

**THE INDEPENDENT STATUS OF THE FEDERAL  
RESERVE SYSTEM**

by

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## CHAPTER I

### INTRODUCTION

The status of our Federal Reserve System has been in question from the date it became a part of our Government. From the date of the enactment of the Federal Reserve Act until now the agency has grown in power over the monetary system. Bit by bit the System has built its monetary tool kit into a formidable working agency. Questions arise as to the appropriate power of the Fed.<sup>1</sup> It can be found that the System was unable to cope with the depression, the wars, and the recovery without additional powers. With powers granted by Congress, at times required, the Federal Reserve Act is now a very amended piece of legislation. But the Fed is what the legislators made it.

Critics of today's Fed are campaigning in an effort to strip the System of its powers to make it, rather than an independent agency, an agency performing routine functions for the Congress and the President. These critics fear that the Fed has grown in power to the point where its overseers abuse the public interest for the benefit of banker interests throughout the structure of the System. They consider the present System a privately operated organization used by its managers to escalate interest rates thus making money scarce.

These views are not held, as we shall see later, by the Treasury, the recent Presidents, neither political party or by most members of

Congress. It is a minority drive.

The leader of the current effort to revolutionize the Fed is Representative Wright Patman (Democrat) of Texas. Rep. Patman is, perhaps, the most knowledgeable Congressman on monetary subjects. He is currently the chairman of the House Committee on Banking and Currency. The task ahead should prove very difficult for him for the simple reason that he has no substantial backing for his efforts outside a small coterie of legislators and college professors. Many students of finance categorize Mr. Patman as a cheap money exponent and turn a deaf ear to his pleadings for reform of monetary management, but Mr. Patman should be heard! His ideas should be evaluated by all those interested in our monetary lives. H. R. 11 is the Congressman's most comprehensive bill introduced to reduce the Fed's power. This study will concentrate on that bill because of its revolutionary proposals.

Congressman Patman went to the Congress on January 4, 1965, and introduced H. R. 11, a bill to aid in "our campaign to return our sovereign monetary powers to the people of the nation, in which the Constitution originally vested them", to use his words.<sup>2</sup> The bill is far-reaching in effects and would cause a sharp cutback in the Fed's independence gained over the last fifty years.

The bill presents a plan for retirement of bank stock. The stock

an individual bank holds in its district Federal Reserve Bank would be returned and replaced by a ten dollar Certificate of Membership. Thus, member banks would possess a membership certificate in lieu of capital stock.

It is Section ten, however, which intends to tear the heart out of the existing Federal Reserve System. The Federal Open Market Committee would be abolished. Open market activity would be engaged in by the Federal Reserve Banks in accordance with Board supervision. The Board would endeavor to pursue the policy of the Employment Act of 1946. Additionally, the Board would advise Congress quarterly on its past and prospective actions and would explain how those steps facilitate the President's economic program.

The Board would bear the following significant changes:

- a. Membership would be reduced to five.
- b. Terms would be reduced to five years.
- c. The President could redesignate the Chairman of the Board before his term as Chairman expires.

Section twelve of the bill provides for an audit of the Federal Reserve Board and the Reserve banks and branches as prescribed by the Comptroller General. The General Accounting Office would be furnished with material necessary to make the audit.

The bill brings the Fed under Congressional appropriations and expenditure control. Receipts of the Fed would be turned over to the

Treasury, while its operating costs would be taken from amounts appropriated by Congress. Accounting practices and procedures would be employed as are by other agencies.

Finally, the bill proposes to amend the Employment Act of 1946 to include a statement permitting the President to outline policy guidelines concerning the money supply.

Mr. Patman has initiated a "grass roots" campaign to convince the public that H. R. 11 is a necessary piece of legislation.<sup>3</sup> Proponents of cheap money will be sympathetic supporters of this bill. Proponents of price stability will win. The Washington Evening Star, on August 17, 1964, stated, "It is unfortunate... that a man who is chairman of the House Banking Committee should engage in such total irresponsibility." Such a comment came after Mr. Patman presented his "A B C's of Money" address in Congress. Professor Seymour E. Harris commented on Rep. Patman's "Primer on Money,"

"No one has defended the interest of the people more vigorously, more persistently, and more courageously against those who have assumed the responsibility of determining how much money there is to be, at what price, and who is to get it." <sup>4</sup>

A study of Mr. Patman's ideas leaves the reader with emotions such as these expressed by knowledgeable people. Few persons who have read Patman are indifferent.

In order to present a comprehensive study of this subject, the following method has been used. First, in chapter II, I will present a

brief history of the Federal Reserve System emphasizing areas where the Fed has gained its money management tools and the reasons why they were granted by Congress, expressed and implied. Chapter III takes us into the criticisms of the independent status of the System as expressed by Rep. Patman. Chapter IV is in the form of a rebuttal by those favoring a continuation of Fed protection from outside interference. Then, in chapter V, I will present my summary comments. The study was made objectively with the intent of laying open to scrutiny the workings of the Federal Reserve System.

Footnotes for Chapter I

<sup>1</sup>The abbreviation "Fed" is used to denote Federal Reserve System.

<sup>2</sup>Wright Patman, Progress Report, August 24, 1965, p. 1.

<sup>3</sup>In Mr. Patman's Progress Report, April 7, 1965, he states, "Success in passing it (H. R. 11) will depend upon the support from what is known as the 'grass roots,' from all over the country." The Congressman has called his campaign the "grass roots" campaign and in every major address emphasizes his belief that any change in the Fed will result only if the public is aroused to take action.

<sup>4</sup>Subcommittee on Domestic Finance, Committee on Banking and Currency, House of Representatives, A Primer on Money, 1964, p. 4.

## CHAPTER II

### HISTORY OF THE FEDERAL RESERVE SYSTEM

#### A. The Federal Reserve Act

The Federal Reserve idea of central banking was the child of necessity. From the moment we as a united population began to function as an independent body, one of our outstanding characteristics was a poor monetary machine.<sup>1</sup>

As banking grew, and monetary problems multiplied, it became evident that existing regulation was insufficient. Banking charters were too easily obtained. Consequently, profiteering in wildcat banks occurred numerous times in underdeveloped western territory.<sup>2</sup> Bank runs and money crises were easily incurred by incompetent personnel. The insolvent bank would cause a run on all banks and therefore a crisis would ensue. As long as a fractional reserve system was in operation all banks would be in this type of danger.<sup>3</sup> There were no standardized checks and audits on the banks of the country to prevent future runs. It was in this era that widespread fear of banks was justified many times over.

The proposed Federal Reserve Act was in essence the platform Woodrow Wilson used to enter the White House. Federal Reserve legislation was a popular issue. The Aldrich Plan, the antithesis of Wilson's, was not a different plan.<sup>4</sup> The choice for Wilson was a vote

against Senator Aldrich since it had become an accepted fact that a central bank was to be established. Mr. Aldrich was painted as a friend of the bankers whose corrupt life could not possibly issue forth legislation benefiting the general public. Wilson, on the other hand, was disassociated with the Aldrich drive and made issue of that fact.

The Federal Reserve Act, hailed as a masterpiece of Woodrow Wilson and Carter Glass, was passed into law on December 23, 1913. Its purpose as stated in the first section was,

"... an act to provide for the establishment of Federal Reserve Banks to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." 5

Under the Act, twelve regional Federal Reserve Districts were established in Washington to act as central authority on policy. The country was afraid of a central bank, quo central bank. Geographic division of the central bank was thought to be more acceptable to those afraid of wealthy bankers and industrialists. Commercial banks were to keep reserves with a Reserve bank. In return the banks were to be extended credit by the Reserve bank. The Fed's first tool, therefore, the discount mechanism employed on discounted paper, was granted here.

#### B. Economic Activity Shortly After the Act

The effectiveness of the new Federal Reserve Banks can be seen by an examination of the reserves picture which was totally changed

after passage of the Federal Reserve Act. It is a naive thought that banks keep reserves on deposit with the Fed, and that this pool of funds is available for use to individual bank short term needs. Actually, one would be surprised at the small amount of currency and coin the Fed actually keeps. When we learn that the Act made possible the elasticity of reserves or money supply, we must understand that these reserves were created. The Fed creates reserves when it gives credit on its books for the bank's discounted commercial paper. This discounting tool of the Fed became one of the most important of the first tools of monetary control. These tools were to provide for economic stability. To a great extent they erased Nineteenth Century banking problems, but additionally they created new problems associated with their use. It was found that these tools could not become automatic tools put to use in an elementary way to stabilize banking and the general economy.

The young Federal Reserve Act, coupled with our inexperience with its power, led us into fields of financial problems in a few short years after its passage. The Fed was tested quickly. World War I was financed by created money. We were pleased, if not surprised, with its flexibility and powerful money-creating ability. With war comes speculation and the need for money to finance production of material. Credit is expanded to meet the needs of industry, otherwise interest

rates on the use of money would become unreasonable. But what is done when there is no more war? When all the money we have created floats around plentifully what are the economic consequences? We found out only too soon that restrictive measures must be used. We had the job of sponging up all the excess money. By the time we realized what had happened to our money, the markings of the country's greatest price declines were making themselves evident. At this point in our management, the words war, inflation and deflation took on broader definitions, now embracing the new Federal Reserve power.

The Federal Reserve itself thought a recurrence of the past war deflation might be averted in the future if it assumed a new, active, discretionary role rather than a passive, relatively automatic role. Immediately we see a broadening of Fed functions originating here, and this notice is significant.

When the Act provided that the Federal Reserve Banks be authorized to participate in open market operations, it was assumed that such operations in Government securities would primarily be motivated by the desire for income. Other reasons were to handle Treasury financing and to use the securities as collateral for note issuance. In routine operations during the early twenties, it was noticed that purchases and sales of securities had expansionary and contracting characteristics. When the Fed entered the market and

purchased Government securities credit was eased and money was made more available and likewise the accompanying interest rates were lower. And, when the Fed sold securities, banks surrendered varying degrees of liquidity, credit contracted, interest rates rose, and money became a more scarce item.

Thus, to the Fed tool kit was added another tool. The Fed was not given this power directly by the Act, nor did the Act restrict its operation. The discovery of the monetary effects of open market operations was a surprise to everyone. It was found to be even more effective than the discounting tool. However, the discovery of open market operations in its new light caused new problems to appear on the horizon. When is support of security prices sacrificed for price stability and desired credit levels, if the conflict should arise? Is the Fed constitutionally permitted to make independent decisions in this regard? These and other questions arose as the powers of the Fed increased. Complexities began to enter money planning and monetary policies in some instances invariably lead to conflicts with fiscal policy. The tools, discounting, adjusting the rediscount rate, and open market operations, coupled with the Fed's decision to play an active, not passive, role opened the doors for a new economic force in America.

### C. The Depression Era

The Fed cannot boast of its activities during the depression. Examining the Fed in retrospect we find a dominant criticism to be that it did little or nothing to improve matters. The Fed's collateral was chiefly discounted paper and gold. It had been supplying the economy with notes backed by this collateral. However, during the depression our gold began to flow abroad and because of reduced investment there was little construction and, consequently, little commercial paper to discount. It is thought that the Fed was naive during the depression. But we had not, till then, experienced a depression of such severity. The System did not have the wherewithal of monetary tools for other action.

### D. Emergency Banking Legislation

The depression taught us that changes were needed in the Federal Reserve legislation. Assuming control of our monetary policy, the Fed was inadequate to cope with new problems incident to its own creation. We had learned the methods of attaining a stable expansion in the economy but our knowledge of credit restriction and price stability was poor and not extensively used.

The Banking Act of 1933 was designed to alleviate Fed weaknesses. The purpose of the Act is stated as follows:

"To provide for the safer and more effective use of the assets of banks, to regulate interbank control, to prevent the undue diversion of funds into speculative operations and for other purposes. "6

Section 12A of the Act created the Federal Open Market Committee authorized to handle the open market operations of the entire Federal Reserve System. The Federal Reserve Act of 1913 had authorized each Federal Reserve Bank to operate in the open market. Under the Act of 1933 any bank which desired to engage in open market operations of its own had first to obtain permission from the Federal Reserve Board. It was learned that interest rates were national and rates could not vary among districts, therefore, there would be no advantage in one district operating separate and apart from the others.

The Banking Act of 1935 is termed by critics as a bankers Act, written only for the benefit of bankers. The members of the Open Market Committee were permitted by the Act to be officials of banks and also members of the Federal Reserve Board. The Open Market Committee is composed of twelve members - seven are governors, and five are drawn from the twelve districts. In the early forties the president of the New York Federal Reserve Bank became a permanent member. The decisions by the Committee are binding on all Federal Reserve Banks.

One very welcome feature of the Banking Act was the provision for Fed lending on all sound banking assets. Previously we had adhered to the "real bills" or "commercial loan" theory, a lending policy based on productive loans, such as a farmer's loan based on the need for soil treatment.

The Fed's first selective tool was result of passage of the Securities Exchange Act of 1934. During the depression the stock market became greatly inflated. Margins were as low as ten percent at times. This mounting ease of credit was dangerous in that stocks were overvalued and there had to be a stopping point somewhere. The Fed was criticised because it hesitated to initiate general credit controls. The Fed, again, was unfamiliar with the phenomenal conditions of this depression. Too, they had no unquestioned authority in this field. Where did the Fed stop using discretion? There were no clearly defined lines of demarcation.

The Securities Exchange Act granted authority to the Fed to set margin requirements. This, again, was the Fed's first selective tool for controlling credit. Heretofore, the Fed's controls of credit had been of the general variety.

#### E. War Finance

On the heels of the depression came the financial problems incident to World War II. And, in time of national emergency, all efforts become secondary to that of averting national crisis. The immediate needs take priority. National defense, including supplying our forces and allies with implements of war, called for financial support. The Federal Reserve placed all its monetary powers at the disposal of the Treasury while its routine monetary actions assumed a lesser role. The System stood ready to create the needed funds and

to facilitate Federal borrowing sufficient to war's demands. The Fed sacrificed sound money management, of course, but it did help create and make available nearly \$400 billion in five years. That was quite an accomplishment in the early forties.

A large measure of the war finance burden is carried by Government borrowing. The sale of Government securities is facilitated by the Fed. In 1942, it was necessary for the Fed to peg securities prices, maintaining the existing interest rate structure. There are dangers inherent in pegging securities prices. When the Fed pegs a security it must also buy those securities not sold. When the Fed is forced to buy the securities, regardless of the needs of the economy, the control of the money supply is thereby less effective. As stated earlier, when the Fed purchases securities in the market, credit is eased, more money is made available, thus inflation could occur. Too many dollars available for few products tend to bid upwards the prices of those products. To avert this escalation of prices counter-measures were taken to lessen the deleterious effects of pegging. Price controls and rationing became common. With these controls in effect it would appear that excess funds would go into securities thereby lessening the need of the controls. Some of this occurred.

In its war finance experience, the Fed has acquired two selective credit tools or controls. These are: setting minimum down payments and maximum repayment periods on consumer goods

(regulation W, 1942), and, setting minimum down payments and maximum repayment periods on residential real estate. The latter was instituted during the Korean War. It is easily understandable why selective tools are a device for controlling credit. They hit the pockets of inflation. Residential construction, for instance, can be controlled. An unthwarted expansion in residential construction could cause an acceleration of the inflation.

#### F. The Employment Act of 1946<sup>7</sup>

At the end of World War II fear became widespread that the economy was due for a recession of large order. It was felt that sharp cuts in defense production and the return of veterans to the job market would cause unemployment. And it was predicted that the economy couldn't maintain a semblance of order. These fears led to the passage of the Employment Act of 1946.

We had gotten our feet wet in public works programs to alleviate unemployment under the New Deal. Why not sacrifice a balanced budget to keep the unemployed workers busy? Why not encourage industry to seek a long run steady rate of growth and soften the effects of short run severe fluctuations? When we are experiencing large scale unemployment all sectors of the economy suffer. If we could bridge short run gaps of unemployment, and maintain maximum employment, production and purchasing power, our economy would function in the healthiest manner possible. The drafters of the

Employment Act intended to have these goals crystallized into comprehensive economic policy. As finally passed, the stated policy of our Federal Government under the Act would be to

"Coordinate and utilize all plans, functions and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions which there will be afforded useful employment opportunities, including self-employment, for those able, willing, to seek work, and to promote maximum employment, production and purchasing power."<sup>8</sup>

Since 1946 it has not been easy to arrive at a uniform interpretation of the Act. Might not the Fed place some provisions of the Act in higher regard than others? Might not the Fed place the goal of full employment secondary to that of maintaining the price level or managing the money supply? As we know, full employment has several meanings. It is an ideal, but we have in recent years found that our overall economic growth and health has been greatest with an unemployed rate of about four percent. It is utopian to plan for total, 100 percent, employment. It can only be approached within one or two percentage points by intense socialistic planning. But, we do not want to sacrifice price stability for full employment, lest both eventually collapse.

#### G. The Accord and After

There arose in the late fall of 1950 a serious disagreement between the Treasury and the Federal Reserve in regard to debt

management. The disagreement reached the White House where President Truman asked the Federal Reserve to maintain the existing rate on Government bonds. After much discussion and unsuccessful exchange, the President appointed a committee to study the matter. Before the committee could report, the Fed and the Treasury, on March 4, 1951, released the "accord."

"The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt." <sup>9</sup>

It must be understood by the reader that there were actually minor differences in Fed-Treasury philosophies. Extended discussions had been made between the two bodies and on most of the problems there existed a mutual agreement in regards to the solutions; but there were minor differences and these differences had been magnified by the press to the extent that the public needed reassurance that an impasse had not been reached between representatives of the two bodies. At issue was debt management with the Treasury and restraining credit expansion with the Fed. The Treasury desired a favorable market for its debt refunding and issue of new securities. The Fed, of course, was the determinant of the favorability of the market. The Fed did not wish to monetize the debt because such monetization would spell an increase in the unprecedented inflationary loan expansion which had

gone unabated since the outset of the Korean Conflict. The "accord" then, was a public statement that the Treasury and Fed were striving towards an agreement of sorts regarding the debt management problem.

There were four major areas of consideration for the two parties.

1. There was in the market a large number of long-term bonds which had grown unpopular. The Fed and the Treasury agreed that a number of these should be taken off the market. The Treasury would offer in exchange for them a 2 3/4 percent, 29 year bond, redeemable before maturity only by conversion into a 5-year marketable Treasury note. The Fed was to promote, to institutional investors, the purpose of this action. The purpose was to encourage these institutional investors to retain the afore-mentioned securities, in order to cut to a minimum the monetization of the public debt through liquidation of outstanding holdings of the 1967-1972 Treasury bonds.

2. It was announced that a limited amount of open market purchases would be made after the announcement of the exchange offerings. This would, in effect, restrain private holders from trying to sell on the market after the terms of the exchange were made known. The Fed would keep the market orderly and would purchase only on a scale-down of prices.

3. The Fed agreed to reduce or discontinue purchase of short-

term securities and to permit the short-term market to force banks to borrow from the Fed to build up their reserves -- thus monetization is reduced. In absence of outside forces, then, the short-term interest rates would be at or very near the Fed's rediscount rate.

4. At the time of the accord there were no substantial amounts of funds seeking to be invested in new securities besides those of banks which the Fed wished not to use. The Fed wished the banks to borrow from the Reserve Banks in order to build up their reserves. It was agreed, then, that a closer relationship would be furthered between the Fed and the Treasury so that a solution would be found for the new issue problem.

The accord made possible the resultant "bills only" policy of the Fed. In 1954 the Fed announced that this policy had been operative and would continue in the future. The Fed found that the most effective way of controlling the interest rates at the moment was to deal in short-term securities, preferably 91-day Treasury bills. Thus, the Open Market Committee could handle short-term securities in its open market activity. We notice here a break from long-term securities support. The free market would, by and large, determine the favorability of Government long-term securities. While adhering to the bills-only policy the Fed still maintained constant vigilance over the long-term market and agreed to buy the securities if the market became disorderly.

The bills-only policy became popular in the Eisenhower years. Critics of the policy say the Fed's hands were tied in regards to long-term securities and because of this the 1957 inflation was the result. The long-term market did become disorderly in 1958 and the Open Market Committee stepped in to restore order.

Material changes in the Fed since the Accord have been minor. Bank holding companies have come under more regulation. Real estate loan provisions have been changed. In 1954 some regional autonomy was eliminated -- Federal Reserve Banks were allowed to pay out notes of the other Reserve Banks. The Small Business Investment Act, effective August 21, 1959, caused the termination of commercial and industrial loans under Section 13b of the Federal Reserve Act. In 1959 Congress passed legislation permitting vault cash to be counted as legal reserves. Central Reserve City classifications have terminated. In 1961 the "bills only" policy was abandoned in order to keep short-term funds from flowing abroad. In August of 1962 we instituted the "swaps" arrangement. The "swaps" provide us with lines of credit among select nations to permit foreign currencies, when needed, to be drawn upon when the balance of payments situation is adversely affecting our gold position. In 1963 the Federal Reserve Act was amended permitting issuance of \$1 and \$2 Federal Reserve Notes. This was done to eliminate Treasury silver certificates of those denominations and make silver available for coinage.

This, in brief, is the history of the Federal Reserve System.

Footnotes for Chapter II

<sup>1</sup>Laughlin, J. Lawrence, The Federal Reserve Act: Its Origins and Problems, The MacMillan Company, New York, New York, 1933, p. 6.

<sup>2</sup>Ibid, p. 4.

<sup>3</sup>The Federal Reserve Bank of Minneapolis, Your Money and the Federal Reserve System, p. 10.

<sup>4</sup>Laughlin, J. Lawrence, op. cit., p. 14.

<sup>5</sup>United States Congress, House of Representatives, Committee on Banking and Currency, The Federal Reserve Act, 1913.

<sup>6</sup>United States Congress, House of Representatives, Committee on Banking and Currency, The Banking Act, 1933.

<sup>7</sup>The Federal Reserve gained no monetary tools by passage of the Employment Act of 1946. However, I have included the Act in the Fed's history because Representative Patman's interpretation of the legislation of 1946 is a vital part of his overall criticism of the independent status of the System.

<sup>8</sup>United States Congress, Senate, Committee on Banking and Currency, The Employment Act, 1946.

<sup>9</sup>The "Treasury-Federal Reserve Accord," March 4, 1951.

## CHAPTER III

### CRITICISMS

There has been a parallel growth of criticism of the Federal Reserve System along with its growth in influence. The critics are now presenting a clearly defined sheet of charges against the Fed, with a fear of bigness and centralized power as their mainstay. This criticism of the Fed has centered around Congressman Wright Patman of Texas, the self-proclaimed champion of the "little man," who is currently campaigning to inform the voter of the imminent dangers of an independent monetary authority.

The Congressman has written much about what he considers the failings of the Fed and has supplied corresponding recommendations. The following chapter will label the outstanding criticisms of the Fed as Mr. Patman and his followers see them. Actually, many of his criticisms are various perspectives of one basic criticism. Gleaned out of his writings, therefore, are fundamental charges worded to include all his many elaborations. Specifically, his campaign is designed to return broad monetary powers to the people, whose spokesmen will be their elected representatives. It is a democratic ideal. Whether it is fitting at this time is the question in need of answer. This chapter intends to present, then, the basic reasons for reconsideration of the present status of the Federal Reserve System.

1. The present Federal Reserve System is not what its founders intended it to be.<sup>1</sup>

Woodrow Wilson and Carter Glass intended the Fed to be publicly-controlled. The system has, over the years, drifted from an autonomous, regional Reserve System to a highly centralized bank organization. The banking interests have, over the years, taken money powers away from Congress. The people's control of the money supply has been whittled away piece by piece, part by part.

Senator Nelson Aldrich, in 1913, presented a central bank idea characterized by banker influence. His plan was rejected for the present Federal Reserve System as adopted in 1913. Aldrich, as a friend of the banking community, lost to a people oriented central banking proposal.

It was in 1923 that the Federal Reserve System began to be a tool of the bankers. The "Open Market Investment Committee", forerunner of the Open Market Committee of later years, began testing it's power. The Committee discovered the monetary effects associated with purchases and sales of bonds in the open market. Gradually, the banking interests, by Congressional lobby and by assumed authority, forced upon the people a Federal Reserve System totally different in intent from the agency established by Congress in 1913.

The Constitution, in Article 1, Section 8, Paragraph 5, granted Congress the power to create money and regulate the value thereof.

In 1913 the Congress delegated this authority to the Federal Reserve System. This authority has grown with a plethora of amendments and assumed powers to the point today where its use of this power is questioned.

2. Banks have been forgetting their primary purpose--serving the area in which they operate.<sup>2</sup>

Banks have divorced themselves from their original mission according to Congressman Patman. Banks were intended to serve the local areas in which they were chartered. But over the years bankers have lost sight of their mission of providing credit to the farmer and businessman. Instead, bankers are seeking profits via investments in U. S. Government and municipal tax-exempt bonds. Bankers have lost their public welfare orientation with the profit motive becoming the paramount objective.

3. Federal Reserve Policy has, at times, neutralized policy objectives of the President and Congress.<sup>3</sup>

By use of its general credit instruments the Fed can enhance or diminish the effects of the Administration's economic policy. The mere possibility of the Fed dampening the effects of a sound Administration policy causes most critics to yell "foul." If, for instance, the President and Congress fashioned a tax cut in order to boost spending and the economy generally, the effects of the cut could be negated by the Fed if it deemed necessary.

Some political campaigns revolve around economic issues. The elected official must attempt to further his campaign promises once in office. But the Fed can dampen some economic programs undertaken by an official elected by the people.

Because members of the Board of Governors serve staggered fourteen year terms it is impossible to restaff the Board with personnel sympathetic to the concurrent administration. One of the seven is retired every two years. If a President serving two terms decided to restaff the Board he could replace only four in his eight years. Needless to say, it may then be too late. The Chairman of the Board serves a four year term and is chosen from the Board members. His term cannot be shortened by the President before it expires.

1. Too much power and control rests in the hands of people whose private interests are directly affected by the Fed's actions.<sup>4</sup>

Private interests can be explained in the following manner:

- a. Commercial banks are owned by private individuals.
- b. A Federal Reserve Bank's board of directors is composed of nine persons, six of whom are selected by commercial banks.
- c. The Federal Open Market Committee is composed of twelve members, five of whom are presidents of Reserve Banks.
- d. The Federal Advisory Council is composed of one member per Federal Reserve district chosen by the Reserve Bank directors.

This is the way private interests dominate the Federal Reserve System. These private interests set prices charged for money and thus make profits at the expense of the general public.

5. Private Banks enjoy special consideration from the Federal Government.<sup>5</sup>

Basically, other private enterprises compete for profits. They employ private capital and resources to produce products or services for the market.

Banks are unique in that they create money at little cost to themselves. Profits are made on created money loaned to borrowers. The Fed bears the cost of private check clearing; therefore, the greatest service in banking is performed free of charge. Banks are protected from competition in that new banks are not granted a charter if their location will detract from the business of established banks.

In 1958 the Fed allowed commercial banks to create approximately \$10 billion for the purpose of lending to business which would in turn release recessionary tendencies. Reserve requirements were lowered. But, instead of lending these funds, purchases of U. S. Government securities increased by \$10 billion and loans to business and consumers actually dropped. While the general economy suffered from the recession, bank profits rose. Almost one-fourth of the \$10 billion went to a few New York Banks.

6. When the Fed and the Treasury signed the accord of March 4, 1951, the Fed wrongly interpreted the signing as a liberation from ties of dependence.<sup>6</sup>

Prior to the "accord" the Fed had pegged the prices of Government securities. Within a month of signing the accord, rates of long-term government securities began to rise and by December of 1952 the rate had reached the level of 2.75 per cent, a rise of .28 per cent above the March 1951 rate of 2.47 per cent. Early in 1952 the Fed began extensive concentration on short-term securities traded in the open market. This policy, popularly called the "bills only" policy, directly affected short-term interest rates. But the policy undertaken by the Fed led to a raising of long-term interest rates. The Fed agreed to buy long-term bonds if the Open Market Committee decided the market was disorderly. Notice that Fed activity is discretionary.

Any decline in the long-term interest rate would be brought about only after a considerable time lag--under the "bills only" policy. For instance, in 1957 the Fed tried to dampen the investment boom by making credit tighter. The cost of lowering investments was a general tightening of credit which finally staggered the investment boom after other sectors had been unnecessarily hurt.

Early in 1958 the Fed desired to stimulate investment. Still, using the "bills only" policy short-term interest rates fell

immediately but long-term rates declined very slowly. In mid 1958 the bond market had become very disorderly. At that point the Open Market Committee lent a hand.

Not until February 1961 did the Fed abandon its "bills only" policy. But the long-term interest rates are still at a high level. Afraid that low rates of interest would cause a flow of capital out of the country, the Fed decided to stem the flow by raising the rate. The balance of payments deficit has intensified this fear. Foreign payments, of course, are primarily concerned with the short run. But by keeping the short-term rate high the long-term rate cannot fall. The bond market will see to that.

7. In recent years the Fed has caused slower economic growth by holding interest rates too high. In 1963 gross interest charges were \$75 billion, \$11 billion of which was for national debt interest.<sup>7</sup>

High interest rates mean a lower rate of growth and greater unemployment. Fiscal action can provide employment and relief for the unemployed but economic growth is not as easily assured.

The Employment Act of 1946 did not exclude the Fed in its policy statement. The Fed was to complement the activities of the other sectors of the Government in assuring a healthy climate in which the "policy" could be executed. It is felt that the Fed, however, has forgotten its responsibilities to this Act since the signing of the accord of 1951. Interest rates have been forced upwards in order to ward off

a bogey series of inflations and the balance of payments problems so greatly feared by the Fed.

8. High interest policy is making the national debt a cumbersome problem.<sup>8</sup>

In fiscal year 1963 the budget deficit was \$8.8 billion; in the same year interest paid on the national debt was almost \$10 billion. The dollar differential could be wiped out with lower rates of interest.

9. The fundamentals of money can be understood by anyone. Unique agency status is not necessary for the Fed.<sup>9</sup>

The Fed assumes expertise in the monetary field and a strange monopoly on the understanding of money. An aura of mystery supposedly surrounds the workings of monetary machinery. The public should decide on monetary issues by electing officials espousing their views. To place an agency in an independent state aloof from public control is non-democratic. The electorate knows as much about monetary policy as they do foreign policy or fiscal policy.

10. The Federal Reserve System is dominated by bankers.<sup>10</sup>

Each of the Federal Reserve Banks has nine directors. In each bank, three Class A directors are chosen from officers of banks in the area; three Class B directors are chosen from the fields of commerce, industry or agriculture; and three Class C directors are appointed by the Board of Governors, who must not be officers, directors, employees, or stockholders of any bank.

In 1964 Wright Patman conducted a poll of bank directors in order to ascertain the degree of bank influence on each director. The poll revealed that one half, or 17 of 36, had been directors of banks before becoming directors of Federal Reserve Banks. Additionally, four of the remainder have held official positions in banks. Nine of the remaining fifteen owned bank stock. Thus, thirty of the 36 had had a direct interest in banking. Eighteen of the thirty-six Class C directors had been bank directors. Two others had held bank positions. Of the remaining sixteen, five had owned bank stock at one time. Totally, 91 of the 108 directors of the Federal Reserve Banks are or have been directly connected with the private banking industry. Their interest in banking is or was, we may justly assume, motivated for gain. Profits of banks is enhanced by high interest rates. As we have seen, the Fed has gradually raised interest rates since the accord of 1951.

11. The Open Market Committee has cloaked its working in a mantle of secrecy.<sup>11</sup>

There should be no secrecy surrounding the money supply, interest rates and credit. But the powerful Open Market Committee meets in secrecy and decides upon the future availability of our exchange medium. Money matters, affecting the public extensively, should not be plotted by so few who have only to gain from high rates of interest at the injury of the workingman.

12. Stock of the Federal Reserve Banks is unnecessary.<sup>12</sup>

Dividends on the stock, approximately \$24 million a year, represent a loss to taxpayers. There is no need today for the stock in light of the fact that its initial purpose was for the establishment of Federal Reserve Banks. The nature of the stock is alien to our usual conception of stock. No proprietary interest is gained by purchase of the stock. It does not represent ownership claim. Voting rights are not based on the quantity of stock held; each bank has one vote regardless of the size of the investment in stock. Upon dissolution, the stockholders receive nothing more than their investment; the remainder is sent to the Treasury.

Stock ownership may cause problems. Private bankers may consider the holding of stock indicative of ownership and consequently assume the right to control the operation of the banks to proprietary advantage. Some officials spend funds of the System as though these funds were private profits. An example is scholarships to employees of the banks financed by funds of the Fed.

13. Funds are not appropriated to the Fed and no audit is made by the General Accounting Office.<sup>13</sup>

In a general sense the Congress does not review the Fed as a part of its normal business. Unlike other agencies which receive appropriations from Congress and must be audited by the GAO, the Fed

operates on interest earned from holdings of Government bonds, and provides for it's own auditing. Of course, the Fed is excluded from the Executive budgetmaking process. These are sufficient reasons for the Fed feeling independent from most agency restrictions.

14. The Tax and Loan accounts subsidize bankers at the taxpayer's expense.<sup>14</sup>

Federal taxes withheld from individual's pay are usually sent to the Treasury by check. These checks are returned to the bank of the employer and the money remains there for the bank's purpose until called for by the Treasury. It follows that this money is loaned out at the going rate of interest and may also be used to purchase Government securities.

In 1963, \$5.3 billion were held by banks across the country in Tax and Loan accounts. The public debt is made higher by the failure of the government to take immediate possession of this money and use it instead of borrowing from the public.

15. Since the New York banks call the tune at the Fed, the Republicans resist almost any change making the System responsive to the President.<sup>15</sup>

Quoting Rep. Patman directly from the pages of the Congressional Record, he eloquently states,

"At its birth in 1913, the Democrats favored the Fed and the Republicans opposed it. It is noteworthy that

today--now that the big banks, mostly in New York, call the tune at the Fed--the Republicans-- at least on the House of Representatives Banking and Currency Committee, of which I am Chairman-- oppose almost any change which would make the Federal Reserve responsive to the President and his economic and fiscal policies. "16

Footnotes for Chapter III

- <sup>1</sup> 88th Congress, House Report No. 175, p. 37.
- <sup>2</sup> Subcommittee on Domestic Finance, Committee on Banking and Currency, A Primer on Money, 1964, Washington, D. C., p. 1.  
Ibid, p. 3.
- <sup>4</sup> 88th Congress, House Report No. 175, p. 36.
- <sup>5</sup> Subcommittee on Domestic Finance, op. cit. p. 89.
- <sup>6</sup> Ibid, p. 105.
- <sup>7</sup> Congressional Record, 1964, p. 17253.
- <sup>8</sup> Subcommittee on Domestic Finance, op. cit., p. 12.
- <sup>9</sup> Ibid., p. 126.
- <sup>10</sup> 88th Congress, House Report No. 175, p. 35.
- <sup>11</sup> Congressional Record, op. cit., p. 17255.
- <sup>12</sup> Subcommittee on Domestic Finance, op. cit., p. 77.
- <sup>13</sup> Ibid., p. 121.
- <sup>14</sup> Congressional Record, 1964, p. 17257.
- <sup>15</sup> Ibid., p. 17284.
- <sup>16</sup> Ibid.

CHAPTER IV  
CRITICS ANSWERED

In forming a rebuttal to the charges made by Congressman Patman, I have chosen the primary targets of his accusations and also prime disinterested parties as sources of reply. The result is, I consider, an adequate reply to Mr. Patman and his supporters.

It is, first of all, important to consider the word "independence" to find what Congress and the Supreme Court mean by the term when they deal with one of the eleven independent agencies. It is appropriate to call the independent bodies arms of Congress whose responsibility is to the Congress and to none other. The executive, upon occasion, may control policy of the agencies by resorting to public opinion, the appointive power, and budget allowances. But, he may not take direct action to fire personnel from agencies merely because of policy conflicts. (An executive of the Federal Trade Commission could not be removed because his office was of quasi-judicial and legislative nature, although FTC functions are part of the executive branch of government, Humphrey's executor v. The United States.) The separation of powers protects the President in the exercise of his power to remove executive officers appointed by him, but prevents him from removing officers whose removal has been restricted

by Congress. Specifically, no removal can be made during the prescribed term for which the officer is appointed, except for causes named in the applicable statute. Therefore, when we speak of an independent agency we must realize that the agency is relatively independent from Executive control but is dependent upon Congress for its very existence.

Because this rebuttal is centered around the proponents of the independence of the Fed, let us consider the Board Chairman's, William McC. Martin's, discussion of independence.

"Independence of the System, to me, simply means that our decisions regarding extension of Federal Reserve credit must be made in the light of their long range impact on the value of the dollar and the soundness of the credit structure on which our market system depends, and not out of solicitude for the monetary financing needs of the government. Independence does not mean that the Federal Reserve can establish goals in conflict with those of the President or the Congress. We should, and do, use our limited powers to produce a monetary climate in which the economy can flourish, adding its strength to the attainment of whatever goals Americans may seek. The Federal Reserve cannot overcome all the maladjustments that keep some Americans from sharing in the general prosperity. The Federal Reserve cannot make the policy decisions that determine ultimately whether this country's international transactions will come again into balance or its gold will flow abroad. What we can do, and all we can do, is to make credit decisions as soundly as our ability permits, so that transactions in international markets may proceed with a minimum of interference from speculative forays against the dollar, and so that domestic markets, in performing their tasks of bringing together those who can supply them, may have the benefit of a reasonably stable price level. If this kind of credit climate is to be main-

tained, the decisions on which it depends should be made by an institution devoted solely to that end and responsible for its achievement. This is my conception of what Congress did in setting up the Federal Reserve System. This independence of judgment strengthens the formulation of the Government's overall economic policy, and the achievement of our national economic goals, as well as strengthening the credit structure on which the Government must rely to accomplish its objectives. ' 1

Mr. Martin has often drawn a parallel between the Federal Reserve and the Supreme Court emphasizing the trusteeship status of the Fed with our money supply and the guardianship of our legal lives by the Supreme Court. The Supreme Court is, however, one of the three branches of government while the Fed is only an arm of Congress. But the unique purpose of the Fed places it in a class by itself and lends some credence to Mr. Martin's "trusteeship" philosophy.

We now turn to the specific charges against this independence and will consider them in order.

1. The present Federal Reserve System is not what its founders intended it to be.

The above criticism makes an implication which is not valid. It implies that the founders intended the System to be publicly (read politically) controlled.

As designed, the System was to be controlled neither by private nor political interests. It was to be an agency concerned only with the task of implementing the policy of the Federal Reserve Act. It was not, certainly, to become a profit making venture for bankers

nor was it to be tainted by political interference, as indicated by the following passage from the Report of the House Banking and Currency Committee by Senator Carter Glass.

"It cannot be too emphatically stated that the Committee regards the federal reserve board as a distinctly non-partisan organization whose functions are to be wholly divorced from politics." <sup>2</sup>

The fact that the elapse of time would bring modifications in the original design of the System was expected by Woodrow Wilson in his first inaugural address.

"We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon; and step by step we shall make it what it should be, in the spirit of those who question their own wisdom and seek counsel and knowledge, not shallow self-satisfaction or the excitement of excursions whither they cannot tell." <sup>3</sup>

Modifications in the System have come bit by bit as the legislators deemed appropriate for the time concerned. The System's changes were wrought by different legislative bodies over the years. We must see that these changes were not a result of conspiracy by bankers finding the legislators asleep. The Congress has not been asleep for fifty years.

2. Banks have forgotten their primary purpose -- serving the areas in which they operate.

Most bank earnings result from loans of various types (60 per cent currently). Considering the size of bank operations one would con-

sider money to be adequately available to good borrowers. Consumer loans from commercial banks are greater today than during the forties when rates were lower. In 1945 loans by commercial banks hovered around one billion dollars; today the figure has increased almost twenty-five times. Population increased during this period from 140 million in 1945 to under 200 million today.

In regard to heavy bank purchases of securities of governments, the American Bankers Association forwards the following reason for such investment.

... commercial bank purchases of Federal, State and local government securities help provide financing vital to the economy. Obviously, any failure on the part of the Federal Government to find buyers for its securities would have some grave consequences for the nation. If State and local governments could not borrow large amounts of money, at low interest rates, they would find it difficult if not impossible to provide schools, parks, roads and other facilities that are valued so highly by the American people. 4

3. Federal Reserve Policy has, at times, neutralized policy objectives of the President and Congress.

At what time would this conflict most likely occur? Most likely when the Administration was pursuing an activity, the result of which would lead to an inflationary pumping of money into the economy. Such activity would tend to cheapen money. In an address last year at the University of Arkansas Medical Center, William McC. Martin explained the folly in helping the Administration in such a venture.

"If we continually make a practice of extending credit to the government solely to provide the Treasury with a cheap source of funds, we would ultimately neglect our responsibility for maintaining the value of the dollar and confidence in the banking system. And surely, in the end, the credit we extended would become worthless, even to the Treasury." 5

The Fed's outstanding goal is the protection of the integrity of the dollar. A spending spree by the Administration with political overtones can cause serious dollar problems. Hence, the System must evaluate political effects on the dollar and react accordingly. The System does help Americans towards realizing the goals they seek but the Fed cannot overcome all the maladjustments that keep some Americans from sharing in the general prosperity. The Fed makes credit decisions as soundly as their ability permits. Some of the System's actions are unpopular, but as trustees of our monetary system the Fed acts in our best interests. With such an independent monetary agency at work, the sum of our economic achievements necessarily will be greater.

With such current considerations as the balance of international payments, economic growth, employment, gold, and price stability weighing upon the decisions of the Fed, economic determinations are made in the light of the effects on all these areas. The effects on each of these interests, then, is of utmost importance to the Fed. If the System has neutralized some economic objectives of the President, such neutralization was appropriate medicine for an improper strain on the dollar.

The difficulty a President would experience in restaffing a Board of Governors was just so planned to keep the Executive out of the money managing business. Constitutionally, the Congress was given the power to regulate the value of currency. As an agency created by Congress, the Fed is the appropriate authority, independent within the government, charged with the task of managing our monetary lives.

4. Too much power and control rests in the hands of people whose private interests are directly affected by the Fed's actions.

There is no list of rules or automatic standards at the disposal of our monetary authorities that will, when applied, gear our economy to the center of the course. Nevertheless, there are several general feelings we have in regard to optimum management. It is felt that experienced policy makers, with pertinent information at their disposal who encourage a free exchange of ideas, are our best choices for monetary overseers.

Men appointed to the tasks of monetary managers must be completely qualified. Because there are no hard and fast automatic rules of monetary policy, men who have grown with maximum banking and economic exposure are more likely to be our best money managers. An appointee to a Federal Reserve Position cannot assume that he is to manage an established order. An appointee must come to his position in battle paraphernalia since he will be required to cope with new issues daily which arise from familiar activity. No incompetent can pose as a financial expert for long.

Too much is at stake to assume that popular politicians could play the roles of monetary managers. A competent money manager is one who is qualified, capable, and fit. Competence is built upon knowledge of the occupation. Knowledge of monetary affairs is possessed usually by persons greatly exposed to experience in that field. To eliminate bankers, those who would have interest in monetary decisions, from the Fed leadership would rule out the having of some very competent men on our monetary team. I, therefore, question the choice of monetary managers from other areas. Specialization of professional men is long respected for its rewards.

5. Private banks enjoy special consideration from the Federal Government.

Representative Patman would have us believe that bankers sit in an advantaged position in regard to profits and competition assured by successful lobby in Washington.

Let us look into the advantaged position. Profits? It is common knowledge that savings and loan associations have done as well or better. Competition? Banks are subject to more regulation and stiffer liquidity requirements, however, competition between banks and savings and loan associations is vigorous. Competition is more assured now than before because in 1962 the savings and loan associations became subject to taxes which had before been avoided. Before 1962 the associations paid practically no Federal income taxes.

Here is an example of the bankers lobby protested by Mr. Patman. Recently, he attempted to increase bank account deposit insurance from \$10,000 to \$20,000 but without requiring the savings and loan associations to fall under FDIC regulatory features governing banks. Both the Kennedy and Johnson Administrations insisted such safeguards be attached to the proposed increase. Thus, Mr. Patman retreated and did not hold hearings on the proposal of the Administration. This prompted Secretary Dillon of the Treasury to write the Rules Committee as follows:

" . . . the position of this Department and the Administration is that an increase in insurance coverage should be considered only within a context of complementary action to strengthen the supervisory framework within which the insured institutions operate, and to enable the responsible federal authorities to oversee more effectively certain practices with important implications for the safety and liquidity of financial institutions." <sup>6</sup>

However effective banker lobbying in this situation was, it can be construed as an attempt to strengthen the financial system. Mr. Patman certainly has an unusual connotation of competition.

Mr. Patman also contends that banks have an unfair advantage in regards to competition generally. Obviously he didn't include subsidized industries, monopolies, and price-supported farmers in his contention.

6. When the Fed and the Treasury signed the accord of March 4, 1951, the Fed wrongly interpreted the signing as a liberation from ties of dependence.

When we reflect on the "accord" we find that the two parties arrived at the agreement mutually. Both parties realized the significance of the accord. The Treasury does not regret the signing. In fact, the Treasury realizes the need of independence of the System within the Government.

In Representative Patman's 1964 Hearings before the Subcommittee on Domestic Finance, ex-Secretary of the Treasury, Dillon, explained the independence of the Fed as a necessity.

"... experience over many years and in many countries has taught the wisdom of shielding those who make decisions on monetary policy from day-to-day pressures. The day of private central banks operating without regard to Government policy is long since gone, and quite properly so. But around the world, almost all countries still find it useful to maintain independence for their central banks within the Government.

Independence naturally implies the right to disagree; and not only to disagree, but to act on the basis of different judgments. Some differences between the Treasury and the Federal Reserve may from time to time be a fact of life. But this need not be distressing. The necessity to test policy proposals against the views of an independent Federal Reserve, is, I believe, the best insurance we can have that the claims of financial stability will never be neglected." 7

7. In recent years the Fed has caused slower economic growth by holding interest rates too high. In 1963 gross interest charges were \$75 billion, \$11 billion of which is for national debt interest.

The allegation is misleading. Gross interest charges is not interest paid to moneylenders.

Gross interest charges include: 8

- a. Interest paid to depositors by banks; in 1963 this figure was \$36 billion.
  - b. Payments to shareholders by savings and loan associations.
  - c. Payments to members by credit unions.
  - d. Almost \$14 billion was paid to holders of Federal, State and local government securities in 1963.
  - e. Imputed interest, or estimated value of services furnished depositors by commercial banks, \$18 billion in 1963.
8. High interest policy is making the national debt a cumbersome problem.

The goal of keeping borrowing rates at a minimum must be balanced against broader considerations of the public interest. Any savings in keeping borrowing costs at a minimum must be weighed as to its effects on the economy. Free market countries have, since World War II, experienced a rise in the interest rate. Ours is still, however, among the lowest. When interest rates are permitted to respond to market forces, price stability has prevailed.

The Commission on Money and Credit, in 1963, spoke along these lines.

"... experience has clearly demonstrated that reliance on money creation to prevent interest rates from rising during a period of strongly rising business activity and

credit demands can only result in inflation. The goal of holding down interest charges on the debt cannot be allowed to take precedence over the important objectives of promoting sustainable economic growth with stable prices." 9

This is not to say that every effort must not be taken to trim the costs of the debt. Appropriate debt management policies provide for refunding, even during an expansionary period. The interest charges are high and are cause for concern but a healthy climate is what we buy with the current level of charges. The price of success is in the present rate structure.

9. The fundamentals of money can be understood by anyone.

Unique agency status is not necessary for the Fed.

Unique agency status finds justification in trusteeship responsibility. Responsibility implies protection of the monetary system from outside interference. When the Fed and other groups speak in favor of independence within the government they are speaking in favor of a condition most conducive to the insurance of a sound dollar.

Mr. Patman is a cheap money advocate. Most monetary experts fear that his type of reform would cause a fluctuation in the dollar's value. The monetary system needs protection from a Patman-like threat. Protection is assured by continuation of the present unique agency status. A subordination of the Fed under the President or Congress removes a degree of check on the possibility of a cheap money takeover.

An example of Mr. Patman's cheap money advocacy comes from his Money Facts, a publication by his Subcommittee.

"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." 10

Mr. Patman's statement is misleading on its face. He is implying that our Government could issue currency and pump it into the economy with no greater ill effects than a bond issue for money. Bonds are certificates denoting borrowing, whereas a simple print of currency and distribution into the system lacks all basic monetary soundness.

10. The Federal Reserve System is dominated by bankers.

Wright Patman fears banker domination of the monetary system on grounds that bankers generally are single-minded towards maximizing profits at the expense of other persons. A sustained rate of growth and monetary stability is preferred by bankers as an atmosphere most conducive to making profits. Bankers aren't speculators. They desire sound use of their loanable assets realizing that the goose that lays the golden eggs cannot be more valuable when killed. If Mr. Patman's allegations were correct bankers generally would be renowned for their wealth.

Let's look at earnings in 1963. 11

Commercial banks

9% on invested capital

Manufacturing	11 1/2% on invested capital
Public utilities	10% on invested capital
Trade concerns	10% on invested capital

Banker's do not dominate lending as supposed by some. Mutual savings banks, savings and loan associations, credit unions, small loan companies, sales finance companies, insurance companies, Federal credit-agencies -- all are competing with banks in the lending business. Therefore, banks do not have a strangle-hold on the borrower regardless of the size of his borrowing. The position of the savings and loan associations is additionally enhanced by a low Federal tax requirement; in 1963 it was only twelve per cent of net income after dividends. Understand that these associations do not fall under regulatory features of the Fed.

11. The Open Market Committee has cloaked its workings in a mantle of secrecy.

Let's look first at the operation of the Open Market Committee and see the basic reason for temporary secrecy.

The Policy Forum on the Open Market Committee is the maker of monetary policy. When the Forum meets, it first discusses recent developments and then launches out into future periods. Practically all members of the Forum bring raw material to the meeting for discussion, material which they consider significant from where they sit and observe the market. Considerable "grass roots" material is presented by

**Presidents of Reserve Banks.** Action to be taken on the findings of a meeting is not restricted to open market activity. If other tools are to be used the Committee recommends such action.

It is important to note that the Open Market Committee members keep in touch daily. Senior members make detailed calls telephonically at eleven A. M. daily to keep informed on the market. Additionally, daily and weekly written reports are prepared by the Trading Desk. Foreign exchange operations are likewise reported upon daily in form of a memorandum and each Bank president is wired daily on the conditions and the actions of the System in that regard. So when the Committee meets formally, decisions of major monetary significance are discussed.

Why the secrecy? Because of the threat of speculative activity. Committee decisions cannot be revealed until after their execution. To announce that the Fed would enter the market to pursue such and such a policy would cause speculators to move in for the kill. Thus the Committee must maintain secrecy in regards to its activity until that activity has been underway for some time. Minutes of the Committee meetings were recently released to the Archives in Washington. This ten year release is also available in major libraries across the country on microfilm. The allegation, then, that the Open Market Committee is a secret organization whose members collaborate to manipulate the money supply in favor of a few interests, logically, is not a sensible criticism.

12. Stock of the Federal Reserve Banks is unnecessary.

Most persons questioned in hearings conducted for Mr. O'Mahoney in 1952 recognize Fed stock as an anachronism but few think there is justification for change. Reasons favoring the continuation of the present stock situation are as follows:

- a. It leaves the System a degree of autonomy from detailed Congressional control.
- b. It serves as a link between the business world and the System.
- c. An official relationship exists between the System and the banks by virtue of the stock holdings.
- d. The situation should not be disturbed simply because the System no longer needs the capital funds.

As to the taxation on dividends of the stock is concerned, it is popularly held that the exemption of taxes being levied on System stock issued before March 28, 1942 is not justified.<sup>12</sup>

13. Funds are not appropriated to the Fed and no audit is made by the General Accounting Office.

Few knowledgeable people would suggest the System be included in Congressional appropriations or be subject to Congressional audit.

Placing the Fed under appropriations would be undesirable for these reasons:

a. Services performed by the System, payments, collection of checks, provision of coin and currency, are indispensable to economic growth and should not be performed in such a manner as to economize to the point of crimping their present worth.

b. An appropriation by Congress to the Fed would have to be of tremendous size or would have to give the Fed more discretionary powers than other agencies in order to assure prompt performance of the services.

c. There would be a tendency on the part of the Fed to increase costs of the services performed if funds became scarce.

d. Placing the System under appropriations would not increase its efficiency.

e. The Fed's quasi-private status would be reduced.

Insofar as audits are concerned, it is generally believed that it would subtract from the independence of the System materially if the GAO performed the audit. Specifically, the GAO audit is not desired for the following reasons:

a. It is not desirable that the Congress get involved in the daily affairs of the Fed.

b. Federal Reserve Banks are already audited in detail by the Board of Governors.

c. It is highly doubtful that the GAO could provide Congress more information than is now given them.

d. The audits would cause a break-up of the much needed quasi-private standing of the banks.

14. The Tax and Loan accounts subsidize bankers at the taxpayer's expense.

The tax and loan accounts provide invaluable services to the Government and the Federal Reserve. Reasons for keeping the tax and loan accounts are as follows:

a. Unneeded taxes can be held by banks until needed.

b. The procedure avoids a whipsawing of bank reserves and deposits from day to day as Treasury receipts and expenditures vary widely over short periods of time. The impact of Treasury operations on the market are neutralized.

c. If there were no T & L account--

(1) The Fed would have to buy Treasury bills when the Treasury was taking receipts out of the banking system.

(2) The Fed would have to sell Treasury bills when the Treasury was putting funds back into the banking system.

d. Funds in the T & L account are held in the community for its own credit expansion.

The present tax and loan accounts tend to stabilize otherwise wild fluctuations in the monetary system. These accounts should not be abolished until a better plan is forwarded.

15. Since the New York banks call the tune at the Fed, the Republicans can resist almost any change making the System responsive to the President.

Resistance has come also from the Democrats. It has been a bi-partisan majority approval of Fed independence. Note the Democratic support below.

- a. A Democratic President and Congress established the System.
- b. Carter Glass, Democratic Senator, and an architect of the Fed, praised Wilson for refusing to allow politics to interfere.
- c. A Democratic Congress and Democratic President, Franklin Roosevelt, in the thirties, established the Open Market Committee and removed the Secretary of the Treasury and the Comptroller of the Currency from their ex-officio membership status on the board.
- d. Democratic Senator Paul H. Douglas led the fight to free the Fed from pegging restrictions.
- e. Wright Patman in 1952 called for a continuation of Fed independence.
- f. The two Governors appointed by Democratic President Kennedy, Daane and Mitchell, have "out-Martined" William McC. Martin in advocating Fed independence.
- g. Democratic President, Lyndon Johnson, in October 1964, boasted of maintaining "the Federal Reserve's traditional independence

within the Government." <sup>13</sup> (The President's preoccupation with Great Society goals and the Vietnam War is cause for his present desire for cheaper money.)

Footnotes for Chapter IV

- <sup>1</sup> Congressional Record, Senate, 1965, p. 739.
- <sup>2</sup> House Report No. 69, 63rd Congress.
- <sup>3</sup> Woodrow Wilson, Innaugural Address, 1913.
- <sup>4</sup> The American Bankers Association, Comments on Mr. Patman's "ABC's of Money", N. Y., p. 14.
- <sup>5</sup> William McC. Martin, "Our American Economy at the Federal Reserve System", Little Rock, Arkansas, July 30, 1964, p. 10.
- <sup>6</sup> Congressional Record, May 27, 1964, p. 11645.
- <sup>7</sup> Subcommittee on Domestic Finance, Committee on Banking and Currency, House of Representatives, "The Federal Reserve System After Fifty Years", March 5, 1965, p. 1232.
- <sup>8</sup> U. S. Dept. of Commerce, Survey of Current Business, July 1964, p. 34.
- <sup>9</sup> CMC, The Federal Reserve and the Treasury, 1963, Prentiss Hall, Englewood Cliffs, N. J., p. 230.
- <sup>10</sup> Subcommittee on Domestic Finance, Committee on Banking and Currency, House of Representatives, Money Facts, September 21, 1964, p. 12.
- <sup>11</sup> The American Bankers Association, op. cit., p. 15.
- <sup>12</sup> U. S. Congress, Joint Committee on the Economic Report, "Monetary Policy and Management of the Public Debt," 1952.
- <sup>13</sup> President Johnson, "Presidential Statement No. 2 on Economic Issues," October 26, 1964.

CHAPTER V  
CONCLUSION

In the preceding chapters I have attempted to present pertinent information bearing upon the question of the independence of the Federal Reserve System. From this presentation, I have derived the conclusion that a continuation of the present degree of independence of the Fed is necessary. In fact, I am of the opinion that the System will continue to grow in power as our society evolves and requires even more complex monetary mechanics.

The following factors influenced my stand on the question of the appropriate status of the System:

1. The System is what Congress made it. Practically every Congress has granted it additional powers.
2. The Board of Governors is a body of specialists who can manage the money supply and interest rate without political interruptions causing them to devote less time and effort to their tasks.
3. It is popularly believed among economists that a continuation of the Agency's status is appropriate.
4. Senator Carter Glass, co-author of the Federal Reserve Act, stated that it was intended that the System's functions be wholly divorced from politics.

5. Among his suggestions, Mr. Patman has not forwarded a proposed change in the existing Federal Reserve System which could enhance the integrity of the dollar--the reforms he has suggested, however, could lead to an undermining of confidence in the dollar if followed.

6. I fear that a monetary authority politically inspired would act for short-run benefits, causing a rise in the price level to ensue in the long run.

7. A rise in the rediscount rate to curb credit expansion is not as harmful as Mr. Patman thinks.

8. Judging from the state of our economy, few would conclude that a change in the Federal Reserve is necessary.

9. Congress has not lost its basic monetary responsibility to the Federal Reserve.

The criticisms by Mr. Patman and his followers are not reconcilable with modern conceptions of monetary theory. Granted, Mr. Patman is a dedicated student of money and banking, but his conception of the most appropriate monetary policy and his means of achieving it is not considered feasible if we are to protect the character of the dollar. To follow his monetary policy would lead to cheap money, then to inflation, then to accelerated economic disturbances characterized by wage-price spirals, disruptive markets and a

general lack of confidence in the dollar. The cheapness of money will not alleviate other economic ills as he supposes. Today economists strive for economic stability couched in a monetary policy producing a stable dollar and containment of the price level. Such a monetary policy prescribes voluntary restraint as well as credit expansion.

It is never popular to make money tight, to tell Americans that the interest rate should be raised and credit availability curbed. But, during the last year we have seen a clear example where the Federal Reserve was again proven right in its efforts to thwart the magnitude of inflationary tendencies. Realizing, as careful students of monetary policy do, that if the expansion over the last five years was not appropriately kept within bounds that it would cause a bust, as indicators foretold, the Board Chairman announced a hike in the rediscount rate in December. After Mr. Patman's public ridicule of the Fed's actions in this regard, we realized that the increase in the rediscount rate was indeed timely, for early in the new year the Administration and party leaders began talking of further curbs on the boom including a tax increase to take up the excesses of inflation. The Federal Reserve had warned us that inflation was imminent a full six months before we realized that it was in fact upon us. It is worth mentioning that Mr. Patman was not afraid of the inflation as late as December of last year. His criticisms of the increase in the rediscount

rate is evidence that he was completely ignorant of the actual economic conditions of the day.

Now, I would like to reinforce my conclusions that the status of the Federal Reserve must be preserved, by presenting some of my observations.

Regardless of American acceptance of Keynesian Economics, involving an active role by government in income determination, it is yet a free-enterprise economy which is based on the law of supply and demand to afford optimum resource allocation and use, and to determine prices. Ill effects occur from artificial stimulation of the economy calculated by psuedo-economists to keep a condition of boom continuing long after a slowdown should have occurred. Some of these ill effects are; depreciating and destroying savings, impairing incentives, forgetting the importance of a parallel between labor productivity and wages, and an implied approval of political manipulations of macroeconomic variables. A principle calculated to prevent the government's active role to an extreme is having coordination as dominating factor over subservience and acquiescence on the part of branches of government and the regulatory agencies. The principle is especially applicable in economics. The hangover from full employment psychology in the postwar era encourages ultra-Keynesians to build props under artificial prosperity and erroneously believe they can

override or outmanipulate the market laws of supply and demand.

One of the primary objectives of the easy money cult is to reduce unemployment which of itself is thought to reduce many of our socio-economic ills. Granted, high unemployment is not desirable over moderate inflation, and Keynes' principles can be invoked to call for injections to boost employment. However, when the expansionary programs attempt to reduce unemployment below four per cent, labor and investors will discover the "money illusion." When inflation is reliably predicted, actions will be taken to discount its effects--unions will demand and probably get higher wages thus intensifying the inflation. If the easy money people cannot keep inflation ahead of expectations, unemployment will return to the four per cent level.

The essence of Representative Patman's campaign to make the monetary system responsible to the people is the placing of the Federal Reserve under Executive control. Debates preceeding the enactment of the Federal Reserve Act, its provisions and amendments, lead me to believe that the System was never intended to be placed under the control of one who could so use its power for his personal benefits.

Most economists agree that there are occasions when credit tightening is required in the task of monetary management. These unpopular activities would hardly be undertaken by an elected official facing an upcoming election. The President himself is vulnerable to such a precarious situation, and I am sure that his best personal interests would greatly influence his public actions. A surrender of monetary control to the President would enlarge his powers greatly and the provision for separation of powers would be violated because the Congress would lose its Constitutional responsibility for regulating the value of money.

Mr. Patman questions the delegation of the monetary power to the Federal Reserve on the grounds that the System has too much policy determination and is too free from Executive and public (political) control. He is opposed by those who consider a monetary authority most desirable which is free to operate for the benefit of the general welfare of the nation. The latter view appears to be the most reasonable view when we consider the complexity of today's society and the virtual necessity of delegating functions of government to prudent and upright employees who act in our best interest. My point is that an appointee would be more likely to exercise the functions of his office more rationally than a popularly elected office holder whose decisions might be made to keep the favor of minority factions. I am not sure that a

popularly elected monetary authority would have raised the rediscount rate as the Federal Reserve did last December.

Mr. Patman's efforts have been centered on the theme of emasculating the Federal Reserve, but his suggestions for appropriate monetary management as an alternative are lacking. He has not concentrated enough on the idea of bettering monetary control to prove the present Federal Reserve to be unsatisfactory. His proposals to strip the System of its powers and return them to Congress and the Executive are not sound.

It is popularly held that the System is adequate to its task of determining the money supply and interest rate. Such popular approval makes it difficult for Mr. Patman to find listeners who embrace his suggested reforms of the Federal Reserve System, regardless of the unpopularity of monetary restraints aimed at thwarting inflationary tendencies. Generally, the vast majority feels that Mr. Patman should not weaken the Federal Reserve and expose the dollar to possible vulnerability with no greater reason than his fear of autonomous decisions on the part of the Board of Governors.

As a closing remark, it should be clear that the Federal Reserve System has become a most powerful arm of Congress, not because its management is thirsty for power but because it has filled a void in the management of a nation's money supply necessary to

compensate for a fluctuating free-enterprise economy. Mr. Patman's attack on the Federal Reserve is the most comprehensive one since the System's origin but his criticisms, once evaluated, appear to be of no material effect. When one reads his articles he should remember that basically the Congressman is a cheap money advocate and his articles should be assayed with that thought in mind. His tirades against banks and bankers, the size of Trading Desk transactions, and other elements concerning Federal Reserve activity have as their base a fear of monetary restraint that will prevent the "little man" from realizing his aspirations with lesser concern about the general health of the economy and the dollar.

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VITA

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*Garland Proco*

APPENDIX

BASIC MONETARY POLICY

Monetary policy may be defined as governmental use of its powers, delegated to the central bank, to influence the money supply and interest rate to achieve general economic objectives. The central bank uses its various monetary devices with the intent of affecting the size of bank reserves, which directly affect the money creating capacity of the banks throughout the country. The money creativity is limited according to the size of bank reserves. When the Fed causes reserves to increase, greater money creativity is possible. Likewise, a diminishing of reserves has the multiple effect of diminishing the money supply.

There are two categories of monetary devices or controls -- general and selective. The general controls are rediscounting, open market operations and reserve requirements. The only selective control in use today is margin requirements on the purchase of securities.

Rediscounting is a term used to describe the procedure whereby Reserve banks lend reserves to banks by discounting paper presented by the banks needing reserve funds. By varying the discount rate the reserves of the banks are affected. For instance, a high

rate will discourage bankers from increasing their reserves, which leads to a general fall in reserves throughout the banking community. Another result of raising the rate is a general adjustment to the rate by market instruments.

Open market operations is by far the most effective monetary control. The operations are concerned with Government securities and bankers acceptances. When the Trading Desk buys securities it pays with checks which, when deposited in member banks, are redeposited by the member banks at their Reserve bank and thus become added reserves for the member banks. A sale of securities by the Desk reduces the member bank reserves by the same process in reverse.

The third quantitative control is the changing of reserve requirements. This control is a blanket requirement for legal reserves to be a specified percentage of demand deposits. A varying of the requirements varies the bank's money creativity immediately.

The selective control, margin requirements, is a method of controlling stock market speculation. It is a Government measure to increase or decrease the use of credit for specific purposes rather than for managing the total supply of credit.

The above monetary management devices are, with rare exceptions, employed simultaneously to achieve a general policy objective. General policy is intended to regulate the supply of money to affect the interest rate. Monetary policy is very effective to check inflation. Interest rates, however, do not appreciably effect loans to farmers and small businessmen in the short-run because they are unconcerned about this interest rate for short repayment periods. An interest rate variation of a point will not materially affect their decision to borrow.

In time of a gold flow threat, a general rise in the rate of interest will stem the flow if the rate is sufficient to bring a greater return on the dollar domestically. The threat of gold flows tend to persist today because a greater return on money can be realized abroad. We must not be too afraid of high rates on interest -- they are much higher in Europe. Traditionally, rates have been higher abroad. And we should not refuse a rise in the interest rate when monetary experts feel that such an increase will stem the gold flow or will check an inflation.

## ABSTRACT

The Federal Reserve System is a complex central bank system which determines the money supply and the level of interest rates. The System was established in 1913 as a monetary authority primarily concerned with maintaining an elastic reserve system which would act as a check on bank runs and money panics. Since 1913, Congress has provided the System with monetary tools enabling it to quickly respond to adverse conditions affecting dollar stability and economic growth. All indicators point to an increase in monetary power by the Federal Reserve System simply because economic growth, national and worldwide, calls for more complex monetary mechanics.

Representative Wright Patman (Democrat, Texas) is afraid of the powerful Reserve System. He would like to strip the agency of its power and reduce it to a routine operation with policy decisions made by the Administration. He charges the Board of Governors of the Federal Reserve System with manipulating the money supply and raising the interest rates for the benefit of bankers of the East.

In my thesis, "The Independent Status of the Federal Reserve System," I evaluated Mr. Patman's criticisms and his recommended

reforms of the System. I have concluded that a continuation of the status of the Federal Reserve System is necessary. Mr. Patman's suggested reforms would invite political interference in monetary affairs and expose the character of our dollar to abuse.