

Money Facts

by

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To Members of the Subcommittee on Domestic Finance:

Transmitted herewith for the use of the Subcommittee on Domestic Finance of the Banking and Currency Committee, and other members of the committee and the Congress, as well as the general public, is a series of questions and answers on the basic workings of our monetary system. It is a supplement to "A Primer on Money" and is designed to highlight in question and answer form the basic points brought out in the "Primer." It has also been indexed so as to facilitate its use.

It is hoped that "Money Facts" will prove useful to students and all others interested in further study of and improvement in our monetary system and that it will stimulate serious thought, research and discussion of the critical issues involved.

WRIGHT PATMAN, Chairman

CHAPTER I

PREFACE

1. Who has the right to create money in the United States?

Under the Constitution, it is the right and duty of Congress to create money. It is left entirely to Congress.

2. To whom has the Congress delegated this money creating right?

To the banking system, that is, to the Federal Reserve System and to the commercial banks of the country.

3. Why is the money-creating power important?

Because, by creating money, banks provide the exchange media which the economy needs to prosper and grow. Since the growth and proper functioning of the U.S. economy require increasing amounts of money over the years, those who control the amount of money exercise great power over business activity, the incomes people earn and economic strength.

4. Why was the banking system given the right to create money?

The reasons are mainly historical. Still the banks do perform a service in creating money. For once the money and credit is created someone must decide whom to give the money and for what purposes. This the banks do. And bank earnings are the return for wise and proper placing of the money supply.

5. What is the Federal Reserve System?

The Federal Reserve System is the “central bank” of the country, composed of 12 regional Reserve banks, and the Federal Reserve Board in Washington and controls the ability of our commercial banks to create money and credit. The Federal Reserve also controls the level of interest rates.

6. Does Congress supervise Federal Reserve policymaking?

No. In practice the Federal Reserve is “independent” in its policymaking. The Federal Reserve neither requires nor seeks the approval of any branch of Government for its policies. The System itself decides what ends its policies are aimed at and then takes whatever action it sees fit to reach those ends.

7. What problems are raised by an “independent” Federal Reserve?

There are two major problems. One is the problem of political responsibility for the country’s economic policies. The other is the problem of final control over the Government’s actions in the economic sphere.

8. What is the problem of political responsibility?

Since the Federal Reserve is independent it is not accountable to anyone for the economic policies it chooses to pursue. But this runs counter to normally accepted democratic principles. The President and Congress are responsible to the people on election day for their past economic decisions. But the Federal Reserve is responsible, neither to the people directly nor indirectly through the people’s elected representatives. Yet the Federal Reserve exercises great power in controlling the money-creating activities of the commercial banks.

9. Why is final control of economic policy a problem?

Because with an “independent” Federal Reserve, Congress and the President can be moving in one direction while the Federal Reserve is moving in the other. The result is sometimes no policy at all. At other times, it leads to the Federal Reserve’s neutralizing the President’s economic policies. This very possibility caused President Johnson to request the Federal Reserve in his 1964 Annual Economic Report to Congress not to nullify his efforts to reduce unemployment and raise incomes. Should the President have to ask any Government agency to go along with his policy as approved by Congress? Obviously not.

10. Who really directs Federal Reserve operations?

Day-to-day operations in each of the 12 regional Federal Reserve banks are supervised by nine directors—six of them selected directly by privately

owned commercial banks. The most important monetary decisions for the system as a whole are made by the Open Market Committee, which is composed of 12 members.

11. Do private bank interests influence Federal Reserve policy?

Yes. Of the 12 members of the Open Market Committee—the Committee which actually controls credit policy—5 are presidents of regional banks. These presidents are elected by the individual regional banks’ nine-man board of directors with its preponderance of private commercial bank representatives. Further, all 12 of the regional bank presidents participate in the Open Market Committee’s discussions, though only 5 can vote. The “discussion” Open Market Committee, then, has 19 members—12 regional bank presidents and the 7 members of the Federal Reserve Board.

12. Does it matter what amount of money is supplied the economy?

Yes, indeed. The money Supply helps determine the general level of interest rates paid for the use of money, employment, prices, and economic growth. Many economists believe the money supply is the most important determinant of these variables.

13. Who determines the money supply?

The Federal Open Market Committee of the Federal Reserve System.

14. Why are interest charges important?

For many reasons. First, interest plays a large part in the cost of living. All business firms borrow to conduct their operations—some more than others. These include firms at every stage of production. So interest is a charge which is added on at each link of the production chain. This is a cost which must eventually be paid by the consumer. If it is not paid by consumers, output cannot be sustained. Thus, interest rates also are a determining factor of the level of business activity. Additionally, interest rates influence production because interest rates influence the amount business spends for investment in plant and equipment, the third largest amount of spending for the country’s annual output. (Interest has this effect because a part of the country’s annual investment is financed by borrowing.)

15. Do interest rate changes and tight money have other effects?

Yes. Consider what happens when the Government is restricting money and credit. Firms find loans difficult to obtain and investment tumbles. Small business is especially hard hit because the larger firms tend to have their credit needs catered to first. Further, when investment falls, firms which produce machinery or build factories find their orders slumping and lay off workers while cutting their own orders for goods. The economy pays for high interest in incomes not earned and in output not produced.

16. What is the “efficiency cost” of high interest?

When investment is cut by high interest two things happen. (1) Business does not take as much advantage of the new, more efficient tools to produce goods as it might. (2) Industry slows down the rate of expansion of the total output capacity of the country’s factories. The result of these twin effects is that tomorrow’s workers work with less efficient machinery and fewer machines than they might. Having fewer and less efficient tools, tomorrow’s workers of course produce less than the could. In other words, the rate of growth output slackens when high interest prevails.

17. What has been the trend of interest rates from 1952 to 1964?

Interest rates in the United State increased in steps between 1952 to 1964; and each major step upward was followed by a recession.

18. What reasons have been given by the Federal officials responsible for the uptrend?

The reasons have differed as the years passed. In the early years, the official reason given was that “too many dollars were chasing too few goods,” causing inflation. In recent years, the deficit in our balance of payments was cited. High interest rates, it was argued, were necessary to keep American capital at home. At all times, there has been constant talk of “fighting inflation,” real or imagined.

19. Can anything be done to stop the trend toward ever-higher interest rates?

Yes. The period from late 1939 to 1951 was as violent and catastrophic as any in the entire history of the United States. At the beginning, of this period, millions were still unemployed from the Great Depression. A short time later, we were shooting away \$250 million every day on the battlefield. Then the war ended and we reconverted to a peacetime economy with tremendous pent-up purchasing power and inflation. Then came the Korean conflict. Yet, during this entire period of economic stress and turmoil the interest rate on longterm Government bonds never exceeded 2½%. And these bonds never sold below par. This proves that the Fed can restrain higher interest rates, when and if it wants to. The Fed has the ability to set the interest rate at 2½% and keep it there.

20. How effective is high interest as an “inflation fighter”?

Well, if killing the patient is considered an “effective” treatment for an illness, then high interest is an effective anti-inflation tool. Of course plunging the country into a deep recession will cut labor’s wage demands and will cause some business firms to make price concessions. But the cost of this is economic stagnation. And even then prices overall will probably not fall and they may even rise. That is, in the modern economy, just lowering the demand for goods and labor somewhat will not necessarily stop a price push. The country learned this bitter lesson in 1958.

21. Does this mean there is no way to restrain inflation?

No. Although the modern economy has a built-in tendency toward inflation—not just in the United States but everywhere in the Western world—and no one has yet found the perfect answer, it is clear that moderation by big business and big labor in their price and wage policies can go a long way toward keeping prices stable. This country has experienced a 8-year upturn from 1961-64 with remarkable price stability as moderate wage-price policies were followed. This is proof that frequent recessions are unnecessary to stop inflation.

CHAPTER II

WHAT IS MONEY?

22. What is money?

Money is anything that people will accept in exchange for goods or services, in the belief that they may, in turn, exchange it, now or later, for other goods or services. Any number of different materials—including paper I O U's—may serve as money. How money functions and what money represents are its important aspects and not simply what it is made of. Today, the American people use coins, currency (paper money) and bank deposits (checkbook money) as money.

23. What did Americans use for money in earlier times?

In the beginning, they used wampum more than anything else. Surprising as it may seem, a bunch of clamshells strung like beads were valuable as money in settler days. But the Indians used wampum as money, and when the settlers wanted to trade with the Indians—as they frequently did—wampum had to be used. So the settlers themselves began to use wampum as money.

24. Did the colonists use coins at all?

Yes. Since the colonists traded with Europe as well as the Indians, they used coins, too. Naturally, there was a rate of exchange between wampum and coins since both were used. In 1641, the New Amsterdam Council fixed the rate of exchange between wampum and Dutch money. As time passed the colonies started minting their own coins and the general use of wampum died out.

25. What was “tobacco money”?

When coin money became short—and this happened—the colonies devised all sorts of money. One—prevalent in Virginia, Maryland, and North Carolina—was the use of tobacco warehouse receipts as money. These receipts were originally issued to tobacco growers when they placed their crop in storage awaiting sale. The owners simply made these receipts

transferable much as endorsing a check today. Of course, as tobacco prices fluctuated from year to year, the value of the tobacco receipt also fluctuated, making it an imperfect medium to hold as savings or by which to designate long-term debt. This illustrates the difficulty of making any commodity—tobacco or gold—the basis of money.

26. What is legal tender?

Legal tender is any form of money which the U.S. Government declares good for payment of taxes and both public and private debts.

27. What is the most important form of money in the United States today?

"Checkbook money" that is, demand deposits in commercial banks. They account, for 80 percent of all the money circulating in the country.

28. Who issues money?

Since the Revolutionary War, the U.S. Government. has minted coins and printed paper money, currency. Other goods, including tobacco receipts, have circulated as "money" although they were not legal tender. But, in the 19th century, the Government delegated its right to print legal tender money first to State banks, then to national banks.

29. Today, who issues coins?

Only the U.S. Treasury has the right to mint pennies, nickels dimes, quarters, half dollars and silver dollars. Then they are issued through the Federal Reserve Banks. The pennies are made of copper; the rest of alloys. Since 1934, the Treasury has minted no gold coins.

30. What is currency?

Currency is paper money, or folding money. Americans use several forms of currency: National Bank Notes, Federal Reserve Notes, Silver Certificates, Treasury Notes of 1890, U.S. Notes and Federal Reserve bank notes. About 94 percent of the currency in circulation today consists of Federal Reserve Notes, issued by the Federal Reserve banks.

31. Have private institutions ever issued money?

Yes. In the 19th century, currency was issued by private “State” banks. Any private company that could obtain a charter to conduct a bank could issue notes. “State bank notes” disappeared when the National Bank Act was passed in 1863.

32. Why was the National Bank Act passed?

The Government wanted a reliable money with uniform value issued by reliable institutions in every section of the country, to finance the growing production and trade. National banks only lost the privilege of issuing bank notes in 1913, when the Federal Reserve System was established.

33. Do private banks issue money today?

Yes. Although banks no longer have the right to issue bank notes, they can create money in the form of bank deposits when they lend money to businesses, or buy securities. (The next chapter will explain how banks create money.) The important thing to remember is that when banks lend money they don’t necessarily take it from anyone else to lend. Thus they “create” it.

34. What backs U.S. currency?

Federal Reserve Notes are backed by the credit of the U.S. Government. American citizens, holding Federal Reserve Notes, cannot demand anything for them except (a) that they be exchanged for other Federal Reserve Notes, or (b) that they be accepted in payment for taxes and all debts, public and private. But, since certain foreign banks may exchange dollars for gold, gold does, in the last analysis, back U.S. dollars. Presently there is a 25-percent gold “backing” for Federal Reserve Notes.

35. Has the United States gone off the gold standard?

Yes, except in its international transactions.

36. Does this change the basis of our money?

In reality, no. The action, which Con took in 1934, merely formalized what had been true all along, which is this: since the 19th century checkbook money, now 80 percent of our money supply, has replaced notes as the most important form of money. And check-book money is created on the basis of all kinds of valuable assets. When a bank makes a loan to a business firm, secured by inventories of machinery, or to a farmer, secured by farm assets, it has, in effect, created a dollar “backed” by inventories, machinery, or farm goods.

37. So, what kind of dollar do we have?

We have a “managed paper currency”—managed because an agency of the Federal Government, the Federal Reserve System, consciously determines and controls the maximum amount of money which can be created by bank lending.

38. To whom does the Constitution give the power over money?

The Congress. The Constitution provides “the Congress shall have power to coin money, regulate the value thereof.” The Supreme Court interpreted this clause, again and again over a period of 150 years, to mean that “whatever power there is over the currency is vested in the Congress.”

39. Why must money be managed?

“Money does not manage itself” is a famous saying of British bankers. It is a saying which Chairman Martin, of the Federal Reserve Board, likes to quote and it sums up the matter quite well. Since the purpose of money is to make it easier for a nation to produce real goods and services, easier to divide the income from this production, and easier to save and invest for the future, the money system should be designed and controlled in ways which serve these purposes best. For example, it is very important to have the right amount of money available at all times. Too little money and too much money are both bad.

40. Why is the right amount of money so important?

The right amount of money is as important to the economic system as the right number of tickets is to the financial success of a theatrical performance.

The theater has only a certain number of seats and distributing too many tickets will cause a scramble for seats when the patrons arrive. Selling too few tickets will leave empty seats. The same holds for money. When the Federal Reserve does not allow enough money to be created, there will be in effect, empty seats in our economy. The economy's growth will be stunted by monetary deficiency—high interest rates with accompanying unemployment and underutilization of plant capacity. Real wealth which might have been created is not created. On the other hand, an economy can suffer from too much money relative to its needs. An overabundance of money, by spurring demand, pressures the economy to produce beyond its capacity. When this occurs, inflation erupts.

CHAPTER III

HOW IS MONEY CREATED?

41. What is the fractional reserve method of banking?

The fractional reserve method of banking originated with the goldsmiths—the predecessors of our present bankers. It is the method of banking in use today. Briefly, it is a system whereby bankers maintain as reserves only a fraction of the amount needed to meet all the claims against them. (The vast bulk of the claims against the banks are the deposits you and I hold. These are obligations which the bank must pay upon our demand.) The goldsmiths struck upon this method by noticing that the people who deposited gold with them for safekeeping only claimed a small portion of this gold at any one time. Therefore the goldsmiths realized that they could lend out a good portion of the gold left with them. They then made loans, which in fact were not of gold but warehouse receipts for gold. These receipts circulated as money. Notice, the gold—actually the certificates of ownership—being loaned by the goldsmith was not his to lend. He did not own it. In other words, the goldsmith wrote receipts to people who were not depositing gold, i.e., to borrowers. So receipts for more gold than the goldsmith actually had in his vaults were circulating. The goldsmith had only a fraction of the amount of gold needed to meet the claims against him. This is the fractional reserve system. When the banks of the United States kept their reserves in gold, their reserves amounted to only a small fraction of the amount of money they had issued, all of which was guaranteed to be redeemable in gold.

42. What are the advantages of the fractional reserve system?

Fractional reserves provide banks with a source of funds which they may invest in sound economic projects, and thus encourage business activity and economic growth.

43. What is the major weakness of the fractional reserve system?

Since no bank can meet all the claims on it at any one time, fractional reserve banking leaves individual banks vulnerable to runs. This is why a system of

central bank reserves—with facilities to lend and transfer reserves in time of need—is necessary.

44. What are reserves in modern American banking?

Reserves in modern American banks are deposits—demand deposits—held by commercial banks at the Federal Reserve.

45. Where did the commercial banks obtain their reserves?

By and large the bulk of commercial bank reserves were created by the Federal Reserve and credited to the account of the various commercial banks which are Federal Reserve “member” banks. The Federal Reserve creates these reserves just as a bank creates checkbook money. By various devices, either loans or other means, the Federal Reserve credits a bank with bankers deposits—“reserves.”

46. Who determines how much checkbook money a bank can create on the basis of its reserves?

The Federal Reserve System sets reserve requirements; that is, the ratio of reserves to deposits that the individual member banks must maintain. This in turn determines how many loans a bank can make, and how many securities it can buy.

47. Where does the Federal Reserve get the money with which to create bank reserves?

It doesn't “get” the money, it creates it. When the Federal Reserve writes a check, it is creating money. This can result in an increase in bank reserves—a demand deposit—or in cash; if the customer prefers cash he can demand Federal Reserve notes, and the Federal Reserve will have the Treasury Department print them. The Federal Reserve is a total moneymaking machine. It can issue money or checks. And it never has a problem of making its checks good because it can obtain the \$5 and \$10 bills necessary to cover its check simply by asking the Treasury Department's Bureau of Engraving to print them.

48. Who gave the Federal Reserve the power to create the money necessary to cover its checks?

The Congress. Because this power to create money is given by the Constitution to Congress, only the Congress can delegate this power. And this it has done in creating the Federal Reserve System—an agency of Congress authorized to create money.

49. How does the Federal Reserve change the money supply?

First, by increasing or decreasing the amount of bank reserves which the member banks of the Federal Reserve System have to their credit on the books of the Federal Reserve banks. Second, by regulations which tell the member banks the maximum amount of bank deposits they may create per dollar of reserves.

50. What is the formula that determines the maximum amount of money available to business and consumers?

Expressed mathematically this is a simple formula $A \times B = C$ where: A = Amount of bank reserves; B = Number of dollar deposits member banks may create per each dollar of reserves; and C = Total bank deposits.

51. Can the Federal Reserve authorities change the money supply formula?

Yes. They can change either or both parts of the formula at anytime and they frequently do change one or both parts. There are certain limits set by time Federal Reserve Act to the changes the authorities can make. But these limits are extremely wide.

52. Does it make any difference which part of the formula the authorities change when they wish to increase the money supply?

Yes. Although the effect on the money supply of changing either part of the formula may be the same, the total economic effects differ depending on which part of the formula is changed. For example, when the Federal Reserve lowers reserve requirements, all of the new money is created by the commercial banks through their lending and investing activity. This obviates the necessity of transferring Government securities from private to public

hands. On the other hand, when the Federal Reserve increases reserves by, say, purchasing U.S. Government securities, the interest income on these securities goes to the Federal Reserve System. Since the Federal Reserve turns over to the U.S. Treasury most of its earnings, the net effect of increasing the money supply by increasing reserves is to favor the private banking system. So, when the Federal Reserve officials decide to increase the money supply, whether they favor the U.S. Treasury or the private banks does make a difference—millions of dollars of difference—in the amount of taxes you, I, and all other taxpayers must pay.

53. As bank reserves rise do private banks “deposit” their reserves with the Federal Reserve?

Collectively, private banks do not deposit a penny of their own funds, or their depositors’ funds with Federal Reserve banks. Reserves are transferred from bank to bank, but nothing the banks can do will increase the total amount of reserves in the system. Practically, only the Federal Reserve System itself can do this or to permit it to occur from a gold inflow. Increasing or decreasing reserves is a conscious act of the managers of the Federal Reserve.

54. How does the Federal Reserve create and destroy bank reserves?

By four methods: (1) by open market operations; (2) by gold purchases for the U.S. Treasury; (3) by loans to commercial banks; and (4) by purchases of eligible paper from member banks.

55. What are open market operations?

They are the Federal Reserve’s purchases or sale of U.S. Government securities in what is called the “open market”—in order to expand or contract bank reserves and hence the supply of money and credit available. The Federal Reserve Bank of New York conducts these transactions as agent for the entire system.

56. What is the “open market”?

It is composed of about 20 private dealers of U.S. Government securities with whom the Federal Reserve Bank of New York trades. Several of these dealers are big New York and Chicago banks.

57. How much in bank reserves has been created by the Federal Reserve?

The answer was given in early 1960 by Chairman Martin of the Federal Reserve Board. Between the end of 1917 and the end of 1959, the Federal Reserve System had created gross additions to bank reserves amounting to a total of \$46 billion. Over the years, the banks had drawn down their bank accounts by \$28 billion by taking out currency (which was printed to meet their requests), leaving them with a net reserve balance of \$18.5 billion.

58. How does the Federal Reserve create bank reserves by open market operations?

The step-by-step details are as follows: Let us assume that the Federal Reserve Bank of New York, acting as agent for the whole System, buys a \$1,000 Government bond in the “open market.” It gives the bond dealer a check for \$1000 drawn on the Federal Reserve Bank of New York. The dealer will, of course, deposit this check in his checking account, say, with the Chase Manhattan Bank. The Chase Manhattan credits the dealer’s checking account with \$1,000 and then sends the check to the Federal Reserve Bank of New York for payment. The Federal Reserve Bank of New York makes payment to the Chase Manhattan by crediting its reserve account with \$1,000.

59. For whom does the Federal Reserve purchase or sell gold?

For the U.S. Treasury.

60. Where does the gold come from?

The gold is either newly mined or else comes from foreign central banks.

61. Why does the Treasury buy gold?

To add to the Nation’s monetary gold stock and assure us enough gold to meet any claims from foreigners who hold dollars.

62. Do banks have an automatic right to borrow from the Federal Reserve bank?

No. Member banks of the Federal Reserve System are eligible to borrow. But being eligible and obtaining a loan are two different things.

63. How are Federal Reserve loans to banks secured?

The law permits a Federal Reserve bank to accept a variety of good collateral to secure its loans. In practice, however, banks borrowing from the Federal Reserve System almost always put up U.S. Government securities as collateral.

64. Do the banks of the Federal Reserve System pay for their reserves?

No. Bank reserves cannot be paid for by private banks. They can be shifted from bank to bank after they are created. But to all intents only the Federal Reserve System itself can create or extinguish reserves. Indeed, when the Federal Reserve creates bank reserves this permits the banks to increase their loans and augment their profits.

65. How do currency and coin enter the money supply?

The proportion of currency and coin in circulation to the total money supply is pretty much automatic. It normally amounts to about 20 percent of the money supply, with bank deposits accounting for the other 80 percent.

66. Who determines how much currency and coin is issued?

Given the total money supply depends on the behavior of individuals and business firms. The amount of currency and coin in circulation depends on how convenient individuals and business firms find currency and coin rather than bank deposits in carrying on trade. As indicated, normally currency and coin make up 20 percent of the money supply.

67. Who determines how much checkbook money shall be created?

A committee made up of the members of the Board of Governors of the Federal Reserve System and the Presidents of the 12 Federal Reserve banks make this decision. The Open Market Committee—as it is called—decides only what the maximum amount of money maybe; it cannot determine the

maximum amount which will actually be created. Money is actually created when private banks make loans or investments. In terms of the formula the Open Market Committee determines "A" and "B." "C" represents the maximum value the money supply can reach.

68. Can Federal Reserve officials help the U.S. Treasury and U.S. taxpayers without increasing the money supply?

Yes. They can create more reserves by buying more Government securities in the open market and by raising reserve requirements for the member banks. This means that, for any given supply of money, the Federal Reserve would own more Government securities and the private banks would hold correspondingly less. This would not entail any change of the money supply. In terms of the formula, "A" would be raised "B" would be lowered, and they would just offset each other so that "C" would remain the same.

69. If the Government can issue bonds, why can't it issue money and save the interest?

A few clear-headed and firm individuals, such as Abraham Lincoln, have insisted that the Government should.

The late Thomas A. Edison stated the matter this way: If our Nation can issue a dollar bond it can issue a dollar bill. The element that makes the bond good makes the bill good also * * * .

It is absurd to say that our country can issue \$30 million in bonds and not \$30 million in currency. Both are promises to pay: but one promise fattens the usurer and the other helps the people.

However, it has long been one of the political facts of life that private banks must be allowed to create the lion's share of the money, even if not all of the money. Thus there is little opposition to the Government's printing bonds and then permitting the banks to create the money with which to buy those bonds; but proposals that the Government itself create the money instead of the bonds have always set off tremendous political upheavals. For example, Abraham Lincoln set off a political furor when he insisted upon having the Government issue \$346 million in money (the so-called "greenbacks") instead of issuing interest-bearing bonds and paying Interest on the money.

70. If the Government issued more money instead of Government bonds, isn't there a danger that the Government would issue too much money and cause inflation?

No. It is no more or no less inflationary for the private banks to create \$1 billion of new money than it is for the Government to create \$1 billion of new money. Furthermore, as an agency of the Government the Federal Reserve System, decides in any case the total amount of money to be created.

CHAPTER IV

WHY WAS THE FEDERAL RESERVE ACT PASSED?

71. What is a central bank?

A central bank has two essential functions. One is to serve as a bankers' bank, i.e., a bank which gives credit to the commercial banks and also holds their official reserves. The other is to adjust the money supply through the power to create reserves or to regulate the commercial banking system's ability to manufacture money. A bank which performs these and other related functions is called a "central bank." The Federal Reserve is a central bank.

72. How does the Federal Reserve System differ from other central banks?

First, it is a system of 12 separate regional banks. Second, membership in the System is not compulsory for private commercial banks, except for national banks.

73. Was the Federal Reserve the first central bank in the United States?

No. Both the First and Second Banks of the United States were chartered to combine central and commercial banking. After 1836, however, when Andrew Jackson refused to extend the Second Bank's charter, the United States was without a central bank.

74. In what ways did American banking experience during this period lead to passage of the Federal Reserve Act?

During the 19th century, the fractional reserve system, operating without central bank supervision led to money panics, bank crises, and depressions. Furthermore, the monetary system proved unable to provide the money necessary for the country's growing volume of industry and trade on a rational basis. National banks could create deposit money and notes, but were limited by their gold reserves. This meant that the total money supply was

unresponsive to the needs of trade. Moreover, since it was customary for country banks to keep their reserves in New York, there were nationwide shortages of money periodically, as at harvest time. And at all times, the New York banks used the pyramided funds in the stock market in New York. As a result, between the end of the Civil War and passage of the Federal Reserve Act, the country suffered from four major money panics: 1873, 1884, 1893, and 1907.

75. In what specific ways did the panic of 1907 lead to central banking in America?

Public indignation at the banking manipulations which led to the panic stirred Congress to authorize a National Monetary Commission, headed by former Senator Nelson Aldrich. The results of the commission's study were published in 20 volumes, and in 1912, a bill was introduced in Congress embodying reforms, of which the most important was the proposed establishment of a central bank with powers to regulate banking.

76. Was the Aldrich Commission alone in suggesting a central bank?

No. The House of Representatives had begun the famous "Pujo Committee" hearings which gave the public a picture of the "money trust," a network of holding companies and other interlocking relationships which gave a small group of Wall Street tycoons control, not only of all the big banks of New York City, but of most of the financial power of the whole country.

77. What were the main purposes of the Federal Reserve Act?

First, it was intended to mobilize reserves—to strengthen the fractional reserve system—and thus increase public confidence in the banking system. Second, it was designed to provide an "elastic currency" responsive to the needs of local business and trade. Third, it was to provide central bank supervision, to insure sound banking practices, and to safeguard against insolvency and loss of depositors' money. Fourth, it was to provide a system by which the banks could clear checks promptly and uniformly throughout the Nation.

78. Was the Federal Reserve System established as a private or public agency?

The Federal Reserve was established as a public agency. But private banks were given control of the 12 regional Federal Reserve banks that is, they were given the privilege of electing six directors of each bank, and these directors—a 2/3 majority—in turn, selected the presidents and other chief officers of the bank.

79. Did the powers given to the Federal Reserve include discretionary control over the quantity of money?

No. It was expected that increases and decreases in the money supply would be ‘automatic.’ Private banks would continue to increase—and extinguish—money by making loans to business in their locality, under safeguards prescribed by the law. The “automatic” feature was that the regional Federal Reserve banks were now available to increase reserves for member banks when and as these needed more lending power to finance the short-term needs of farmers and businessmen in bringing their goods to market.

80. What other powers were given to the Federal Reserve?

The Federal Reserve was given the right to discount “eligible paper” for member banks, that is lend money to the banks on the basis of the commercial paper arising from loan transactions with their customers. The minimum amount of reserves which member banks were required to keep on deposit with the Federal Reserve, however, was prescribed by law.

81. Were any powers given the Federal Reserve Board in Washington?

Yes. The most important was the right to review and determine the discount rate—the interest rate charged by the regional banks when they loaned the commercial banks money on eligible paper. Other powers included formulating new rules to safeguard the banks against dangerous practices.

82. Who must join the Federal Reserve System?

State-chartered banks are not compelled to become members of the System. All National banks, however, must join as a matter of law. Membership in the

System requires meeting certain minimum standards prescribed by the Board of Governors of the Federal Reserve.

83. In what ways was the Federal Reserve System an improvement upon the Preceding monetary system?

1. It permitted mobilizing reserves where they were needed in times of difficult and eliminated the pyramiding of reserves in New York.
2. The Federal Reserve, although a central bank, was also in part decentralized, operating in 12 regions throughout the country.
3. The Federal Reserve Act provided virtually uniform regulation for all the banks of the Nation. (Although almost half of the banks of the Nation are not members, banks accounting for 85 percent of all commercial bank deposits are members)
4. The Federal Reserve System was designed to provide an adequate money supply, one which expanded and contracted with the needs of trade.

84. How is the Federal Reserve System organized?

The Federal Reserve System is composed of the Board of Governors, the 12 Federal Reserve banks. Approximately, 6,100 private commercial banks are members of the System. The most important Policy making group is the Federal Open Market Committee.

85. How many members of the Board of Governors are there?

There are seven members of the Board of Governors. They are appointed by the President for terms of 14 Years, with one term expiring each 2 years.

86. Where are the 12 Federal Reserve banks located?

In Boston, New York, Philadelphia, Richmond, Atlanta, Cleveland, Chicago, St. Louts, Dallas, Kansas City, Minneapolis, and San Francisco.

87. Who are the members of the Federal Open Market Committee?

The Federal Open Market Committee consists of 12 members, 7 members of the Board of Governors plus 5 of the 12 presidents of the Federal Reserve banks. These are the voting members. But all of the regional bank presidents participate in policy discussions of the Committee. In that sense it is a 19 member Committee.

88. What are some of the routine operations of the Federal Reserve System?

Check clearing, furnishing currency, acting as fiscal agent for the U.S. Government (by issuing all notes and bonds of the Federal Government).

89. What are some of the regulatory operations of the Federal Reserve?

First, it regulates the number of banks in the System by fixing requirements for membership. Then it examines the books of State member banks to see that these banks meet the requirements for operations laid down by the Board of Governors. (National banks are periodically examined by the Comptroller of the Currency in the Treasury Department).

90. What are the important policy operations of the Federal Reserve System?

The Federal Reserve has the power to determine the money supply and thus strongly influence the level of economic activity and the general level of interest rates. It controls the money supply through its control over the, within limits, percentage in reserves member banks are required to hold behind their deposit liabilities and by controlling the amount of reserves actually available to member banks. The most important tool for controlling the amount of member bank reserves is in the hands of the Federal Open Market Committee.

91. What are the sources of revenue of the Federal Reserve?

By far the largest is interest on its holdings of U.S. Government securities. This accounts for almost 99 percent of Federal Reserve income.

92. How much of the Federal Reserve earnings must be returned to the Treasury?

No law or regulation specifies how much of the Federal Reserve's earnings must be returned to the Treasury, but in practice the Federal Reserve spends all of the income it cares to spend, pays dividends to member banks on their "stock" and sets aside a large amount as "surplus." The remainder is then returned to the Treasury. It usually returns an amount several times the amount of its expenses.

CHAPTER V

WHO DETERMINES THE MONEY SUPPLY?

93. Who appoints members of the Federal Open Market Committee?

Seven of the nineteen members of the “discussion” Committee are appointed by the President of the United States and confirmed by the Senate of the United States. Their term is 14 years. The other 12 participants at Open Market Committee meetings are elected through votes of private commercial bankers; specifically they are the presidents of the 12 Federal Reserve banks, elected to their posts indirectly by bankers from banks which are members of the Federal Reserve System.

94. What are the most important Open Market Committee powers?

The Open Market Committee has the power to determine the Nation’s Supply of money and credit, and therefore, the general level of interest rates, among other things.

95. How does the Federal Reserve influence interest rates?

By open market operations, and by setting the required reserves of member banks, the Federal Reserve determines the amount available for lending. This together with the demand for loanable funds is the heart of the market for money that sets interest rates. In addition, by open market operations, the Federal Reserve can effect the level of interest rates on Government bonds. And finally, the Federal Reserve influences expectations about interest rates.

96. Why is the Federal Open Market Committee one of the most powerful groups of men in our country?

Because in many ways their power is equal to that of the President in deciding how the world’s greatest economic mechanism will operate. By regulating the supply of money, the Committee can control the general level of interest rates. This in turn is one of the major determinants of the level of business activity in the country. The Committee, then, has the power to offset any action taken by anyone to stimulate or restrain the country. This indeed is power.

97. Are current open market operations what the founders of the Federal Reserve System intended?

No. It was expected that in monetizing “eligible” short term commercial paper, the Federal Reserve would provide sufficient liquidity to sound banks in periods of need (or restrain excessive credit expansion). While the Federal Reserve was expected to exert supervisory powers, it was expected that the money supply and interest rates, would be fully responsive to business conditions. Thus the discount rate, rather than open market operations was regarded as the Federal Reserve’s most important tool.

98. Why was the discount rate regarded as an important regulatory tool?

Because under the original Federal Reserve arrangement, no specific limits were placed on the amount of money the system could create. After all, if the banks had eligible paper to rediscount, then the regional bank would automatically create reserves. This raised the possibility of infinite money creation provided the banks’ lending rates and the system’s charges were in a fixed favorable relation. But if the system could control the discount rate, it could discourage rediscounting or borrowing from it simply by raising its discount rate high enough. At a high enough rate, the commercial banks would find no businessmen willing to borrow. Thus the supply of eligible paper available to the commercial banks would dry up and, in turn, the commercial banks would be unable to acquire more reserves by discounting. The automatic system than had a regulator; namely, the discount rate.

99. Is eligible paper discounted much today?

Very rarely.

100. Why have open market operations replaced discounting as the most important means of regulating the money supply?

Basically, because the Federal Reserve found open market operations a more sensitive tool to control the money supply. And through the years the Federal Reserve has decided that its responsibilities were not consistent with the authorization of an automatic money supply.

101. Precisely what does the Federal Open Market Committee do?

It determines the amount of government securities the Federal Reserve will buy and sell, in order to influence the level of bank reserves. In essence, the Committee determines U.S. monetary policy.

102. What functions have been left to the regional banks?

Now that discounting eligible paper is rarely used, the regional Federal Reserve banks clear checks and gather statistics and other economic data.

103. Have the intentions of the founders of the Federal Reserve System been altered by the turn to open market operations?

Yes, when the System was originally founded a struggle was waged over who would control the Federal Reserve—public or private interest. The solution was a compromise. But what (in 1913) was the master switch governing the money supply—the discount rate—was left in the hands of a totally public body—the Federal Reserve Board in Washington. This was a deliberate act. President Wilson rejected the notion of diluting the public nature of the Board when he said, “Which one of you gentleman would have me select the presidents of railroads to be on the Interstate Commerce Commission to fix passenger rates and freight rates?” But when Congress in 1933 and 1935 authorized the Open Market Committee, which in effect succeeded to the policymaking role of the Board, it gave private interests a firm foothold in determining monetary policy—the money supply and the general level of interest rates. Five of the twelve voting members of the Open Market Committee are regional bank presidents. These men hold their offices through the votes of bank directors, two-thirds of whom are elected by private bankers. The other seven bank presidents, of course, participate in the discussions of the Open Market Committee. The upshot is that men whose views must meet the test of the private bank-selected directors help determine the Government’s monetary policy. A purely public group has given way to a mixed body with questionable qualifications to represent the public interest.

104. Who should be members of the Committee?

All members of the Committee should be public servants. There is absolutely no reason why they should not be. Private influences—especially private bank influences—have no place in setting the Nation’s monetary policies.

105. What is the Open Market Account?

It is the unit of the Federal Reserve Bank of New York that carries out sales of bonds and bills for the Treasury. The manager of this account acts as agent for the Treasury, the Federal Open Market Committee and seven foreign banks.

106. How does the open market work?

The actual operations are as follows: the Treasury determines each week how much money it will need during the week following and notifies the manager of the Open Market Account. All interested parties, including the 20 dealers are notified and bids are made on Monday. On the following Tuesday, the Treasury announces to whom the securities have been sold.

107. How much business does the Open Market do?

The annual volume of dealings in Government securities in New York amounts to over \$400 billion. Of this the Open Market Committee of the Federal Reserve accounts for roughly \$20 billion.

CHAPTER VI

WHO OWNS THE FEDERAL RESERVE BANKS?

108. Why do some people believe that the private banks “own” the Federal Reserve System?

Because the original act required that member banks invest a sum equal to 6 percent, of their capital in the stock of their regional Federal Reserve bank.

109. Was this required to disseminate Federal Reserve ownership?

No. This “stock” requirement was actually a safeguard against misuse of the Government credit that was being delegated to the banks. Because private banks, and the regional Federal Reserve banks they controlled, might pass on loans that were doubtful, the probity of Federal Reserve notes (and Treasury balances kept on deposit at the Federal Reserve banks) might be endangered. Forcing member banks to “invest” some of their capital in the Federal Reserve was a guarantee against loose practices.

110. What exactly is the “stock” owned by the banks?

It is not “stock” in the normal, corporate-investment sense of the word; it carries no Proprietary interest; it cannot be sold or pledged; it represents no claim on Federal Reserve assets, and carries no voting rights. It is not ownership stock at all.

111. Could the Federal Reserve operate without this “stock”?

Yes. Today, it serves no worthwhile purpose whatever. Eliminating the stock would change nothing in the basic structure and functions of the Federal Reserve. The Federal Reserve does not need the money. It can write its own check whenever it needs money.

CHAPTER VII

WHY WAS THE FEDERAL DEPOSIT INSURANCE ACT PASSED?

112. What problems emerged in the banking system in the twenties?

The transformation of the banking system into a credit mill fueling the wildly inflating stock market—via call loans to brokers—revealed fundamental weaknesses when the stock market collapsed. Together with mistaken Federal Reserve actions the collapse of the market weakened many banks to the point of bankruptcy. After the bank holiday several emergency legislative efforts were made to improve the banking system mid to protect the banking public.

113. What changes were made by the Banking Act of 1933?

This act prohibited interest on demand deposits in order to prevent unsound competition for demand deposits, and also as compensation to the banks for having to pay the fee for insuring deposits. In addition, the Federal Reserve Board was given power to change reserve requirements, subject to approval by the President. Also, in turn, investment bankers were prohibited from accepting public deposits. The most important part of the Banking Act of 1933, however, was the establishment of a temporary deposit insurance plan which went into effect on January 1, 1934. This was made permanent by the Banking Act of 1935 which established the Federal Deposit Insurance Corporation.

114. What is the Federal Deposit Insurance Corporation?

A Government-sponsored corporation to provide insurance for depositor of funds in banks against the loss of such funds, up to \$10,000.

115. What is an insured bank?

A bank is insured when it complies with FDIC rules and becomes an insured member of the organization. In selecting members, the FDIC considers the adequacy of the bank's capital structure, its earnings prospects, and the

general character of its management. At the end of 1962, 13,455 banks were members, while only a few hundred small banks had not joined.

116. What is an insured deposit?

When a bank becomes a member of the FDIC each individual deposit in time bank is insured up to \$10,000.

117. What happens if an insured bank fails?

Depositors receive the full amount of their deposits, up to the maximum of \$10,000 per deposit, usually within 10 days to 2 weeks. If the FDIC desires it may set up a new bank in the community.

118. How many insured banks have failed since 1933?

Four hundred and forty-seven (as of December 31, 1963).

119. Where does the FDIC get its money?

From assessments on insured banks, and interest on U.S. Government securities it holds.

120. Where did the FDIC get money to start operations?

The Treasury purchased \$150 million of stock in the FDIC, and the Federal Reserve, on instructions of Congress bought \$139 million of stock. This stock was repaid by the FDIC in 1947 at 2 percent interest.

121. How much do the insured banks pay the FDIC?

Insured banks pay annually a gross assessment of one-twelfth of 1 percent of their total deposits.

122. Is the FDIC subsidized by the Federal Government?

Yes. Although it paid back the original \$289 million of stock several subsidies remain. The fact that the FDIC gets half its total income from Government securities itself represents a sizable subsidy.

123. What direct commitment does the Treasury have to the FDIC?

The 1947 amendments to the Federal Deposit Insurance Corporation Act provide that the FDIC can borrow up to \$3 billion from the U.S. Treasury at its discretion. The law directs the Secretary of the Treasury to put up this \$3 billion any time the FDIC wants it.

124. Does FDIC regulate and control insured banks?

Yes. Under the provision of the act which allows the FDIC to see to it that banks do not engage in “unsafe and unsound practices in conducting business” and which allows it to lay down basic requirements for membership, the FDIC has come to regulate the banks rather completely. The FDIC can prevent banks from making investments its examiners deem undesirable. And, FDIC conservatism is making it more and more difficult for small businessmen and farmers to get the financial assistance they need.

CHAPTER VIII

HOW THE FEDERAL RESERVE PROVIDES PUBLIC FUNDS TO THE PRIVATE BANKS

125. Do private banks enjoy a special relationship with the Federal Government?

Yes, a very special relationship. The business of banks is to lend money. The profit comes from the difference between the cost of creating money and the price they charge borrowers for that money. Now the cost of creating money is negligible. Congress has delegated the power to create money to the banking system without a charge. The banks do not pay a license fee or a payment charge for their reserves. Thus the raw materials the banks use cost them nothing. Also the Government subsidizes the private banks in other ways. The banks receive free services from the Federal Reserve. Check-clearing is one example. Further, the Federal Government provides private banks with protection from competition and the hazards of failure. New national banks are not chartered unless the Federal officer in charge of such matters thinks the new bank will succeed and will not “weaken” substantially any already existing bank. Then again, the FDIC has set rigid standards for a bank to receive insurance. No new bank whether National or State chartered can very well succeed unless it obtains insurance. A basis for this insurance is that time new bank will not face, or cause, “undue” competition.

120. Why is the Government interested in subsidizing the private commercial banks?

Because it furthers the public interest, up to a point. Our economy cannot function without a sound banking system and a well run, reliable money supply. The Government’s concern for the banking system is actually a concern for a flourishing economy. Bank profits are necessary for a good banking system. So the Government makes provisions through its regulations that bank profits are protected. Bank profits are only a means toward furthering the general public interest.

127. In recent years has the Federal Reserve exhibited an under regard for bank profits and an offhand regard for the public interest?

Yes. In recent years the Federal Reserve has, regrettably, followed a policy which has given away billions to the private banks. It has done this by increasing the money supply largely through lowering bank reserve requirements. The Federal Reserve could have provided part of the increase in the money supply itself by purchasing Government securities. But it did not choose to do so.

128. Is there an example of the Federal Reserve's letting the private banks create all the money needed to increase the money supply?

Yes. In the early part of 1958, the Federal Reserve lowered reserve requirements in order to let private banks increase the money supply by a maximum of \$10 billion. The purpose of reducing reserve requirements was to make more funds available for loans to business. The banks, instead, used the new "excess" reserves to acquire \$10 billion of interest-bearing U.S. Government securities. This is an example of a giveaway"—Where the Federal Reserve should have purchased Government securities instead of letting private banks do it—to the advantage of their profits and to the disadvantage of the taxpayers.

129. What was the bond giveaway bill?

This was a bill sponsored by the American Bankers' Association, introduced in Congress in 1959. Its purpose was to transfer \$108 billion of Government securities from the Federal Reserve to private bankers. The goal was to reduce "enormous" Federal Reserve holdings of Government securities—and transfer them, and their interest income, to private firms. The mechanism was to permit banks to count vault cash as reserves, and use the "excess" reserves thereby created to buy bonds from the Federal Reserve. The bill was passed into law only after the House stated its firm opposition to the give that the new away sections of the bill, and expressed the hope "excess" reserves would be used to expand business loans.

130. Is there any reason to give private bankers more bonds?

Since they already receive almost \$2 billion in interest from the Government, and have profited steadily from reserve requirement parings, it would be

wrong. Bonds should be transferred to the Federal Reserve from the private banks, not the reverse.

131. Do private banks perform a service in buying Government bonds?

No, because they create money—an obligation of Government simply to buy bonds guaranteed by the Government. There is no risk involved, as there is in loans to businessmen and consumers. The banks' traditional functions are to lend to private borrowers and assume the risks of creditors. Their reward for buying bonds with money they create is the "subsidized" profits they enjoy.

132. What is the "burden" of U.S. Government bonds, held by the private banking system?

The burden is the heavy bond interest payments, borne by the taxpayers, that go to private bankers when the same amount of money could be created by an agency of Government. Then the taxpayers would not bear this tremendous cost on Government bonds purchased with reserves given to the private bankers.

CHAPTER IX

WHAT IS MONETARY POLICY?

133. What is monetary policy?

Monetary policy deals with the operating instructions of the managers of our money factory. Monetary policy is what fits money into the structure of the economy. In specific terms it consists of the decisions the money managers make about the quantity of money, the price of money, and the availability of money. These are the quantities the money managers can manipulate precisely. Of course, the goal of a particular monetary policy at any one time is to steer the economy in the direction desired by the monetary authorities. In the broadest sense, monetary policy can be thought of as manipulation of the money supply in the pursuit of broad economic goals.

134. What types of broad monetary policy are there?

There are two. One is called “passive” and the other “active” monetary policy.

135. What is “passive” monetary policy?

A passive monetary policy is one which does not provide for any day-to-day or year-to-year decisions by money managers to influence the volume or kinds of economic activity. The money supply is not regulated to achieve a specific economic target. This does not mean that interest rates do not move up or down. They do. But these moves of the interest rate do not result from any deliberate action by the monetary authorities.

136. What rules guide the money supply in the passive case?

Broadly speaking, they are automatic, akin to the rules a thermostat follows in controlling a room’s temperature. For example, the system can be told to increase the money supply by, say, 8 percent a year. Or, more complicated rules can be devised.

137. What is “active” monetary policy?

Active monetary policy is the decision of the Government to give its monetary agencies the power and the responsibility to influence the economy, through deliberate and constant adjustments of the monetary mechanism. With active monetary policy, the prevailing level of the money supply and of interest rates at any time, results from a conscious choice by the central bank.

138. What kind of monetary policy has the United States followed in recent years?

An “active” policy.

139. What subtypes of active monetary policy are there?

There are two. One is “tight money policy”—a policy which restricts the money supply in order to decrease its availability and raise the general level of interest rates. The other is “easy money policy,” the opposite of a tight money policy.

140. What kind of action has been characteristic of Federal Reserve activity?

Generally speaking a “tight money policy.”

141. Is a tight monetary policy a delicate instrument?

No. And this is the cause of much of the controversy about monetary policy. The effects of monetary policy are extremely widespread. For example, a tight money policy works by slowing down the whole economy. Sometimes this is what the Federal Reserve wishes to do. At other times, it is clear that the Federal Reserve is interested only in restricting some particular activity—as was the case with the consumer buying upsurge of 1955 when consumers were devouring autos and other drabbles. In order to restrict consumer buying of durable goods, the Federal Reserve tightened money. But there are times when the Federal Reserve is not interested in restricting consumer buying and, nevertheless, tightens money for other purposes. An example is the period from late 1961—1962. The Federal Reserve tightened money during this period in response to the balance-of-payments deficit. It had no wish to

restrict consumer buying. On the contrary, there was widespread concern about sluggish demand and unemployment. But if tight money restricted demand in 1955, it follows that it should have been expected to restrict demand in 1961, and it did. Such is the shotgun effect of tight money that any attempt to use it as a precision tool must fail.

142. Must the money supply grow over the long haul?

Economists unanimously agree that the stock of money will have to grow—probably at about the same rate as the economy—if economic growth is not to be stunted. Failure to provide adequate money will spawn an era marked by deep recessions, abortive recoveries, low investment high interest rates, and chronic unemployment. This long-pull need for adequate growth in the money stock is the first commandment for monetary policy—active or passive.

143. What does the Federal Reserve mean when it says, “It can’t push on the string”?

The Federal Reserve is drawing attention to the fact that while tight money—pulling on the string—can always slow down the economy, easy money cannot always spur the economy. Their argument is that in a depression businessmen become so pessimistic that they are unwilling to borrow for investment despite rock bottom interest rates. At the same time, banks, in a depression, are very choosy about lending. With many businesses on the verge of bankruptcy, good credit risks are hard to find. So though the Federal Reserve provides the banks with vast amounts of reserves, the banks, they claim, find it very difficult to place the money with prospective business investors.

144. What kind of monetary policy did the founders of the Federal Reserve think they were encouraging?

Passive. When the Federal Reserve was founded there was no thought, either in or out of Congress, that the country’s monetary policy would be anything but passive. The Federal Reserve System was established to provide automatic increases in the money supply in proportion to the need of trade and commerce. At least that was the theory.

145. What happened to the original concept?

By 1920 Federal Reserve officials were taking at least occasional steps to reduce the supply of money in order to slow down general economic expansion and to effect a reduction in prices which these officials thought desirable. This was but a first step toward an active monetary policy. After the collapse of 1929—1933, the final turn in active versus passive monetary policy came. The Banking Act of 1935 gave final form to the Open Market Committee. With this act the Federal Reserve claimed that Congress had placed responsibility for national monetary and credit policies in the Federal Reserve System. In truth, the 1935 act makes no mention of “monetary policy,” “monetary powers or “monetary controls.” Nor is there any provision suggesting changes in the original monetary policy beyond the Federal Reserve Act of 1913.

146. What were the lessons of World War II about economic policy?

The main lesson was that our country need never again suffer from a prolonged depression like that of the 1930's. During the war we had full employment and the economy produced gigantic quantities of goods. If we could maintain full employment in wartime why not in peacetime ! Only now our economy can produce goods to eliminate poverty, ignorance, and disease rather than goods or the destructive processes of war. The second lesson was that the Great Depression resulted from the failure of Government to recognize and assume its responsible role in the economy. This included the monetary aspect of Government policy.

147. What did the 1946 Employment Act say about monetary policy?

The act says it would be the policy of the Federal Government “to coordinate and utilize all its plans, functions and resources” to promote “maximum employment, production and purchasing power. And this was to one in a manner calculated to foster and promote free competitive enterprise.” There was no question in anybody's mind, at the time the act was passed, but that monetary policy would be coordinated with other policies of the Government in the pursuit of full employment. And so they were, until shortly before the famous Treasury-Federal Reserve “accord” of March 4,1951.

148. What was the famous Treasury-Federal Reserve “accord” of March 4, 1951?

It was the culmination of a longrun conflict between administration policy and the Federal Reserve which ended in the Federal Reserve becoming “generally independent” of the policies of the rest of the U.S. Government. From that time on the Federal Reserve undertook to go “its own way” in deciding national monetary policy.

149. What was the result of Federal Reserve “Independence”?

In practical terms the result was to commence a long decade of progressively tighter money. Given its freedom, the Federal Reserve has instinctively chosen to tighten money at every conceivable opportunity. The fact that tight money is a shotgun weapon to be used only for broad economic effects did not deter the newly independent Federal Reserve from trying to aim at specific targets.

150. What is the “bills only” policy?

“Bills only” refers to Federal Reserve Open Market Committee trading in the open market confined to very short-term Government securities, preferably 91-day Treasury bills. This was a move to affect bank reserves, and hence overall credit and the money supply, only through short-term interest rates. Long-term interest rates would be affected, but only indirectly and after a time lag. This, in effect, created a so-called free market in long-term Government securities. The Federal Reserve ceased supporting long-term U.S. Treasury bonds, except in cases where the market became “disorderly” or “threatened” to become disorderly.

151. When was the “bills only” policy abandoned?

Only in February of 1961, after repeated urgings from Congress and the newly elected President Kennedy.

152. In what way can the demise of “bills only” be taken as the end of an era?

It signaled the end of giving priority to controlling inflation and the balance of payments by tight monetary policy. President Kennedy and President Johnson chose other techniques of economic control—such as the tax cut, the

accelerated depreciation schedule, operation “twist” the “interest equalization tax” to discourage oversea flows of funds.

153. What is the basic reason the Federal Reserve has continually tightened money?

Fear of inflation. The Federal Reserve has been haunted by the fear of inflation for years. There is very little evidence to justify this fear. The economy has paid heavily to ease the inflation nightmares of the independent monetary authorities. Using tight monetary policy, presumably to stop inflation, while the economy was actually stagnating, is positive proof that something is basically wrong with the theory and practice of Federal Reserve monetary policy. It indicates that Federal Reserve policy has arrived at the point where it is willing to make the economy pay a calamitous price for a dubious safeguard. If inflation indeed threatens, then one fact is clear: monetary policy is an unsatisfactory weapon with which to fight it under conditions of 1958—1963.

154. Has tight money raised the national debt?

Yes. It can be shown that if the interest rates of the early 1940’s had prevailed throughout the postwar period, the total national debt would be \$40 billion less than it is now. This is just one of the terrific costs of tight money, and also proves that raising interest rates is not a simple solution to more serious economic problems. Interest will just not work in a simple fashion.

CHAPTER X

WHAT IMPROVEMENTS ARE NEEDED IN THE MONEY SYSTEM?

155. Isn't the suggestion of improving the money system both impudent and a call for needless tinkering with the economy?

Not at all. The monetary system of today—improved as it has been over the past 200 or so years is still man made. There is no reason to conclude that the system is perfect. The process of improving the money system is not complete any more than is the process of improving our national life generally. Further, in every period of our history, people, especially bankers, have resisted any change in our money system with the cry, “leave well enough alone.” Then some disaster would strike and the monetary system would be changed in panic and haste. The system always looks solid, or, at least, adequate until the moment it becomes inadequate. The fact that the system is now functioning more or less satisfactorily is no reason to shun inspection. Economic health and progress is the result of continual care and attention.

156. What is the main problem of the Federal Reserve System today?

In a word, Federal Reserve independence. Congress and the people are faced with the issue: How can we bring money management under genuine public control in order to coordinate monetary with other public policies? The original intent of the Federal Reserve Act was to insure such control; that intent is still valid. Our Government must squarely face the challenge of recapturing the tiller of its money system.

157. In practical terms what is meant by Federal Reserve “Independence”?

There are two sides to independence—one is economic, the other political. On the economic side, independence means that the Federal Reserve formulates and executes economic policy, using its monetary controls, without any necessary reference or coordination with the policies being followed by the

other branches of the Government. This, of course, invites clashes between the Federal Reserve and other parts of the Government. Clashes have occurred, with sad results for all. On the political side, independence means that the Federal Reserve is not accountable to anyone for its actions. As the situation now stands, there is no mechanism by which the Federal Reserve can be made to change a policy it has chosen to follow. The members of the Federal Reserve do not come up for election as do Members of Congress or the President. Though an arm of Congress, the Federal Reserve is not responsible to it. The Federal Reserve does not present an annual report to Congress nor does Congress review the system's actions as a normal part of its business. The Congressional power of the purse—the historic source of the legislatures power—does not apply to the Federal Reserve, which provides its own revenue. The System is not even subject to audit control of the General Accounting Office. Finally, the President, though he may select one or two of the members of the Federal Reserve Board, appoints them for 14-year terms. In the normal course of events, these men cannot be removed from office and because of their long tenures they do not reflect any single President's ideas.

158. How does the Federal Reserve justify its independence?

The argument the Federal Reserve offers runs as follows: The money side of economic policymaking is somehow unique. First: It affects everyone. Second: It involves “unpopular action”—following a tight money policy to prevent inflation. Many people only take a short run view of their welfare. These people may influence Congress or the President to favor inflationary views. There is great danger, they claim, that if the Federal Reserve were responsible to the President or Congress, the System would find it difficult to act against inflation. Therefore, the people must deed their control over their money to a group of men who would act like trustees and take the long-term view of the people's welfare. They would do for the people what the people or the representatives would not do in their own best interest—control inflation.

159. Would inflation result if the Federal Reserve were made responsible to the President or Congress, or made subject to an annual audit by the General Accounting Office?

Not at all. The notion that the American people and their elected officials are inflation-minded runs contra to political realities. Inflation hurts not the wealthy but the low-and middle-income families who live on fixed incomes,

the old with their modest pensions, all those who have set savings aside for their old and or their children's education. These people make up a considerable part of our population. There is not a practicing politician today who does not know that inflationary policies lose more votes than they gain. Also, the evidence of the postwar period shows that our political leaders have been sensitive to the problem of inflation. Both Presidents Kennedy and Johnson and their staffs have worked long and hard to maintain price stability. Are these the "politicians" who would take a short-sighted view of the country's need?

160. How can inflation be handled, if it threatens, without harming the economy?

This is a very deep economic issue, and economists themselves do not have all the answers. But what we do know is that monetary policy alone will not normally contain inflation except by doing considerable damage to full employment and maximum economic growth. What may conceivably work to achieve price stability and adequate economic performance is enlightened restraint on the part of business and labor in their wage-price policies. The job of promoting such restraint naturally falls to the President with all his power to cajole and persuade. Therefore, for all its jealously guarded independence, the Federal Reserve must ultimately rely on the active cooperation of the political leadership of the country for a sane approach to price stability. Thus the "politicians" the Federal Reserve wants to be free of are the very ones the Federal Reserve must depend on to make the System's policy successful.

161. Are the effects of money policy so unique that the monetary policymakers need to be free from all accountability?

No. It is hard to see what is so mysterious about monetary policy. Everyone is affected by tax and expenditure and by foreign policy in both areas, the Government frequently must take "unpopular action." Raising taxes is not popular. Sending men to fight in Korea is unpopular. No one suggests that we should have an independent "defense policy board" or an independent "tax policy board". Why then an independent money policy board?

162. Should the President be permitted to pursue his economic program, if Congress approves?

Yes. The President is elected by the people. During his campaign for election the President normally advocates some economic policy. The economic issues weigh heavily in the campaign. Why then should the President find himself faced with an independent Federal Reserve Board which may not agree or may even try to nullify the policies he wishes to pursue? The President should be able to fashion a total package of economic policies, including monetary ones, as he sees fit. The money authorities should have the right and duty to counsel and advise. But they should not have the power, as they do when they are independent, to nullify the intended effects of the President's programs.

163. Is Federal Reserve independence inefficient?

Absolutely. We now have two centers of economic policymaking. One in the President and Congress; the other is the Federal Reserve Board. Both these policymaking centers control powerful economic tools. Each can turn the economy in any direction it wishes. Yet neither has control. As things stand now, economic policymaking is run like a dual control car, driven by two drivers one of whom insists on his independent right to use his own brake and accelerates as he and he alone sees fit. It is pure luck if the motor is not constantly stalling. We have not always been lucky. This is no way to run economic policymaking. Both the speed and direction signals controlling the economy should come from one, and only one, source— which must be the President and Congress in our democracy.

164. Is the “trustee” notion of monetary policy alien to American democracy?

Of course. The claim that the people do not know what is good for them, and therefore a small group of men should be given the power to make decisions and then to take action without being held accountable to the people is 100 percent undemocratic. The essence of democracy is that the people decide for themselves, through their elected officials, what is good or bad for them. Further, to give monetary control to a group like the Federal Reserve is to hand over enormous power unfettered by responsibility to anyone. In a democracy, especially the American form, the holders of power, all most without exception, are responsible to the people, through elected officials in the use of this power. The Federal Reserve's ideas that they should be

considered trustees rather than stewards runs counter to anything that Americans have believed about power and responsibility since the founding of the Republic.

165. Who favors Federal Reserve independence?

The private banks who control the System, together with some allies— notably, Wall Street newspapers and other members of the financial community.

166. Has the Federal Reserve’s record since the accord demonstrated superiority in the management of our monetary system?

On the contrary, the Federal Reserve’s persistent fear of a bogeyman “inflation” had led it to slow our economy’s growth and cause periodic recessions, and moreover to maintain “tight money” even during periods of recession and economic slowdown.

167. What other reforms are needed in the Federal Reserve System in addition to the introduction of responsibility?

1. The reorganization of the membership of the Federal Reserve Board, toward greater responsibility.
2. Abolition of the Open Market Committee.
3. Coordination of monetary with other economic policy.
4. Financial accountability, via audits.
5. Congressional checks, through the normal appropriations processes.
6. A reappraisal of the “tight money” policies.
7. A lessening of private bank influence in the Federal Reserve System.

168. What reforms should be applied to the Federal Deposit Insurance Corporation?

The FDIC should be prohibited from substituting its own standards of management for those of private bankers. By confining itself to the insurance function, it would not be providing a monopoly profit position for existing banks and discouraging constructive loans to farmers and small businessmen.

169. Are reforms needed in the Treasury?

Yes. The system of selling U.S. Government securities through a small group of preferred dealers should be abolished. There is no reason to guarantee government bond dealers vast profits. In addition, the Treasury's practice of leaving deposits of public funds with private banks at no interest should be stopped.