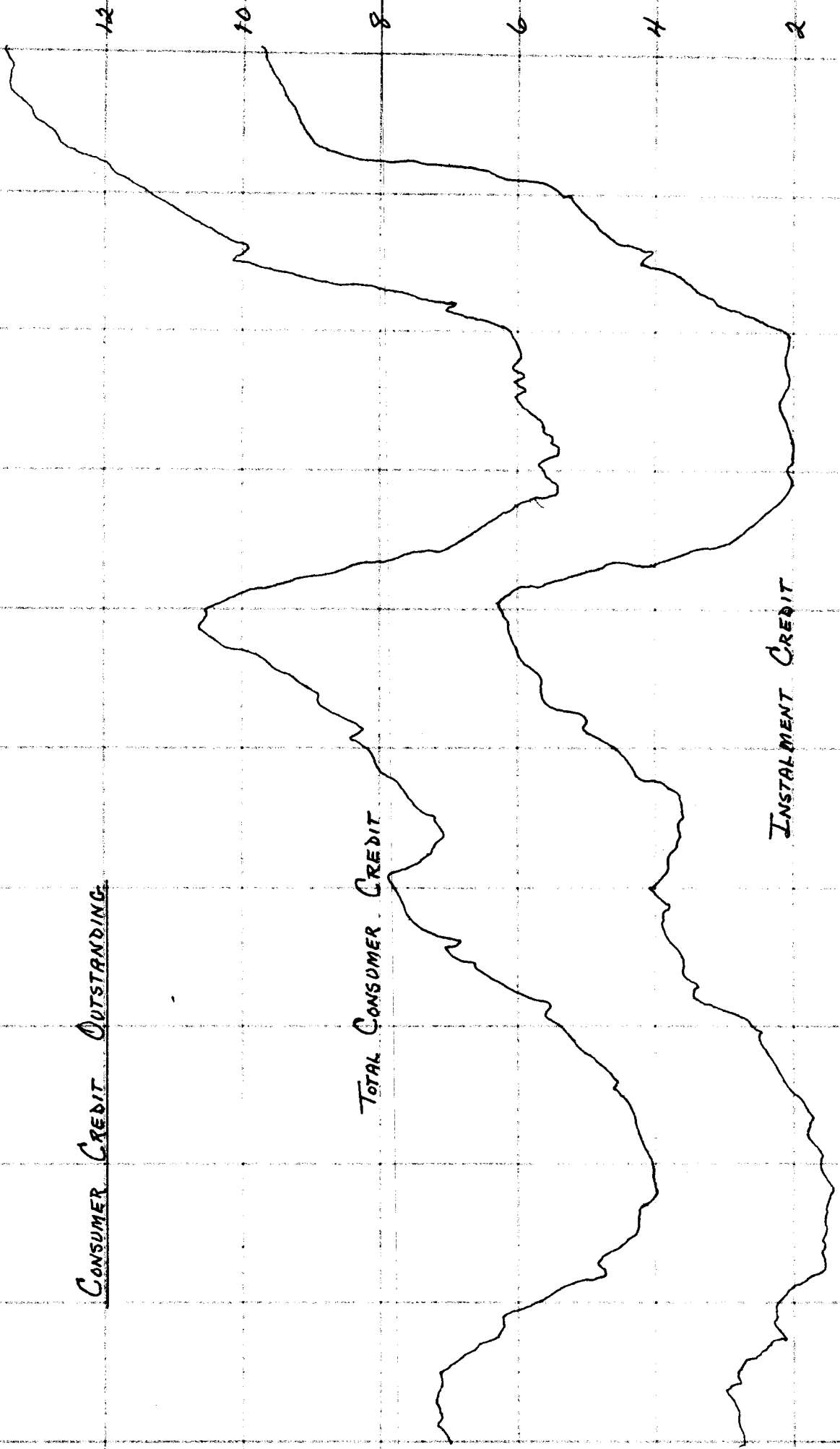
4

2

CONSUMER CREDIT OUTSTANDING

TOTAL CONSUMER CREDIT

INSTALLMENT CREDIT



SOURCE: FEDERAL RESERVE CHARTS ON CONSUMER CREDIT

to restrain the rising forces of inflation during the war years by restricting the buying power of money and encouraging savings. Any regulation of this sort is tremendously more complex than the general credit controls; it involves more detailed administrative and regulative problems and procedures.* It is not concentrated in one market and involves many and varied transactions; it affects the buying habits of the consumer directly. In spite of these considerations, regulation of consumer credit is only a temporary measure to be used only when Congress authorizes it; this in spite of the fact that it represents an extremely potent weapon with which to fight inflation and keep stable business conditions intact.

With the Federal Reserve System occupying such a prominent position in the banking structure of the country, it is in a position to influence many practices by the use of moral suasion. While this is not a formal instrument of credit policy, it deserves mention because of its very definite effect on member bank credit. The Federal Reserve can make its position and views known in many ways and member banks give a great deal of weight to these opinions. It has worked well in the last few years on curbing an extremely optimistic view on the economic situation with the attendant easy credit policies which might have been adopted by many banks. This has little to back it up as a definite instrument of policy except the supervisory powers of the Federal Reserve.

Selective instruments of national credit policy, though used in their modern form for less than fifteen years, have been developed

* 2, p.83

far enough with respect to stock market credit and consumer credit to show that such instruments can be a useful complement to the older and more general instruments--discount rates, open-market operations, and reserve requirements. They are flexible in themselves and can help to make credit policy in general more flexible. Their distinguishing characteristics are that they are applicable to parts of the economy instead of to the economy as a whole and that they can be used to restrain the demand for credit without operating, as general instruments do, through the stiffening of money rates.*

IV. Increasing Government Influence

The Federal Reserve System was created under law as an independent body, functioning under the leadership of the Board of Governors in the manner which befit its purposes. While this situation still exists today in law, as a practical matter it has to contend with problems arising from the action, or inaction, of other governmental agencies.

The most prominent agency with which the Federal Reserve must work with is, of course, the Treasury. A complete divorcement between these two bodies is both practically impossible and most undesirable. The reason for this is twofold. In the first place, a great part of the work of the Federal Reserve Banks is performed by them as fiscal agents of the Treasury; and in the second place, the Federal Reserve authorities have the responsibility of regulating credit conditions in general and particularly those in the money market, where the Treasury constantly goes to borrow money.* Further than this, the huge amount of funds which the Treasury has at its disposal could act in direct opposition to the Federal Reserve's policy if they are not handled in the correct manner. For instance, Government deposits in member banks can act to tighten credit if they are suddenly withdrawn; if this were done in a period when a relaxation of credit was needed, the Federal Reserve has no power over it. That some relationship should exist was recognized by the founders of the system and originally the Secretary of the Treasury and the Comptroller of the currency were ex officio members of the board.

* 8, p. 101

However, in 1935, they were dropped from the board in an attempt to remove it from political pressure and increase its formal independence.

This has not entirely removed the Treasury from the Federal Reserve, however; nor was it intended that it should. The two bodies consult on many matters and arrive at a decision by mutual agreement. This is best demonstrated by the Federal Reserve's action in supporting the government bond market. While this seems to be agreeable on the surface, it harbors some very deep complications. While in theory the Treasury and the Federal Reserve meet on equal terms to discuss policy, in fact the Treasury is in a position to monopolize and dictate the terms; it carries the weight of the administration behind it, as well as commanding potent forces of its own. Therefore the case has been that the Treasury has forced its decisions on the Federal Reserve, principally under the thesis that it is a time of stress and that the administration's policies must predominate. When the Federal Reserve balked recently in pegging the price of government bonds, they dropped ten points; this clearly shows the artificial factor which the Federal Reserve was forced to inject into the market when it was doing everything else in an effort to curb inflationary tendencies. In spite of the inequalities which do exist, the co-ordination of credit policy must continue to be a joint venture between the two agencies if stable policies and credit conditions are to be maintained.

Another factor of government with which the Federal Reserve System must contend is the many agencies which have been set up either to make loans directly or to guarantee loans made by other institutions.

The best known of these is the Reconstruction Finance Corporation, which is authorized to make loans to business when credit is not obtained elsewhere; its loans run into billions of dollars each year. The Farm Credit Administration has several agencies which advance agricultural credit in the farm areas. The Rural Electrification Administration makes loans to encourage the use of electricity in rural areas. The Veteran's Administration is authorized to guarantee and insure loans to veterans. The Federal Housing Administration can insure home mortgage loans received from banks and other financial institutions.* It is obvious that these agencies can increase the supply of credit funds by a tremendous amount through direct loans and can encourage a great deal of credit expansion through guaranteeing or insuring loans from other institutions. Over this great reservoir of credit the Federal Reserve has no control whatsoever. Very often the activities of these agencies may run counter to those of the Federal Reserve System. The point in question is the great credit potential in the hands of a strictly political body; and administration can almost always be assumed to have an inflation bias. Any recession or curbing of business would undoubtedly have serious repercussions come the next election. Therefore, while the Federal Reserve might be trying to curb credit in an attempt to insure sound business conditions and avoid a violent reaction after a boom period, these agencies may well be pumping credit out in an attempt to prolong and continue the prosperity. While this situation is not a necessary corollary

in such instances, the danger is still there; and the possibility of this being the case is very likely, if past history be any criterion.

The Federal Reserve System also has the Congress to deal with along with the above-mentioned parties. As it is a creature of the Congress, the System is subject to such restrictions as this body may see fit to establish for it; the Congress may amend, abolish, limit, or expand the Federal Reserve's powers at any time. In the past, direct intervention has been rather limited, the establishment and modification of consumer credit controls being the most recent and probably the most far-reaching legislation of the moment. However, the peaceful coexistence has had its bad moments and its adversaries within the Congress. At the present time, the status quo is being eyed with great concern by the Subcommittee on General Credit Control and Debt Management--better known as the Patman Committee.

Two years ago, in 1949, another Congressional subcommittee investigated monetary policy and in its report stated that the freedom of the Federal Reserve System to formulate and carry out credit policies for the purpose of stabilization should be restored. However, Representative Patman as a member of that committee dissented from the majority opinion and said that steps should be taken to increase the responsibility of the System to the executive branch of the government. Against this backdrop and the fact that the Federal Reserve System is emerging out of the war years into a position where it can in conscience take a stand on credit policies without the exigencies of the emergency situation compelling them to bow to other authority, Representative Patman heads a committee which must of its very nature investigate the situation of

the Federal Reserve's independence and make recommendations to the Congress.

There has been great interest recently on this relationship and the recent controversy, termed the "great debate," serves to point up the vital and basic nature of the Federal Reserve independence from the Executive branch of the government. After following the Treasury for many years, the Federal Reserve, early in 1951 as part of the fight against inflation, "substituted 'orderly market' for par support of government securities through a so-called 'accord' with the Treasury."* This was the first step by the Federal Reserve in its attempt to re-establish its historic independence, which it was granted in the Federal Reserve Act and which was maintained in the Banking Act of 1935. The "accord" points up the much more basic issue of independence while yet remaining a milestone in Federal Reserve activity.

The Patman Committee has begun hearings which must of necessity encompass this problem. The role which it will play in the future development of this relationship is immense. However, there are two issues which seem to be the main points. First, should the battle to keep the economy stable and the dollar sound be fought mainly with the indirect controls of credit and fiscal policy or with the panoply of price, wage, and production controls? Second, what should be the status of the Federal Reserve System? Should it be subservient to the Treasury, serving as a perpetual inflation machine? Or should it seek to be a supreme

* 5, p. 34

court of finance, balancing the legitimate needs of the Treasury against the need of holding the economy on a steady course?*

In preparation to the hearings on these questions, the committee sent questionnaires to many of the interested parties in an attempt to form a basis upon which the hearings themselves would be held and to aid in corrolating the immense amount of material which would be required in order to reach some sort of conclusion. These questions were addressed to the Secretary of the Treasury, the Chairman of the Board of the Federal Reserve System, the Chairman of the Federal Reserve Open Market Committee, the Federal Reserve Bank Presidents, the Council of Economic Advisers, and several other groups who could add informed opinion to the inquiry. These questions and the answers thereto have been collected and published by the committee. It is the purpose of this paper to examine these replies as they effect the Federal Reserve's control of bank credit and the independence of the system in carrying out such credit policies as it deems advisable.

Representative Patman outlines in the foreward to the published replies six points which he urges be explored and concentrated on by the committee. They are:

1. Economic expansion and controlling inflation.
2. Changes in the interest rates and their effects on economic expansion and inflation.
3. Special reserve devices.
4. Credit rationing other than by interest rates.

* 6, p. 184

5. New debt instruments.

6. Federal Reserve - Treasury relations.

Because of the expansiveness of the inquiry, it is not possible to cover all the points mentioned above here. However, an attempt will be made to digest varying points of view on special reserve devices and the Federal Reserve - Treasury relations.

The reply of the Secretary of the Treasury is very complete and covers the full range of Treasury activities as they affect monetary and fiscal policy. However, there are some very pertinent comments with respect to its relations with the Federal Reserve System. The question was:

What provision, if any, is there for resolving policy conflicts between the Treasury (or other agencies of the executive branch) and the Federal Reserve System? Do you believe that this power should lie with the President (or already does under the Constitution)?*

The Secretary limits the question to exclude functions of the System which are clearly within the power of Executive responsibility, such as duties delegated by the President to the System under various Acts of Congress or under the emergency powers granted the President. The Secretary then continues:

The only statutory provision dealing directly with conflicts is found in Section X of the Federal Reserve Act (12 U.S.C. 246), which provides that "wherever any power vested by this Act in the Board of Governors . . . appears to conflict with the powers of the Secretary of the Treasury, such powers shall be exercised subject to the supervision

* 10, p. 28

and control of the Secretary." This statutory provision does not, however, appear to deal with conflicts as to what constitutes appropriate public policy.[#] It has not been drawn upon, therefore, in an effort to resolve that type of conflict.* The Secretary makes note of the independence of the System from the President and of the fact that this could lead to the two agencies working to impede one another or in actual conflict. "Since the President does not have the power of removal, it would appear to me that he is without power effectively to direct."^{**} He admits that Congress could change this situation but he does not recommend that it be changed.

In the event of an impasse between the two agencies, the Secretary says that good management demands that they get together and attempt to reach an understanding. Prolonged effects on the economy, he believes, would lead to public opinion causing one side or the other to give way to a settlement; or Congress might legislate a resolution to the conflict.

"I think one of the most important steps toward providing a quick means of settling such disputes would be a public, and a congressional, recognition of the fact that it is natural, proper, and desirable for the President to seek to settle them by having all the interested parties sit around a table to discuss their differences with him. That would seem to be an almost axiomatic method of solution of a dispute."^{***}

The Secretary goes on to explain that this would not and should not involve domination or dictation but only free discussion of the respective views. He further emphasizes that the powers of the President

Emphasis mine

* 10, p. 28

** 10, p. 29

*** 10, p. 30

should not be extended beyond what he now possesses to settle such disputes, in essence none at all other than free discussion.

While this position offers no drastic change to the present situation, there is, I believe, a consideration which has not been fully developed, if at all. The Treasury is under the jurisdiction of the President, and as such, would be following Presidential directives and, in general, the policies of the administration. Disputes, when they arise, would almost certainly be bound up with administration policy as exercised through the Treasury. It seems only logical, then, that the President would hardly be in a position to approach such problems with an open mind and enter into any free discussion in any way except to back up the Treasury and attempt to reinforce its position.

The recent dispute between the Treasury and the Federal Reserve will serve as an example. The Federal Reserve, through its Open Market Committee, stopped pegging the government bond market over the strong objections of the Treasury; this resulted in the prices of government bonds declining below par. The effects will be to restrict the availability and attractiveness of credit and to attempt to install a deflationary element into the economy. However, from the Treasury's standpoint it makes the floating of new issues more difficult and adds to the cost of maintaining the debt; also, any reduction in economic activity will reflect badly on the administration. It is obvious what position the President would take in any discussion of this problem; any meetings would almost certainly resolve themselves back to the original dispute between the Treasury and the System. It therefore seems to be somewhat of a fiction that discussions with the President can be thought of as a

true tribunal for the settlement of these differences. I do not mean to condemn them, but only point out the pitfalls which they may entertain. These meetings may well throw fresh light and a new viewpoint on the dispute, but the viewpoint may tend to be somewhat short-sighted on the administration side. It seems almost axiomatic that the administration will tend to take the short run viewpoint as the course of political expediency rather than long run view which may be more prudent but engender serious political repercussions.

In answer to the question of how such disputes could be resolved and if conflicting policies could be followed indefinitely, the Secretary of the Treasury maintains that mutual discussion, negotiation and argument with the President would lead to an eventual settlement. He does not believe that the two agencies should pursue conflicting policies indefinitely and doubts whether either public opinion or the Congress would permit such a situation to continue. He recommends "no drastic changes in order to resolve disputes" but thinks that they will be resolved through discussion and negotiation. In response to another question, the Secretary brings out a very important point which may tend to clarify the terms of this co-operative relationship. He says, in part:

The Treasury and the Federal Reserve System have co-operated very well in matters of common interest. . . . Co-operation does not necessarily mean unanimity of opinion on every problem. Nor does it mean the suppression of differences to promote one view as against another.*

* 10, p. 80

Throughout this discussion, the Secretary of the Treasury seems to emphasize the basic independence of the Federal Reserve from the direct control of the executive branch. He states that as a creature of the Congress, it is answerable only to the Congress and brings out the ability of this body to intervene by legislation into the policies and the affairs of the system. However, there seems to be a great deal of emphasis on the resolution of conflicting policies through discussion with the President. Could it be that the Treasury believes that such conferences, rather than being open and non-dictatorial in character, would tend to bolster its case and really result in a "swaying" of opinion to its side? The question is open to wide debate, but the inference still remains; it seems that while direct executive control is not advocated by the Treasury, there is strong support given to an increase in Presidential influence in matters of conflict between the Treasury and the Federal Reserve.

The second set of extensive replies is that of the Chairman of the Board of Governors of the Federal Reserve System, Mr. William McC. Martin, Jr. Under the heading "Relationship to Executive Branch" the first question asks what is the responsibility of the Chairman, the Vice Chairman, and the other members of the Board of Governors to the President in performing their respective functions? The answer in part:

"The Board of Governors has been recognized as an independent establishment of the Government. The Federal Reserve Act prescribes the responsibilities of the Board and indicates that the Board is to act upon the basis of its own best judgment, subject to such guiding principles and restrictions as Congress has prescribed. However, the Board's important functions, especially in the credit and monetary fields, are closely affected by those of other agencies of the Government. Accordingly, in taking any important action, the Board gives careful consideration

to policies indicated by the Executive or by the various Government agencies in order that its policies and those of the Government as a whole may be integrated to the fullest extent practicable in the light of the System's statutory responsibilities. In carrying out some functions which it exercises pursuant to certain authority other than the Federal Reserve Act,[#] the Board has a direct responsibility to the President."^{*}

The Chairman of the Board has succinctly stated the position of the Board in relation to Executive branch of the government. He has stressed the basic independent nature of the System, however always bound by the limitations prescribed by the law. He further emphasizes this point in answer to another question regarding the legal position of the System.

"The courts have not had occasion to determine in which of the three branches of the United States Government the Board of Governors and the Federal Open Market Committee should be classified. Irrespective of the branch of Government in which they may be deemed to fall, however, these agencies have been established by Congress to exercise important and unique functions of Government--generally described as reserve banking functions--which relate to the regulation in the public interest of the volume, availability, and cost of money; and, recognizing the need for independence of judgment in the exercise of these functions, Congress has indicated its intent that the Board and the Committee shall act according to their own best judgment and direction, subject always to the limitations and policy directives prescribed by law.

"Credit and monetary functions, like the functions of the judiciary, depend for their effective performance upon impartial and objective judgment."^{**}

This last statement brings out an excellent analogy and should be given much thought. Just as the Supreme Court acts as the highest arbiter of the laws of the land, might not the Federal Reserve Board, while not a separate branch of the government, act as the high court of finance? It

Emphasis mine.

* 10, p. 240

** 10, p.242

does not seem that the two functions are so widely divergent that this comparison cannot be made with some weight. In further upholding the independence of the Federal Reserve Board, the Chairman went on to cite the original intent of the Act as expressed by its framers and Constitutional and legal precedents.

The problem of co-ordinating conflicting views and policies is recognized by the Chairman. He also brings out the increasing influence which is being exerted by the various other government lending agencies on the policies of the Federal Reserve System.

"Scrutiny of the diverse kinds of interrelationship of interests between the Federal Reserve and the Council of Economic Advisers, the Treasury Department, other Federal bank supervisory agencies, and Federal lending agencies generally indicates the complexity of the inter-agency problem which faces the Federal Reserve in its responsibility for general credit and monetary policy that will contribute to stable economic conditions. By one device or another, over-all credit and monetary policies need to be formulated with appropriate evaluation of other spheres of activity which affect the volume, availability, and cost of money and the economic situation generally."*

In the general sphere of co-ordination of policy, reference is made to a National Monetary and Credit Council as suggested by the Hoover Commission. Such an advisory agency, while not guaranteed as the answer to this problem, should be given a trial and "might gradually be evolved into an effective advisory and co-ordinating mechanism in the domestic field without impairing the essential operating flexibility of the various agencies."** This proposal seems to have considerable merit and is more of a positive step in the direction of more effective co-ordination

* 10, p. 271

** 10, p. 272

than has been previously stated. However, it would still remain only an advisory board with out the power of a binding decision; but this is necessary in order to preserve the freedom and independence of the various agencies. This situation was commented on by Mr. Allen Sproul, President of the Federal Reserve Bank of New York in a statement to this subcommittee on March 20, 1952. He said in part:

"I certainly would not want to suggest such a body as advisory to the President, with the implication that final decisions in this field, as in so many others, would be made by the Presidential office. The practical effect of that might be to place the Federal Reserve under the domination of the Treasury, or to place both the Federal Reserve and the Treasury under the domination of some White House group. Such a National Advisory Council, if it recommends itself at all, should be a clearinghouse for the discussion of policy problems in related fields, and for developing staff co-ordination; it should not be a super authority with either explicit or implicit executive responsibilities and duties. If establishment of such a domestic advisory council, by the Congress, is to be considered, therefore, I would bracket with it the suggestion of a new Congressional mandate to the Treasury and the Federal Reserve, as insurance that the council would not try to substitute its judgment for the judgment of these two agencies."*

The joint answer of the Presidents of the Federal Reserve Banks to the question of whether the banks are part of the government or part of the private economy points up the rather unique position which the banks hold and further emphasize, I believe, the necessity of continued independence if they are to retain this position.

"In our opinion Federal Reserve banks are partially part of the private economy and are part of the functioning of Government (although not technically a part of the Government). Because they are a part of the functioning

of Government the public interest is dominant in their policies. They thus carry out the original intent for which they were formed which was to function somewhere between private enterprise and the Government itself (much closer to the Government than are national banks, but not so close as are "Government agencies"). We believe that it was an essential part of the intent of Congress, in enacting the Federal Reserve Act, that Federal Reserve banks should thus be allied to the Government but not be a part of the Government itself.**

Mr. Sproul, President of the Federal Reserve Bank of New York, elaborates on this point with this comment:

"I share the belief that it was the original intent of those who created the Federal Reserve System, that the Federal Reserve banks should function somewhere between private enterprise and the Government. I believe that it has been the continuing intent of each succeeding Congress that the Federal Reserve banks should be allied to Government but not part of Government. I believe that there has been and is wisdom in this segregation. It has generally protected the Federal Reserve banks from partisan political pressure; it has enabled the Federal Reserve banks to repel the pressure of private interests; and it has provided the country with a central banking system staffed by men who have made central banking a career, and operated the Federal Reserve banks according to standards of efficiency and service which compare favorably with the best in Government undertakings and private enterprise.***

The above comment reflects quite clearly the thought of responsible and most interested parties on a question that is most fundamental in the formation of credit policy in this country. For no matter what methods may be available or may be used by the Federal Reserve, without this freedom of thought and action, its purpose is clearly thwarted and the exercise of its power becomes but a token gesture in the face of absolute Executive control. Even the Secretary of the Treasury has not

* 10, p. 649

** 10, p. 649

advocated this subservience to the President, although in many cases this would work to his interests and make his job indeed much easier. It would seem that the Federal Reserve has made out a very strong case for itself and that it has gained support from almost every corner.

V. Conclusion

The Federal Reserve System as it now stands has several problems which effect the national economy in a very direct manner. The greatest of these, and the most fundamental, is the independence of the System from other governmental agencies and its continued freedom from Executive control.

The Federal Reserve, while set up to be an independent agency, cannot attain this in any complete or absolute sense of the word. Its operations are too intertwined with those of the Treasury to allow for any complete separation; 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.* This proposition cannot be denied; but just what are these "times of stress"? It seems that almost constantly since the thirties the nation has been in some sort of crisis, at least in the eyes of the administration. Under these conditions the Federal Reserve has been unable to exercise its powers with the freedom to which it is entitled under the intent of the Federal Reserve Act.

The Treasury has been a firm advocate of easy money because of the huge debt which it has been forced to carry and its insistence on keeping down the servicing of this debt. The Federal Reserve, on the other hand, advocated tightening up on credit and producing a more rigid monetary situation. And so the impasse has existed. Senator Paul Douglas said a year ago: "The Treasury has pulled the strings, and the Federal

* 2, p. 210

Reserve has danced to its music. . . . For under the guise of keeping the interest rate down, they have. . . created inflation.** This situation ceased to exist, in part at least, when the Federal Reserve pulled the plug on the government bonds.

This situation should not exist and certainly the proposal to put the System under the control of the Executive would only result in the permanent and final control of the monetary policies of the country being open to the vagaries of the politicians. There must be an effective counter-balance set up to cope with any such autocratic system.

"We can hardly visualize the despair and spirit of hopelessness which would settle over the banking industry and business in general if the Texas Democrat (i.e. Representative Patman) ever achieved his purpose in making the Reserve answerable to the White House. There is no reason to believe that this country would not follow the road of ruin taken by all other nations in the world that have allowed the central banking system to become subservient to politicians.***

The problem is how to get the most reasoned, deliberative judgment on both sides of the issue and to subject these to conference and argument. The two agencies, i.e. the Treasury and the Federal Reserve, must meet on a common ground and in good faith discuss the issues as they exist, apart from any political considerations; neither bowing to the other in stature and neither dominating the other.

The country now stands at the crossroads; there has been a slow drift towards Socialism which has permeated the actions of government for some number of years. If government control is allowed to

* 4, p. 212

** 7, p

encompass the Federal Reserve, it may well lead to the control of other lines of business. The subjugation of the Federal Reserve to Executive control would be but one step towards an ultimate goal. Therefore, Federal Reserve independence has much broader implications and should be recognized and upheld on these several grounds.

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