1. A Modest Proposal

In June 1934 Eugene Black resigned as Governor of the Federal Reserve Board and returned to the former post he held as head of the Federal Reserve Bank for the Atlanta district. Until a permanent successor to Black was chosen, the affairs of the Board were directed by its Vice Governor, J. J. Thomas, a man of exemplary personal traits, but somewhat limited in his knowledge of economics and banking.

In the months following Black's resignation several names were bandied about Washington as those of likely successors to the post he had vacated. But it was not until a blistering day in August that I heard my own name included among the list of prospects. On this day, when I was seated next to Henry Morgenthau at a White House conference, he suddenly leaned over and whispered: "Marriner, I've been talking to the President about your filling Eugene Black's place."

He waited for a reply. For once in my life I was mum. Nothing more was said, nor were any questions asked when the meeting ended. I'd never thought of myself as a candidate for the vacant post or for any other public post. June 1935 had been set as the limit of my stay in Washington, the date coinciding with the end of the school term. I meant to return to Utah with my family at that time.

Several days after the White House meeting, Morgenthau asked me directly what I thought of the prospect he had raised. I said I'd given it no thought, but would be glad to do so if the matter was under serious consideration by the President. I was told that it was.

Sometime in September, when Morgenthau took me to an-

other White House meeting, Roosevelt informed me directly that I was being considered for the post of Governor of the Federal Reserve Board and asked how I felt about that prospect.

I replied that the post would be an appealing one only if fundamental changes were made in the Federal Reserve System. Over the years, practices had grown up inside the System which had reduced the Reserve Board in Washington to impotence. The System had originally been designed to represent a blend of private and public interests and of decentralized and centralized authorities, but this arrangement had become unbalanced. Private interests, acting through the Reserve banks, had made the System an effective instrument by which private interests alone could be served. The Board in Washington, on the other hand, which was supposed to represent and safeguard the public interest, was powerless to do so under the existing law and in the face of the opposition offered by the men who ran the Reserve banks throughout the country.

When Roosevelt expressed interest in the specific changes I had in mind, I asked for time to put them into shape.

The congressional elections of 1934 caused a month's delay and it was not until November 4 that I had another meeting with the President. I brought to it a memorandum I had prepared in the meantime with the help of Lauchlin Currie, then a member of the "Freshman Brain Trust" in the Treasury Department.

This memorandum, which led to the Banking Act of 1935, is now deposited among the Roosevelt papers. It should have more than passing interest to the historians of the epoch. While Roosevelt beforehand had engaged in the very agreeable political game of attacking "Wall Street control" of the American economy, the attack was largely theatrical in character. It had never been followed by off-stage action of the sort that could make the nation's financial centers useful servants of the national welfare. The memorandum I presented to Roosevelt on November 4 proposed in explicit terms that this sort of action

should be taken, and indicated, furthermore, how it should be taken.

Tens of volumes would be needed to record the evolution of all the problems to which the memorandum was addressed, but it is enough for the purpose of this narrative if the following details, most relevant to subsequent developments, are here presented:

When the Federal Reserve System was formed in 1913, its main objective was to avoid money panics and the recurrent periods of credit stringency that had plagued the nation. Thus a regional credit pool was established within each of the twelve autonomous Federal Reserve Bank districts, along with an interregional check and currency clearing system. Member banks could bring their commercial paper to the Federal Reserve banks in the area and, at a rediscount, gain from the Reserve banks the means to supply temporary, seasonal, and emergency needs of customers who wanted credit and currency.

As representative of the public interest, the Federal Reserve Board in Washington was given a general supervisory role over the System, expressed in general directives toward which it was to point its operations. The real control over those operations was entrusted to the impersonal, pervasive, automatic, and impartial workings of the gold standard. The mechanics of the standard, and not any arbitrary decision made by a human being, would determine the amount of currency and bank credit that could be made available to the economy at any given time.

These assumptions on which the System was based were outmoded soon after the System was created. First, with the outbreak of the First World War the gold standard was abandoned by virtually all parties in the war. Thus this automatic determinant of economic conditions was rendered useless. Second, while the public debt at the time the Reserve System was created stood at less than $1 billion, when the war ended, the debt was about $27 billion.

Of these factors, the growth of the public debt was to have

special significance for future developments. It gradually became evident to the autonomous Federal Reserve banks, to the Federal Reserve Board, and particularly to Benjamin Strong, the Governor of the New York Reserve Bank, that when they bought and sold the government securities expressing this debt of $27 billion, they directly influenced not only market conditions but also the reserves of the member banks. Through the reserves they influenced the volume of deposits; through the deposits, the volume of loanable funds made available to commercial banks; and through the commercial banks they influenced the minutest operations in the economy.

These influences were not merely regional or local. They were national in scope. Thus the bankers came to realize that the principle of regional autonomy, expressed in the organization of the Reserve System, would have to be modified so that the purchases and sales of government securities could be co-ordinated on a national scale. In 1922 a small informal committee of governors, headed by the Governor of the Federal Reserve Bank of New York, began to deal with this problem. And committee functions thereafter grew apace with an appreciation of the effects produced by the operations of individual Federal Reserve banks in the government security market.

As a foreshadowing of trouble that was to come, one word on the nature of a governor's position at this time should here be interjected. The governor of a Federal Reserve bank was its chief executive officer. There was no explicit statutory basis to this post, however. It was created by action of the directors of each Federal Reserve Bank, and it was they also who chose its governor. Its head, as provided for by statute, was its chairman. The chairmanship, unlike the post of governor, was filled by action of the Federal Reserve Board in Washington. In the day-to-day operations of a bank, however, he was subordinate in importance to the governor. And the governor, it should be said again, was the creation of the private interests which supplied a majority of the board of directors and who hired and fired the

governor without let or hindrance by the Reserve Board in Washington. The significance of this will presently be made clear.

The creation of the informal committee of governors in 1922 (called the Governor's Committee on Centralized Execution of Purchases and Sales of Government Securities) to deal with open market operations was a belated recognition by the Reserve System of its responsibilities in this field. Soon thereafter the Federal Reserve Board more directly expressed its own interest and by resolutions adopted in March 1923 provided that on and after April 1, 1923 this committee of governors should be superseded by a new committee to be known as the Open Market Investment Committee of the Federal Reserve System. Membership was limited to the governors of the New York, Boston, Philadelphia, Cleveland, and Chicago Reserve banks. They were to devise and recommend plans for open-market operations of the Reserve banks in accordance with principles and regulations set forth by the Reserve Board.

Upon the formation of the committee, there was established a Federal Open Market Investment account, which was operated by the New York Reserve Bank under the committee's supervision. The dominating influence over this account was provided by the Governor of the New York bank, though from a legal standpoint the actions of the committee as a whole were subject to the approval of the Federal Reserve Board and the individual concurrence or participation of each of the other Reserve banks.

A further alteration in the composition of the committee, though not in its operational principles, was made in March 1930. At this time the name of the committee was changed to that of the Open Market Policy Conference. It included all twelve governors of the Reserve banks, and the execution of policy decisions was entrusted to a five-man body formed of the bank governors who had constituted the previous Open Market Investment Committee.

All these developments were without statutory form. It was not until the Banking Act of 1933 was passed that the status and functions of a body engaged in open-market operations was given specific statutory recognition. By the terms of that act, there was created a Federal Open Market Committee consisting of one member from each Federal Reserve district to be designated annually by the board of directors of the Reserve bank. The committee was to meet in Washington at intervals and under conditions prescribed by the statute.

While the form was now legally defined, the fundamental weakness that had existed throughout the history of such bodies was retained. Specifically, while no Reserve bank could engage in open-market operations except in accordance with regulations adopted by the Reserve Board, the statute preserved the right of any Reserve bank to refuse to participate in operations recommended by the committee. Thus the Federal Reserve Board, which was ultimately held responsible for policy, could not initiate it. It possessed only the power to approve or disapprove of the policies initiated by the Open Market Committee. The committee, which was formed of governors who represented the private interests in control of the Reserve banks, could initiate policy but could not execute it. The board of directors of the individual Reserve banks, who took no part in forming policy, had the power to obstruct it.

In human terms, before a uniform decision could be reached regarding open-market operations, with their far-reaching consequences affecting the volume of reserves and the supply of money and credit in the economy, there had to be a complete meeting of minds between the governors of the twelve Reserve banks and the 108 directors of all those banks, plus the Federal Reserve Board in Washington. A more effective way of diffusing responsibility and encouraging inertia and indecision could not very well have been devised. Yet it seemed to suit the New York Federal Reserve Bank, through which private interests in

the New York financial district exercised such enormous influence over the national economy.

Reform of the foregoing situation was clearly indicated. Responsibility over open-market operations had to be unified in character and vested in a clearly identifiable body. But apart from this administrative change, there was a need for reform in other directions.

I exclude from this account the reforms that would require labored technical explanations, and single out a specific reform toward which my own thoughts were drawn when I had fought to keep my banks open in the early years of the depression.

This was a need to broaden the types of paper eligible for discount at the Federal Reserve banks. It seemed to me that restriction of the rediscounting privilege to short-term commercial loans and investments—as under the original Federal Reserve Act—hamstrung the operation of the Reserve System.[1] Moreover, if the banking system limited itself to this kind of commercial traffic, it would die of atrophy. In October 1934, for instance, the paper eligible for rediscounting privileges—within the meaning of the Federal Reserve Act—amounted to only slightly more than two billion dollars. In actual practice this volume would be sweated down considerably, in order to meet the exacting operation of the "eligibility provisos." Banks could not live on interest from such a small volume of loans, and an attempt to confine themselves to these loans would greatly curtail the scope of banking. The more business the banks refused—and their decisions in this respect would be markedly influenced by the extent to which their loans would be eligible for discount, as well as the rediscount rate—the more other agencies, including the government, would capture the credit field.

While the banks were restive under the emerging condition where they relied more and more on holdings of government

obligations to keep up their income, the condition itself was due to the failure of the banking system to perform its functions adequately. If, for instance, the banking system utilized in real-estate loans and other long-term investments the savings and excess funds they possessed, bank business activity could be greatly stimulated and the government would then be able to withdraw rapidly from the lending field. Moreover, to the extent to which banks assumed their proper role in the economy, to a like extent would the government's debt be reduced, since a greater part of that debt was incurred in refinancing mortgages and in undertaking other functions that the banks had failed to perform.

I was not unaware of the dilemma banks then faced because of the "eligibility" provisions that governed Federal Reserve rediscount privileges. If, on the one hand, the banks went into the long-term lending business, they ran a double risk of the depreciation of their assets and of an inability to make a quick conversion of their assets in time of need. On the other hand, if they did not go into this long-term business, the outlet for their funds would be extremely limited; the funds would lay idle as accumulated savings, and thus, in accordance with the theory stated previously in these pages, contribute to the forces that culminate in depression.

Was there a way out of this dilemma?

I felt there was. It could be found by shifting attention away from the word "liquidity" and centering it on the words "sound assets." More explicitly, I felt it important to bestow "liquidity" on all "sound assets" by making these latter a basis for "eligible" borrowing at the Reserve banks in time of need. This would permit banks to concentrate their efforts on keeping their assets sound and to pay less attention to the narrow form or calendar date of maturity. Reliance on the form of paper as a guide to soundness—as under the original Federal Reserve Act—had not protected the banking system from the disaster

of 1929–32. On the contrary, it was a contributing cause to that disaster.

I wanted the problem of liquidity to cease to be a concern of an individual bank and become the collective concern of the banking system. For a single bank that adopted a policy aimed at paying off all its deposits at a moment's notice—even though the national income was cut in two—could not adequately perform its duty of serving the community as a middleman for investing a substantial proportion of the community savings. To protect itself against depression conditions when good local loans go bad, a bank's portfolio would have to consist of superliquid open-market paper. In contrast with this, I wanted to make it possible for banks, without abandoning prudence or care, to meet local needs for both short- and long-term funds. This could be done by the proposed method of making all sound assets liquid by permitting them to be rediscounted at the Reserve banks.

With this bare account of the forces and ideas that lay behind the memorandum I presented to Roosevelt on November 4, I now turn to the memorandum proper.

It began with an explicit statement that "if the monetary mechanism is to be used as an instrument for the promotion of business stability, conscious control and management are essential." Without that control, experience showed that "the supply of money tends to contract when the rate of spending declines. Thus during the depression the supply of money instead of expanding to moderate the effect of decreased rates of spending, contracted, and so intensified the depression. This is one part of the economy in which automatic adjustments tend to have an intensifying rather than a moderating effect."

If there was to be a conscious use of monetary controls, then the Reserve Board, which "is nominally the supreme authority in the country," had two duties. It had the duty "to assure that adequate support is available whenever needed for the emer-

gency financing involved in a recovery program, and to assure that a recovery does not get out of hand and be followed by a depression." Yet the Reserve Board was in no better position to work consciously toward the end of economic stability in the future than it had been in the past. The reasons were to be found in the defects of the System already indicated.

To remedy these defects, these minimal changes were needed:

First: That the power over open-market operations, which has such great bearing on the supply of reserves and the volume of money and credit, should be taken away from the privately run Federal Reserve banks, acting through their governors; that the power should be vested in an Open Market Committee of the Federal Reserve Board in Washington; that this committee of the Board should have the right to initiate open-market policies and be responsible for their execution and results.

Second: That the separate office of chairman of the board of directors of a Reserve bank should be abolished and its functions merged with those of the governor; that by law the governor should be made the formal as well as the actual head of the Reserve bank; that he should be chosen annually, and the Federal Reserve Board be empowered to approve or reject any nomination of a governor made by Reserve bank directors.

Third: That the explicit definition of "eligible paper" that could be rediscounted at the Federal Reserve banks should be deleted from the Reserve Act; that with the substitute concept of "sound assets" as a guide, the power of the Federal Reserve Board in Washington to define "eligible paper" should be clarified; that, in accordance with the state of the national economy, the Federal Reserve Board should be able from time to time to issue regulatory orders defining the character of sound assets with corresponding orders affecting changes in reserve requirements.

In the course of a two-hour elaboration of the memorandum and the legislative program it would entail, Roosevelt's atten-

tion never wavered. Now and then an electric question would shoot out from him. Now and then, as when I departed from the memorandum and suggested that branch banking should be included in the proposed legislative program, he shook his head and objected. Branch banking signified "bigness" to him, and ran contrary to his disposition to think of problems in terms of small local units of power. Now and then he would race ahead of me to plot the trend of what I was saying. As a supremely effective political leader he also understood what my proposals would entail in political terms.

At last his powerful hands slapped down on the table in his characteristic gesture of decision as he said:

"Marriner, that's quite an action program you want. It will be a knock-down and drag-out fight to get it through. But we might as well undertake it now as at any other time. It seems to be necessary."

Then he added: "Gossip has gotten around about my considering appointing you the new Governor. It is only fair that you should know that formidable opposition has developed as a result. However, I don't give a damn. That opposition is coming from the boys whom I am not following."

To this I replied: "Well, Mr. President, if you don't give a damn, I don't see why I should."

Had I known at that time how strong the opposition would be, I doubt whether I'd have had the courage to take the job. But at the time, Roosevelt's pledge of support was all I needed to hear.

Six days later, on November 10, he announced my appointment as Governor of the Federal Reserve Board. At the same time a White House statement contained a thumbnail sketch of my business and banking connections, written as though it was a stockholders' report. It listed the capital value of each enterprise along with the volume of business it did each year. In this respect I believe the form of the announcement is unique among those which accompany Presidential appointments. But

it was designed to offset the charge then current that every official of the New Deal was a crackpot and a visionary, unqualified to hold public office because he had never met a pay roll. Here, then, was evidence to the contrary, to silence, or at least to disquiet, the opinion-makers in the world of finance, industry, and business. The nominee had met pay rolls—and large ones—many times. For the consumption of large areas of the nation that retained painful memories of bank crashes, the announcement emphasized the fact that the nominee was a Westerner who headed a banking organization that had come through the depression years without loss to its depositors.

I had nothing to do with the preparation of this statement and was a little amused by its character. I felt at the time that the legislative program I proposed to initiate as the new head of the Reserve Board would stand or fall on the merits of the ideas it advanced and, as such, was something apart from my past career or future fate.

Senator Carter Glass of Virginia was to teach me that the contrary was the case.