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The Federal Reserve System and its Relation to Monetary Conditions in the United States: A Study of the Banking System of the United States

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THE FEDERAL RESERVE SYSTEM
AND ITS RELATION TO MONETARY CONDITIONS IN THE UNITED STATES.

A study of the banking system of the United States.

A THESIS.

Submitted in partial fulfillment of the
requirements for Department Honors.

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May 16, 1938.

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Money affects us in so many ways, it is only natural, therefore, that we should be concerned with the monetary system of our country and the way in which it operates. From the beginning of the United States we have tried to solve the monetary problem and have failed repeatedly.[1] The depression of 1929 brought the fact immediately before us, and the business recession of 1937 emphasized our inability to cope with it.

With conditions as they are, it is evident that something must be done with the system so that in the future the severe business cycle may be alleviated. With this in mind, let us look at the banking institution as it has progressed.

Prior to 1913 the experience of the United States with central banks was limited to the First and Second Banks of the United States, which existed between 1791 and 1836. The First Bank of the United States which was organized in 1791 failed to be rechartered in 1811 not because of its not having been operated efficiently but for political reasons. Even at this early date, it became evident that our banking system would be hampered and controlled by politics.

After 1811, the lack of a central bank was keenly felt. Therefore, in 1816, the Second National Bank of the United States was chartered for twenty years. In 1832 it became the issue of the presi-

dential campaign between Clay and Jackson. As Jackson who was not in favor of rechartering it won, it automatically went out of existence in 1836.

Following the experience with the Bank of the United States and the State banks as custodians of public funds, the Independent Treasury System, or hard-money policy, by which the government might take charge of its own funds, came into existence by the Act of July 4, 1840. Although the law was repealed in the following year, it was re-enacted on August 6, 1846. This was discarded for the national banking system of 1863, which existed until 1913.

The defects of this system were many. The principal one was the rigidity of its note circulation. The volume of notes was regulated not by the wants of trade, but by the price and the interest yield of the United States bonds. There was no elasticity. Our currency system did not allow for seasonal needs or was not able to prevent money panics.

Too, the pyramiding of reserves was another great defect. It resulted from the ability of a bank to redeposit in another a part of its legal reserve. During periods of stress this proved detrimental, for banks counting the deposits which they possessed in other banks as part of their legal reserve, would call for them. It was embarrassing, however, for these banks to receive this call for deposits at a time when they too, were in need of all their cash reserves.

We were also faced with the clumsy and wasteful method of clearing checks. The only method of clearing out-of-town checks was through correspondent banks which was very expensive and time consuming.

Finally, the uncoordinated and entirely independent character of our banking system made it impossible for banks to help one another. Even in spite of good Federal over-sight there was much inefficiency and bad banking, showing that a central control of the business was desired.

In 1893 this dissatisfaction with the system took the form of a demand for an elastic note issue. But nothing was done about it. It wasn't until 1905 that the House Banking and Currency Committee began to work out tentative banking measures based on the idea of a clearing house association.

Then followed the panic of 1907 which clearly showed the existing defects. It resulted in partial reform with the enactment of the Aldrich-Vreeland Law which was purely an emergency measure. But it did provide for the organization of a body known as the National Monetary Commission. Senator Nelson W. Aldrich, chairman of this committee, made his report in 1912, and recommended a national reserve association, or a central bank with fifteen branches throughout the country. At the next election, the Democrats gained control of congress, and as expected, rejected the proposal which the Republican Commission had made. They passed the Federal Reserve Act December 23, 1913. The new administration believed in decentraliza-

tion. In order to keep their hold on the people they established a regional system.

The new law was immediately attacked. Bankers in general were hostile to the new form of a central banking system as outlined in the Federal Reserve Act. The American Bankers Association called it a form of "socialism", objecting to the appointments of the president of the board which had a dominant position. The greatest objections of bankers were the distrust of the administration of the system with the fear of political influence and the fact that no interest was to be paid on the reserves which had to be deposited with the reserve banks.

On the other hand, many people looked toward this act gratefully for the benefits which were expected to be derived from it. John Skelton Williams, Comptroller of the Currency, in his report in 1914 summarized the direct benefits in the following manner. First, it would supply an absolutely safe circulating medium which will command its face value in all parts of the country; second, it provides for mobilization of bank reserves of all districts; third, it eliminates the indirect tax of millions of dollars annually upon the commerce of the country imposed in the shape of collection or exchange charges on checks; fourth, it furnishes a discount system by which every well-managed member bank may convert commercial paper into money by rediscounting; fifth, by making

it possible for banks to convert its assets readily into cash the necessity for larger reserves cease; sixth, it makes it possible for banks to lend money to unencumbered farm property thereby helping the farmer; seventh, it provides for the establishment of branches in foreign countries which should aid foreign commerce; eighth, the establishment of a system of bank acceptances and an open market for commercial paper will aid international trade. (2)

Opposition or no opposition, the system was organized and put into practice. The Federal Reserve Act, or the Owen-Glass Bill, as it is sometimes referred to, being named after Senator Robert Owen who was chairman of the Senate Banking and Finance Committee, and Representative Carter Glass, chairman of the House Banking and Finance Committee, provided for the division of the United States into twelve regional districts, making it a decentralized regional set-up. Each district contains a reserve city which gives the district its name and contains the reserve bank of the district. These are Boston, New York, Richmond, Philadelphia, Atlanta, Cleveland, Chicago, Minneapolis, St. Louis, Kansas City, Dallas, and San Francisco.

The Federal Reserve Act recognized that the essential difficulty in American banking lay in its undue decentralization and consequent dissipation of its strength. Fundamentally, therefore, it sought to give relief by providing for the combination of reserves and for joint control of and oversight over banking. The reserve banks were provided for this end.

The co-ordinating body is the Federal Reserve Board. It was composed of eight members, six appointed by the President with the advice and consent of the Senate, and two ex-officio members, the Secretary of the Treasury and the Comptroller of the Currency. In 1923 an act was passed which added the sixth appointive member, a "dirt farmer" to care for the agricultural interests. The terms of office were ten years and staggard , but this appointment threw the system out of harmony. So, in 1933 the terms were changed to twelve years. The offices of it are in the Treasury Building in Washington, D.C. The Secretary of the Treasury was also chairman of the board, but one of the appointed members was designated as governor of it who was the chief exective.

On August 23, 1935 the Federal Reserve Board became known as the Board of Governors of the Federal Reserve System and the title of governor was changed to chairman. The removal of the ex-officio members was designed to increase the independent status of the new board. It consists of seven members appointed by the President for a term of fourteen years, which are staggard to provide for rotation in office.

Some of the more important duties of the board are: (1) to approve or disapprove changes in the rediscout rates, (2) to review open-market operations, (3) to determine and define the character of the paper which is eligible for rediscount within the limits of the Federal Reserve Act, (4) to permit or require one Federal Reserve Bank to rediscount the paper of another, (5) to supervise the issuance of

Federal Reserve Notes, (6) to supervise the Federal Reserve Banks and to insure the soundness of this operation.

Too, provisions were made for a Federal Advisory Council which is composed of twelve members, one member representing each Federal Reserve district. The members of the council are selected annually by the board of directors of the Federal Reserve Banks. The council which meets four times a year with the Federal Reserve board has the power to make recommendations concerning banking and credit policies and discuss business conditions with the board. It merely acts in an advisory capacity, and has not been a very important factor in the administration of the system.

Now as to the membership in the Federal Reserve system. First of all, if a bank is a national bank, it must join the system. If it is a state bank, it is a matter of choice. However, if it does join, it must live up to the requirements of the system. The advantages of a state bank in joining the system are shown in the power of rediscounting, of securing aid in time of emergency, in the prestige which is attached to membership, and in the many services performed by the system free of charge for them, from the benefit of the clearing and collection system to the assistance of officers of the Federal Reserve Banks at all times on all matters. However, the Federal Deposit Insurance law requires that all state banks with deposits above $1,000,000 must be members of the Federal Reserve system if they

are to be insured after July 1, 1942. Today one out of every two and one-half banks in the United States belong to the Federal Reserve system.(3)

As for the requirements necessary for membership, in order to become a member, a bank must subscribe 6% of its capital and surplus to the capital stock of the Federal Reserve bank of its district. Too, a member bank must keep all of its legal reserves on deposit with the Federal Reserve bank. These deposits pay no interest. This is one of the reasons why state banks have been reluctant to join. Besides this, the banks are subject to the supervision of the Federal Reserve bank at all times.

Now for the reserve requirements. As one of the reasons for the establishment of the system was to get away from the "pyramiding of reserves" defect, reserves which are now deposited with the Federal Reserve bank may not be redeposited in another bank. The reserve banks are supposed to be able to meet emergency demands from their member banks, thus alleviating the defects of pyramiding. The percentage of reserves for demand deposits is 7, 10, 13 for country banks, reserve city banks, and central reserve city banks respectively. Against the time deposits a 3% reserve must be kept by the member banks in the form of a deposit with its reserve bank.

However, this section of the law authorizes the Board to change reserve requirements for member banks "in order to prevent injurious credit expansion or contraction." Thus, this can be done not only

to counter-act expansion but also to anticipate and prevent contraction.

It did exactly this on January 30, 1937. The Board of Governors of the Federal Reserve system increased the prevailing reserve requirements for member banks by 33-1/3%, as follows: on demand deposits, at banks in central reserve cities, from 19-1/2 to 26 percent; at banks in reserve cities, from 15% to 20%; and at country banks from 10-1/2% to 14%; on time deposits from 4-1/2% to 6%. (4)

For the purpose of affording member banks ample time for orderly adjustment to the changed requirements, one half of the increase became effective March 1, 1937 and the remaining half on May 1, 1937. By that action the board eliminated as a basis of possible credit expansion an estimated $1,500,000,000 of excess reserves which are superfluous for the present or prospective needs of commerce, industry, and agriculture, which in the judgment of the board would result in an injurious credit expansion. (5)

As a result of this change on March 1, the required reserves of the member banks increased from about $4,600,000,000 to $5,400,000,000 and excess reserves declined from about $2,100,000,000 to $1,300,000,000. (6)

In view of the large amount of excess reserves remaining after the increase in requirements and their broad distribution, member banks were able to make the change with very little borrowing. The great majority of banks had sufficient reserves in excess of requirements to

meet the increase, some drew upon their balances with other banks, and although a few found it necessary to liquidate some earning assets, the effect was not disastrous.

During the alloted time the member banks sold government bonds but, at the same time, the Reserve Banks bought these up on the open market. Because of this process the reserve of the banks on April 30, 1937 reached approximately $1,600,000,000 but on May 1, 1937 it was brought back to about $800,000,000.(7)

But we should note that because of this cushion of excess reserve, banks had become independent of the Federal Reserve system. They had no need to borrow as has been shown. And when the squeeze was applied, rather than go into debt they sold securities. Moreover, banks which had deposits in other banks called them home. The result was the elimination of $1,100,000,000 in inter-bank deposits.(9) This accounts for the decline of total deposits of banks throughout the country. In addition, it resulted in a definite contraction of bank credit. The sale of securities in this period and in the period immediately following it outpassed new loans, thereby becoming a restricting influence on business generally.

Another purpose of establishing the system was to provide for an elastic currency. Therefore, Federal Reserve Notes were provided for in the act. These notes, issued by the Federal Reserve Banks are backed 100%, but only 40% in gold, the remaining 60% in commercial paper.

An elastic currency was supposed to result from the 40-60% requirements, as in time of greater business activity, the banks would have more commercial paper, thereby being able to issue more notes. In February, 1932, the Glass-Steagall Act allowed the banks to use United States Securities as part of the 60% reserve requirements behind Federal Reserve notes. Federal Reserve notes are as a result our most elastic and most important currency.

The Federal Reserve bank notes have never been very important. Originally, they were to displace the old national bank notes, but as this was not done, few were issued. In 1918, the Pittman Act provided that the Federal Reserve banks issue bank notes secured by Pittman Certificates to take the place of the silver certificates, which would be drawn from circulation. When the government again purchased silver and reissued silver certificates in 1921, the bank notes were cancelled.

Another issue of the Federal Reserve bank note was provided for in the Emergency Banking Act of 1933. $2,000,000,000 worth of Federal Reserve bank notes were printed, but few were issued, and these were recalled later.

Now to the member banks themselves. When a Federal Reserve bank has paid all of its necessary expenses, its stockholders are entitled to receive an annual dividend of 6% on paid-in capital stock, the dividend being cumulative.

After these prior claims have been met the banks were required to

pay all surplus earnings to the government as a franchise tax, except they were allowed to keep one-half of such earnings and build up a surplus fund until it reached an amount equal to 40% of paid-in capital. In 1919 the law was amended so as to permit banks to retain all surplus earnings after payment of prior claims until a fund equal to 100% of subscribed capital was accumulated. In the Banking Act of 1933, this law was changed so that provision was made for a Federal Deposit Insurance Corporation which guaranteed all deposits up to $10,000.

Each Federal Reserve Bank has a board of directors composed of nine men divided in: Class A directors representing stockholding member banks, Class B directors composed of business men located in the district, and Class C directors who are appointed by the Board of Governors of the Federal Reserve system. Class A and B are elected by the member banks. The term of each director is three years, and are so arranged that the term of one director of each class expires each year. One Class C director is designated as chairman of the Board of directors, and is also the Federal Reserve Agent. The chief executive of a reserve bank is the governor who is elected by the board of directors.

To tie the whole plan together is the Gold Settlement Fund which is a deposit of gold kept by each Federal Reserve bank at Washington for the purpose of facilitating the clearance of checks. In order for one bank to pay another, the individual reserve accounts are either

debited or credited at the close of each day's business, and the difference transported saving both time and money.

This, in brief, is the Federal Reserve System. We note that Federal Reserve banks are primarily bankers' banks, which differ greatly from banking institutions in other countries. The reason why the system was given this unique position, and why its functions even in the act were so limited in scope is traceable to the fact that it was grafted on an existing banking stem instead of being developed from the root as in other European systems. (8)

The system was established. But how did it operate? Rediscounting was to be the principal means of access which the member banks would have to the Federal Reserve banks. This works so that if a member bank granted a loan to a customer and took a promissory note in return, this promissory note, if eligible, could be passed on by the bank to the Federal Reserve bank, and receive for it the face amount less the rediscount rate of the Federal Reserve bank. This was provided for in order to aid the member banks in time of stress. The board controlls this operation by its power to change the rediscounting rates, and by its definition of commercial and eligible paper and notes.

Then, the open market operations was to work in the following fashion: If during prosperity the Federal Reserve authorities felt that the expansion of loans by member banks was becoming excessive,

they could raise the rediscount rate to prevent the member banks from securing too much aid from the reserve banks. In addition, the Federal Reserve banks would sell their United States securities in the open-market. On the assumption that the purchases of the securities is a member bank, the securities would be paid for by reducing the deposit account which the member banks carry with the Federal Reserve banks. Since this account is the legal reserve of the member bank, it would be forced to rediscount at a higher rate in order to replenish its reserves; otherwise the amount of loans and hence deposits which it will be be able to make will be curtailed. Even if an individual had purchased the securities the net result would be the same.

Beginning March 1, 1936, complete control overopen-market operations was centralized in the open-market committee consisting of the Board of Governors and five representative of the Federal Reserve banks. This centralization was deemed necessary to end the previously existing diffusion of authority. Open market operations are to be governed with a view of accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.

Thus we see the system was alleged to be able to produce price stability through its control over the rediscount rates on commercial paper and through its open market operations in the time of

boom by raising rediscount rates and selling government securities. In times of depression they would lower rediscount rates and buy government securities. But this has not worked due to the relation of rediscount rates and market rates in this country. In Great Britain the rediscount rate is higher than the market rate. This means that banks rediscount only in emergency. Whereas, here the rediscount rate is generally lower than the market rate. This makes it profitable for the member banks to rediscount more or less continuously with the Federal Reserve. Therefore, it is claimed that the rediscounting facilities in this country lend themselves to a permanent increase in bank credit.

Too, rediscount rates are not very effective in times of prosperity. The ordinary reserves of the banks are such that they can carry through a considerable expansion of credit before they are forced to resort to the Reserve System, and by that time, the damage could already have been done. Even if the rediscount rates would raise the market rates, it is improbable that demand for credit would be slackened, for the increase would only be a fractional expense to a business man who needs the credit. Therefore, a rise in rediscount rates will have little effect in checking an upward saving of prices.

However, the advocates of the Reserve System repose more trust in the open market operations than in the rediscount rates. But the open market operations are limited by the ability of the Federal Reserve system to sell government securities which is strictly limited by the amount of such securities which they have previously

accumulated. Too, any constrictive effect of the open market policy could be offset by an increase in the ratio of time deposits to demand deposits, the relative deposits of Reserve and other cities as compared with the Central Reserve cities, and the velocity of money or credit. Finally, even if credit were restricted and the interest rates rose, gold and foreign exchanges from abroad might cancel much of the intended effects.

These operations have little effect in times of boom and even less in stemming a depression. At such times the volume of credit shrinks and the banks have idle reserves, therefore, they do not have to resort to rediscounting in order to make loans, and a reduction in the rate offers no bait. As for the open market purchases, it is ineffective for the banks to use their fund to get out of debt to the Reserve system rather than to make loans. At the same time, business does not want to borrow without the consumer demand which it has lost and banks, too, are reluctant to lend.

Now let us look at how the Federal Reserve system actually has worked.

From 1914-1917 little outside of routine matters was accomplished by the Federal Reserve System. The banks became indebted to the Reserve banks for they found it hard to pay the 6% dividend on their stocks.

From 1917-1920 the World War greatly influenced its activity. Our entrance into the conflict necessitated raising huge sums of money to finance the war, which was accomplished by Liberty Loan drives and "Borrow and Buy" policies. The loans of member banks increased from $9,370,000,000 in 1917 to $19,852,000,000 in 1920. (10)

In 1918 the Board was faced with the problem of either preventing undue credit expansion by raising the rediscount rates high enough so as to discourage member bank rediscounting, or to keep interest rates down in order to make it easy for the government to raise funds. It followed the latter policy. In reality they should have raised the rediscounting rates. This same mistake is being made now. The system is helping the government instead of business.

In November 1919 they did raise the rates until finally in 1920 a rate of 7% was reached, but by that time expansion had gone too far.

Commodity prices fell as did member bank loans and investments. Then followed the decline in business of 1920 and 1921. But there was a tremendous inflow of gold into this country during the immediate period which followed. This allowed the banks to pay off their indebtedness to the Reserve Banks, thereby resulting in a contraction of the Federal Reserve credit.

As a result, a slight business recession took place in 1924. The authorities of the Federal Reserve banks attempted to ease

the situation by lowering rediscount rates and purchasing government securities. The problem cleared up and through 1925 and 1926 conditions were fairly stable.

Concerning the depression, Sir Charles Morgan-Webb in his book, "The Money Revolution", offers the following explanation:

In 1926 the Dollar Stabilization Policy which we commonly call a policy price stabilization, was instituted by Governor Strong. It was this departure of the United States from the gold standard instead of causing inflation which kept inflation at bay from 1922-1928. By this method the huge amount of gold which was flowing into the country was exchanged for gold certificates, therefore credit was kept down by the fact that it took 100% gold to buy gold certificates instead of using it as the necessary 40% gold backing for money. However, in 1928 the Federal Reserve Board turned from the national policy of stabilizing the dollar to the international policy of the traditional gold standard. This move let loose the inflative force of the impounded gold of the dollar stabilization policy allowing inflation to take place up to the limits of the enormous accumulation of gold reserves on hand. At the same time, the board adopted a policy of deflation by raising the bank rate to 4, 4-1/2, or even 5%. Thus it was operating both inflative and deflative methods.

The inflation added fuel to the speculation then raging. The

deflation effectually killed the prosperity of the country. The outburst of speculation was due to the operation of the gold standard acting on the excess gold reserves when they were released from the sterilization imposed upon them by the dollar stabilization policy. Therefore, it caused severe inflation of currency and credit, but at prices too high for commerce and industry to benefit. Though credit was overflowing in the United States, industry had no use for it at the high rates of 5% which it could be obtained. It was used to a 3-1/2% bank rate. At such a rate it was useless as far as commerce and industry was concerned. Therefore, commerce and industry declined but speculation flourished. Banks welcomed these amateur speculators as a profitable outlet for their surplus money then not being used by business. At first the high rates had no effect on speculation.

The effect of the Federal Reserve Board to raise rates thereby to stop speculation merely increased it. When brokers found they couldn't get the money they needed from banks, they offered extravagant rates of interest to individuals. The end came when the bank rate was raised in August, 1929 to 6%.

At this point he asserts that contrary to the popular notion, the decline in prosperity preceded the collapse in speculation, and

was not caused by that collapse. It was rather the former that caused the latter. And it was the deflative effect of the rise of the bank rate from 3-1/2 to 5% and finally to 6% that caused the decline in prosperity. The rates were too high for commerce and industry.

This is the interpretation advanced by Sir Charles Morgan-Webb who is a member of the managed currency field. However, he is suggesting that the rates were too high, that they should have been kep low, and that expansion of credit continued not only to speculators but to business and commerce as well. He failed to realize that in the period of 1928 and 1929 banks were loaded with loans which had beenmade and continued indefinitely. They had no extra money to carry on expansion. The peak had been reached, a decline was sure to follow. It was too late to turn the tables at that time.

Evidently he also failed to realize that if business sees a chance to make profits, a lower or a higher rate of interest has little effect on the amount of money borrowed. Business was at its peak. Far-sighted men saw the inevitable decline, and no profits were anticipated.

It seems to me that the mistake lies in the fact that when the accumulation of gold of the stabilization policy was set loose, too much expansion was allowed to take place. What should have been done was the reserve requirements and rediscount rates should have

been raised immediately when the money was placed in circulation. Therefore, expansion would have been gradual. The raising of the rates would have been a deflative movement and one to counter-act the inflative gold put on the market.

I think that conditions which followed the issuing of that accumulated gold is comparable to the period today which shall be discussed later.

Almost immediately after the break in the security markets, the Federal Reserve System began its easing measures. In 1930, the rediscount rate was lowered to 2% and further reduced to an all-time low of 1-1/2%, in May, 1931. However, business continued to decline. The Federal Reserve Board engaged extensively in the open-market operations with a view to easing the market situation generally. In the two years, 1930-1931, they purchased about $300,000,000 of government securities and in 1932 over $1,000,000,000.[11] It was expected that the resulting increase in loanable funds in the hands of private institutions would, through the reduction of rates, stimulate recovery.

In spite of these purchases, member bank loans continued to contract. This continued contraction in commercial bank credit has been one of the most disturbing influences in the recovery program. Bank expansion must take place before recovery can proceed. In 1933, the depreciation of the dollar and the N.R.A. pro-

gram which raised costs and prices threatened the little recovery which had taken place. In 1933 and 1934, the government stepped in and passed laws to stimulate loans by setting up and extending the powers of the Reconstruction Finance Corporation, Home Owner's Loan Corporation, The Industrial Loans Act, etc. With the creation of these facilities, bank loans expanded, but the increase was short-lived.

The Reconstruction Finance Corporation was one factor that accelerated the run on the banks in the latter part of 1932 and early 1933. It had been authorized to finance banks if necessary, but publication of these loans was not made public. In 1932, Congress enacted a bill calling for publication of these loans. When these facts were made public, people became uneasy about their money resting in the banks who were recipients of the loans. Fear set in, and a general run on banks began, whichwas halted only by the Bank Holiday declared by President Roosevelt on March 5, 1933.

But the purchase of bonds in the open market by the Federal Reserve Board from 1929-1933 materially increased the supply of bank reserves. These reserves were created through purchases of United States Government Securities by the Federal Reserve Banks as a part of the system's policy to ease money conditions with a view to counteraction deflationary forces and encouraging recovery. In the autumn of 1933, when excess reserves had increased to $800,000,000,

the system discontinued its open market purchases. Since that time reserves have been increased by importation of gold from abroad, and by the issuance of $700,000,000 of silver coin and currency by the Treasury.(12) These reserves accumulated and became so excessive that in 1936 it raised the reserve requirements as a means of restraining the possibilities of commercial credit inflation. However, even after this action, the excess reserves remained far larger than they were prior to 1934.(13)

At that same time a new dilemma appeared. The appearance of strong speculative tendencies in the financial and commercial markets seemed to demand not only a tightening of margin requirements, but also of interest rates; but, on the other hand, an increase in the interest rates would seriously affect the government's fiscal problem. The system again chose to aid the government.

Marriner Eccles, chairman of the Federal Reserve Board, in March 1937 advocated the continuance of the easy money policy under present conditions. He said that to restrict the available supply of capital and thus to make it difficult to employ people out of work would be both anti-social and uneconomic. But he did say that to be successful it had to be accompanied by a prompt balancing of the Federal budget and the subsequent retirement of public debts by the government in relationship to the expansion of private credit.(14)

In March 1937 when the Board raised the reserve requirements to the limit, many people declared the act would cause a decline in business. In August, 1937, a business recession set in. Their prediction had come true.

But I do not think the recession was due wholly to the actions of the Board. At that time conditions were such that a decline was certain to follow.

Temporary inflation had been caused by the bonus pensions being paid, and prices were exceedingly high caused by anticipation of war. Production had been unusually active in this period, but the increase in the output was not as great as that in buying, and inventories were enormous having been purchased in the winter of 1936 and the spring of 1937.

The raising of the reserve requirements just made the people aware of the prevailing conditions. Fear set in. Thus, the reserve system helped on a crisis that was bound to arrive. Too, people were all anticipating inflation and began to buy stocks and commodities. Huge government expenditures and its monitary policies seemed to predict it. But in 1937, the government began to utilize and borrow the money from the social security fund. This, in itself, was a deflationary measure, for instead of borrowing the money on the market which would extend credit, they used the money collected as taxes. Along with this, the govern-

ment intimidated that they intended to balance their budget. At the same time, reserve requirements had been raised. With this reversal of policy, inflation looked improbable. People began to unload their stocks and commodities.

On August 20, 1937, discount rates were reduced from 2 to 1-1/2%. By thus cutting the rates, the Reservey system assured the business that the banks would be in a position to lend cheaply. This was a timely gesture. It assisted in carrying out the system's policy of monetary ease and make Federal Reserve bank credit available to commerce, agriculture, and business. These were the first changes in basic discount rates since May, 1935. But before use could be made of these lowered rates, business had declined to such an extent and fear had set in that they were not of much value. Business continued to decline. In December, 1937, industrial activity declined further to a level of about 25% below the first eight months of 1937.(15)

Now in 1938 the Board is trying to slow up credit expansion which is resulting from President Roosevelt's gold desterilization program. During April, 1938, the Federal Reserve open market committee has sold $108,000,000 of government bonds and bought $89,000,000 of Treasury bills and $19,000,000 of Treasury notes in an attempt to check the rise in government bond prices.(16) This will tend to hold up interest rates and counter-act to some extent the benefits of the recovery measures. This is to prevent a harmful re-

action which will result later if bonds advance too rapidly under present easy money conditions.

It is this condition which I believe comparable to the period which followed the releasement of the accumulated gold reserve from the dollar stabilization policy in 1928.

Paul Douglass, Professor of Economics at the University of Chicago, claims that our system of banking helps to make business unstable in at least three ways:

(1) It creates a cumulative multiplication of credit at times when it is not needed, and a cumulative contraction of credit when credit is most needed.

(2) In practice it helps to finance investment through the creation of bank credit, and the sharp fluctuations in the demand for capital goods which this causes accentuates both the upswing and the downward collapse of business.

(3) It is always menaced by the fact that the bank credit which it creates is many times the amount of cash into which it is supposedly convertible, so that the banking system cannot redeem the claims against it if any considerable percentage of its depositors ask for cash at the same time.[17]

These criticisms seem to me to be well directed. To correct these evils, various plans have been devised. Dr. John Bauer and Nath-

aniel Gold proposed than an United States bank be set up which will establish branches throughout the country which may take over those private banks which create demand deposits. This bank, operating in cooperation with a Bureau of Fiscal Control and a Public Improvements Corporation would alone have the power to create credit. It would make loans to private business and advance credit to the P.I.C. for a program of public works to put all the unemployed to work. The primary purpose is to make available the necessary monetary purchasing policy for the unemployed. In addition, the bank would seek to stabilize the general price level. If prices fell below a normal level, the proportion of new currency issued for improvements would be increased, thus sending prices up again. If prices rose above normal, the issuance of new money would be reduced thus lowering prices. (18)

But Douglass disagrees with this in that he believes danger lies in making a governmental agency the sole body to make commercial loans to private industry, fearing that political influence would enter in.

In place of this he proposes the plan set forth by H. C. Simmons. He would take the creation of purchasing power away from the private banks and would lodge it in the hands of the government. Thus, the ownership of the Federal Reserve banks, which now lies in the hands of the private member banks, would be taken over by the national government through the purchase at par of their stock. The

Federal Reserve bank would then begin to buy up government bonds either from the banks or in the open market and would issue in return Federal Reserve notes equal to the par value of the bonds. The government, therefore, would receive the interest upon these government bonds. The government would then save the present interest of approximately $1,000,000,000 a year, plus a profit on all new money issued. Monetary purchasing power would be created by the government instead of by private agencies. Deposit banks would have to keep 100% reserve in cash, therefore deposit banking would be absolutely safe and the defect of a fractional reserve would be removed.

As for long term loans, these would be made through the direct purchase of bonds or securities by individual customers or through investment trusts. These investment trusts could obtain money from the general public by selling their own shares and investing the cash received into industry, but not investing more than the amounts paid into them. Short-time loans could be handled in the same way.

Also, this plan by abolishing the difference between credit and money would enable society to control the entire amount of the circulating medium instead of vainly trying to control the private medium of money, and through ineffective rediscount and open market policies. Secondly, it would prevent the creation of commercial credit to finance investment, since investments would have to come from savings. (19)

Summarized, the plan would insure the safety of deposits, give large revenues to the government, provide complete social control over monetary matters and present abnormal fluctuations in the capital market. At the same time it would permit the allocation of productive resources as between individual concerns to remain primarily in private hands.

Thus we see the plan set forth by Professor Douglass. I, too, agree that a change is necessary, and although approving of his plan, propose other measures.

To me the wisest measures would be the divorcement of the banking system entirely from the hands of the government and its policies. If the banking system were functioning to aid business and industry to its utmost, the government would be benefiting, too. In the past it has been the shifting from one to the other that has ruined the attempt to curb the severe business cycles. But at present, with government regulation being made more stringent in all fields, this plan does not seem at all probable.

Therefore, other measures which are more likely to be possible should be suggested. There still is a serious conflict of jurisdiction between state and national banking laws which points to the necessity of strengthening, integration and better coordination of banking policy. New laws such as Federal Deposit Insurance are aimed at this. Others in this direction should follow, until the banking system would be one unit.

Professor Douglass claimed that bank credit which it creates is many times the amount of cash into which it is supposedly convertible and therefore harmful. I agree in this, but propose a change in the rediscount rates to correct the deficit. With reference to page 15, the present plan of rediscounting lends itself to a permanent increase in bank credit. If rediscounting rates were higher than the interest rates as is the case in Great Britain, banks would rediscount only in times of emergency; therefore the Federal Reserve system would have more control over them.

This would be an extreme deflationary measure, if put into practice. However, at a time such as is prevailing when the gold desterilization act is being instituted and a deflationary measure is necessary, it seems a wise time to start such rates. Excess reserves are high enough so as to make this possible without causing banks to borrow to a great extent. It is the pyschological effect on the people which would need to be counteracted. But this, too, could be met if the government instituted measures which would encourage industry and give it a favorable outlook.

This, in brief, is our monetary system. Included here are the changes proposed by eminent authorities to correct the defects in it. We know that the system has failed in curbing the depression and and in speeding up recovery. However, we must take into consideration

that the Federal Reserve System cannot act as it deems necessary for the good of business alone. Many other things enter in. The World War broke out soon after its formation and required individual tactics to handle the situation. During the "twenties" the Board was faced with the dilemma of either aiding the United States or the European Countries with the idea that their prosperity meant prosperity for us, too. Even had other steps been taken, the outcome could not have been predicted.

Now, they are faced with the problem of making money available for the government and contracting the credit to avoid inflation.

Thus we see that it is a complicated matter. We have developed and gone a long way down the road to good banking from the first monetary system of the United States, but the road is still open to a better system for which we are striving.

APPENDIX

(1) Wesley C. Mitchell, "Business Cycles", National Bureau of Economics Research, Inc., New York 1928, Page 387. Business Recessions in the United States and approximate duration of business cycles 1790-1925:

	Duration Of Cycle
1796* Financial Crisis, Spring	
1802 Recession Early in Year	6
1807* Recession Late in Year	6
1812 Brief Recession, June, War with England	5
1815* Crisis, March, Following Peace	3
1822 Mild Recession, May	7
1825* Panic, Autumn	3
1828 Recession, Summer	3
1833 Recession, Panic, Autumn	5
1837* Panic, Spring	4
1839* Panic, October	3
1845 Brief Recession, May	6
1846 Mild Recession early in Year, War with Mexico	1
1847* Recession, financial panic, November	2
1853 Recession, Last Quarter	6

		Duration Of Cycle
1857*	Recession, Late Spring, Panic in August	4
1860	Recession late in year, Prospect of Civil War	3
1865	Recession, Second Quarter, Close of Civil War	5
1870	Recession, January	5
1873*	Violent Panic, September	4
1882	Recession Lat in Year, Financial Panic in 1884*	9
1888	Slight Recession, Early in Year	5
1890	Financial Crisis, Autumn	3
1893*	Severe Panic, May	2
1896	Recession Early In Year	3
1900	Brief and Slight Recession Spring.	4
1903*	Financial Strain, Spring	3
1907*	Severe Crisis, Autumn	4
1910	Mild Recession, January	2
1913*	Recession, Summer	3
1918	Recession, after Armistice, November	5
1920*	Severe Crisis, May	2
1923	Mild Recession, Summer	3
1929	Severe Panic	
1936	Recession	

*Dates thus marked show the commonly accepted crisis years.

(2) Earnest Ludlow Bogart &Charles Manfred Thompson, "Readings in Economic History of this United States" (N. Y., 1916) - Page 709

(3) Horace White, "Money and Banking" (Boston, 1935) Chapter XXIV

(4) Business Week - October 16, 1937

(5) Federal Reserve Bulletin, February, 1937. Volume 23, No. 2, Page 95.

Federal Reserve Bulletin March, 1938, Volume 23, No. 4, Page 215

	June 21, 1937 to August 15,1936	Aug. 15,1936 to Feb. 28,1937	March 1,1937 to April 30,1937	May 1, there-after
Demand Deposits:				
Central Res. City	13	19-1/2	22-3/4	26
Reserve City	10	15	17-1/2	20
Country	7	10-1/2	12-1/4	14
Time Deposits:				
All Members	3	4-1/2	5-1/4	6

(6) Federal Reserve Bulletin, February, 1937 - Volume 23, No. 2, Page 95

(7) Federal Reserve Bulletin, April 1937 - Volume No. 23, No. 4, Page 283

(8) Encyclopaedia Brittanica, Inc., "The Encyclopaedia Brittanica" N. Y. 1929 - Volume 9, Page 138

(9) F.R.B., April, 1937 - Volume 23, No. 4, Page 284

(10) Business Week - October 2, 1937

(11) Horace White, Money and Banking. page 583.

(12) The Recovery Problem in the United States. Brookings Institution, (Washington, D. D., 1936), page 442.

(13) Refer back to pages 9 and 10.

(14) Philadelphia,Record, April 23, 1938, page 1.

(15) Federal Reserve Bulletin, Volume 22, No. 8, page 615.

(160 Federal Reserve Bulletin, Volume 24, No. 1, page 1.

(17) Paul H. Douglass, Controlling Depressions. (New York, 1935), page 165.

(18) Ibid., pages 190-194.

(19) Ibid., pages 246-250.