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Contents:

FEDERAL RESERVE BANK OF MINNEAPOLIS

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Statement of Frederick L. Deming, President, Federal Reserve Bank of Minneapolis, before the Subcommittee on Domestic Finance of the Committee on Banking and Currency, House of Representatives, February 4, 1964

Beginning in January this year, hearings on the Federal Reserve System after 50 years have been held in Washington, D.C. before the Subcommittee on Domestic Finance of the House Committee on Banking and Currency. At these hearings, members of the Board of Governors of the Federal Reserve System, the presidents of the Federal Reserve banks and others have been called to testify.

Mr. Frederick L. Deming, President of the Federal Reserve Bank of Minneapolis, appeared before the Subcommittee on February 4. In view of the wide publicity given the hearings, it was felt that readers of the Monthly Review might be interested in reading Mr. Deming's statement to the Subcommittee.

Mr. Chairman and Members of the Committee:

It is a pleasure to appear before you this morning. I want to thank you for your invitation and for the opportunity to join with you in your examination of the Federal Reserve System. I hope that what I have to say about the proposals contained in H.R. 9631, H.R. 9685, and H.R. 3783 will be of some small help to you in your deliberations.

I have been associated with the Federal Reserve System for almost twenty-three years, first as an economist with the Federal Reserve Bank of St. Louis, then, successively, as director of research and First Vice President there, and, since April 1957, as President of the Federal Reserve Bank of Minneapolis. Twenty-three years is a long time, long enough, it seems to me, so that I can claim a familiarity with the Federal Reserve as a working institution. I believe that the Federal Reserve System, *as presently organized,* is an effective instrument of national economic policy.

I do not contend that the Federal Reserve System — although fashioned by intelligent, dedicated men — is perfect. But then neither am I sure that "perfect" is a word which can be meaningfully applied to institutions. The question is not whether a particular institution is perfect, organized in the best possible way. This is something no one can answer. But whether a particular institution works well enough, whether it discharges its responsibilities adequately, this is something that can be determined. And for the Federal Reserve System, the answer must, I think, be that it has and does.

Nor would I claim that all decisions made by the Federal Reserve System have been perfect. Certainly reasonable men can differ about whether monetary policy — of the last few years, the postwar years, or the 50 years since 1913 — has always been the most desirable and effective. But again, this is not the question at issue here. What is being considered here is whether a differently organized or structured Federal Reserve System would have turned out, or will turn out, a better monetary policy. It is this that I very much doubt. If monetary policy has at times been inappropriate, it is not, I submit, because of faulty organization or structure.

I want to address myself first to certain major aspects of the institutional character of the Federal Reserve System. When the System was created 50 years ago it was a new kind of central banking institution, particularly adapted to the American political and economic scene and reflecting the American genius to meet a need in a pragmatic way without being overly concerned about what I might call "organization chart logic." The Federal Reserve System was designed to be a *federal system* — a unique blend of centralized and regional functions and responsibilities. It was designed to carry out a clearly public purpose but was organized so as to draw strength from the private sector—a unique blend of public and private. And it was designed so as to be shielded from day-to-day political pressures but made responsible to the legislative branch of Government through what Chairman Martin has aptly called a "trust indenture."

It seems to me that two striking facts stand out when one studies the history of the Federal Reserve System. First, it is not a static, unchanging institution and it never has been. It has been changed by amendments to the Federal Reserve Act and by other statutes, some of these changes being of major proportion and some of minor scope. Within the framework of the laws it also has evolved over the years, changing as its environment has changed, and it will undoubtedly change further as the years go by. These evolutionary changes have been both with respect to structure and to central banking techniques.

Second, despite all of the changes, both statutory and evolutionary, the basic original concepts of federalism or regionality, of the blend of public and private, and of the desirability of insulation from politics have been preserved. And I might comment that this reflects the American genius for making institutions work. Changes are sought for practical reasons—usually when history has demonstrated a need for them but sometimes when it may be clearly seen that future developments will call for them. Changes are not made just to tidy up the organization chart.

In my judgment the reasons underlying the concepts of federalism, of drawing strength from the private sector for a public institution, of shielding the central bank from politics, are as valid today as they were in 1913. Therefore, I shall speak in opposition to most of the proposed legislation contained in the bills I referred to earlier.

A Regional Federal Reserve System

It is fashionable to say nowadays that regionalism is less strong in the United States than it was in 1913, that this is particularly true of money and credit, and that monetary policy must be national in concept and formulation. I agree in part with these points but not with the often asserted conclusion that the regional nature of the System is outmoded.

As every member of the Congress knows full well, the United States is composed of regions which have at least as many differences as similarities in conditions and problems. The Ninth Federal Reserve district with its wide areas, its relatively small but very vigorous population, its heavy dependence on farming, lumbering and mining, its hundreds of small banks, and its many other distinctive characteristics, simply is not the same, nor has it the same problems in degree or kind as the other areas of the United States. Rapid transportation and communication, greater mobility of people and the rise of non-resource based activity may have made it less isolated but have not greatly lessened its individuality.

I do not state these points from a narrow sectional attitude. I note them to underline the fact that national developments reflect the sum (or sometimes the remainder) of regional developments and that national averages can conceal wide regional variations. Therefore, in my judgment, it is important to recognize that regional variations exist and to take them into consideration in formulating national policies so that such national policies can serve most fully the purposes for which they are designed and thus the true national interest. This, I believe, is federalism in its best form.

I should like to comment now on those proposals contained in H.R. 9631, which if enacted would, in my judgment, effectively destroy the regional character of the System. It is proposed in H.R. 9631 that the Federal Open Market Committee be abolished and responsibility for the conduct of monetary policy, and in particular open market operations, be transferred to a newly constituted Federal Reserve Board. It is proposed, in other words, that Reserve Bank presidents be relegated to advisory roles. Now, being a Reserve Bank president, I cannot address myself to these proposals—and more specifically, oppose them—without running the risk of appearing to be serving my own narrow interests and of being immodest as well. Naturally, I should like to avoid appearing so, but the regional character of the Federal Reserve System is, in my view, so important, so worthy of being preserved, that I must risk appearing selfish and immodest. I personally do not believe that my opposition to the proposals of H.R. 9631 is narrowly motivated. I hope you will believe me in this.

May I begin by pointing out—although I am sure you are aware—that Reserve Bank presidents, as members of the Federal Open Market Committee, take the standard oath of office for public servants, swearing without reservation to support and defend the Constitution of the United States. Thus, bank presidents are, by virtue of the oath they take, public servants. So it matters little, at least insofar as the conduct of monetary policy is concerned, how they are elected.

The proposal of H.R. 9631 to which I address myself here would, as I have said, effectively destroy the regional character of the Federal Reserve System. They would, in effect, take from bank presidents their voice in monetary policy deliberations, and in so doing would make the continuing regionalism of the System without meaning. To be sure, Reserve Bank presidents would still be available as advisers to the newly constituted Federal Reserve Board. But an adviser is not the same as a participating member of the Federal Open Market Committee—either in the Committee room or back in the district.

My point is simply this: Reserve Bank presidents, by virtue of the positions they occupy and the talents they bring to their tasks, can and do make significant contributions to the economic welfare of the country; but they will be able to continue effectively doing so only if they remain as they are, voting participants in monetary policy deliberations.

Reserve Bank presidents, spending most of their time in their districts, are able, collectively, to bring to monetary policy deliberations a thorough knowledge of what is going on around the country. They are able to bring a detailed knowledge of regional economic developments. This is extremely important, for as I noted earlier and as you well know, aggregate economic statistics do not always tell the whole story, and information about regional developments is not so abundant that we can afford to dispense with first-hand impressions. Reserve Bank presidents also are able to bring to monetary policy deliberations a knowledge of what I call "grass roots thinking," what all manner of individuals are thinking about current economic problems. In the course of their working days, bank presidents talk, not just as is sometimes supposed with commercial bankers, but with business and labor leaders generally—and, I might add, with a good many less auspiciously placed individuals. And in so doing they get a feel for what is worrying people around the country, and for how they view current economic problems and policies; they get a feel, in short, that is extremely valuable in deliberations about monetary policy.

Reserve Bank presidents also serve as educators. Participating as they do in all manner of discussions, formal and informal, in their districts, they are able to explain System policies and, in so doing, gain increased acceptance for what has got to be done. Bank presidents are, then, in a very real sense, two-way communication links between their districts and Washington.

As indicated before, it can be argued that as consultants or advisers Reserve Bank presidents could still perform as they do currently. Perhaps. But less well, I think. You simply cannot lessen their role in monetary policy decisions—and this is what the proposals of H.R. 9631 would do—without making them less effective in their jobs.

One final point should be noted here. The presidents have brought, via their staff briefings, a variety of well-informed, indeed expert, opinions about monetary policy to System deliberations. In part they have been able to do this because they have been able—as individuals and as participants in the monetary policy process—to attract capable staffs of economic experts, staffs which nicely complement the Board's very able staff. Again, however, you cannot lessen the role of Reserve Bank presidents and still expect to attract the same calibre of men as you are currently getting, nor expect that bank presidents will be able to gather around them men of the quality as those who currently serve.

To sum up, I can only say that I believe a regional Federal Reserve System—guided not only by Governors but by bank presidents as well—is a stronger System than a centralized System would be. And I say this fully aware of the dedication and knowledge which members of the Board of Governors bring to their assignments. It is just that every organization needs all the talent it can get. There is strength in diversity of opinion, or the potential for such. And there is strength in a thorough knowledge of what is going on and being thought "back home."

Public and private blend

I turn now to the second aspect of the System's institutional character—the unique blending of public and private strengths. Specifically, I shall comment on H.R. 3783 in which it is proposed to retire Federal Reserve bank stock, but I want to range a bit more widely in my general remarks.

Part of the strength of the Federal Reserve banks is derived from the fact that they are constructed in an understandable, a conventional, manner with capital, with balance sheets, with boards of directors, and so on. More of their strength comes from the clearly discernible interest and cooperation of the member banks, which reflects their holdings of Federal Reserve bank stock and their participation in the selection of directors of the banks. Still more of their strength comes from the intelligent, informed and interested, and I might say almost dedicated, attention given their assignments by these same directors.

From my point of view it would be a mistake to change the institutional characteristics of the System in an attempt to create a different "image" when the present "image" is both comprehensible and acceptable and when the institution seems to be working well.

Much has been made of the fact that member banks elect six directors and that the Board of Governors appoints only three for each Reserve Bank. From my personal observation of the directors at two Reserve Banks, Minneapolis and St. Louis, I would say that all directors regard their positions as public trusts and take their oaths of office with that point of view. None conceives of himself as representing a special group, but as bringing to the bank experienced management counsel and particular knowledge of economic developments in his special geographic area or his special fields of competence. They take their positions seriously, they bring their management experience to bear on Reserve Bank operations, which is one reason we operate efficiently and economically, and they provide a considerable body of economic intelligence. In point of fact, we at Minneapolis use the alumni from our bank and branch boards as one regular source of economic information. The alumni do not, of course, participate in the regular work of the Board of Directors nor are they consulted on credit policy matters that properly are the province of current directors. But as a source of information on current and prospective developments they are used extensively. As Chairman Martin has observed many times, the directors of the banks and branches constitute a network of experience and intelligence that cannot be duplicated anywhere else in the world.

Against this background let me comment specifically on the proposal to retire the Federal Reserve bank stock. Perhaps I should say at once that I recognize that ownership of Federal Reserve stock does not carry with it the ordinary rights of stock holders. I think the member banks thoroughly understand this point; I, at least, have never heard a member banker assert that he had such rights by virtue of the stock ownership. I might say further that I recognize that the Federal Reserve banks do not need capital stock to operate. And finally, I realize that retirement of the stock probably would produce some additional income for the Government since there would be no dividend payments to make on the stock.

After considering all of these points, I conclude that there is no pressing reason to retire Federal Reserve stock and that such a move might result in real disadvantage. There is no real question as to the fact of public control of the System. The presence of the stock, and of the surplus, does not operate to inhibit the necessary actions of the central bank. And finally, the out-of-pocket cost of member bank stock holdings in the Reserve Banks is not great and probably is worth its cost.

Various assumptions and methods of estimate may be employed to come to a figure on net Treasury gain in receipts if all present Federal Reserve bank stock were retired. My own estimate is that the figure is in the vicinity of $8 million. While this sum is far from insignificant (it is somewhat larger than the total annual expenses of the Federal Reserve Bank of Minneapolis) it seems to me to be well spent. It certainly is no deterrent to membership in the System; indeed, in a way it helps to reduce the inequities between reserve requirements of member and nonmember banks.

I think that the elimination of the stock might well be regarded as a change far more radical in its implications than simple arithmetic might make it seem. We presently do have good cooperation between member banks and the Federal Reserve banks. And since in this country both monetary policy and bank supervision depend for their effectiveness, at least in part, on cooperation, this works to benefit society as a whole. The System, I believe, enjoys a reputation for good work; its "image" is a good one. Why should we jeopardize these things for what would seem to be relatively little gain in revenue to the Treasury.

Insulation from politics

I come now to the third aspect of the System's structure that I regard as important, one which also has been preserved through the years—its separation from day-to-day political pressures. My comments here are partly general, but also run specifically to part of H.R. 9631 and to H.R. 9685.

As I see it, the framers of the Federal Reserve Act and subsequent Congresses deliberately built into the System an insulation from day-to-day hurly burly of politics. I believe they did this partly because they read the record of history which indicates the wisdom of shielding the money power from the sovereign's untrammeled use. But they did this also in order that monetary and credit policy could be formulated and implemented flexibly in response to changing conditions. One of the great virtues of monetary policy is that it can move quickly; the Congress recognized that legislative action on monetary policy normally could not be taken with necessary speed. Therefore, it used, as noted earlier, a form of "trust indenture" in delegating to the System certain of the money powers the Congress constitutionally holds.

The Congress certainly did not expect the System to be so independent as to destroy the unity of Government, and the System has never regarded itself as independent in that sense. I think it obvious that in a democracy monetary policy cannot be made in disregard of the opinion of a Government elected by the people. The System has reported regularly to the Congress, has welcomed investigative studies such as this one and has tried to pull its weight as a part of Government, as a public institution with considerable responsibilities.

In providing this insulation, the Congress has written into the statutes various safeguards. Among them it established long terms for members of the Board of Governors. Among them it gave the Board power to control its own budgets and those of the Reserve Banks and to examine and supervise the banks. It did not make the System subject to appropriations and, after 1933, excluded the Board of Governors from audit by the General Accounting Office. The Reserve Banks have never been audited by the Comptroller-General; the Board has always carried this responsibility.

The proposal in H.R. 9631 would provide for audit by the General Accounting Office; the proposal in H.R. 9685 would provide for covering most System income into the Treasury and for appropriations to meet Federal Reserve bank expenses not covered elsewhere.

I oppose the appropriations proposal on two primary grounds: one, it would weaken the insulating features to which I referred earlier; and two, it would more likely than not reduce Federal Reserve bank efficiency in operation.

My reasoning on the second point is as follows. Presently the Reserve Banks are efficiently operating institutions with considerable consciousness of costs and with sufficient flexibility in revenues so as to provide no incentives to over-budget in order to have funds to meet unforeseen increases in necessary expenditures. Appropriations financing, in contrast, by the very nature of the process, tends to have built-in rigidities which on the one hand almost require budgeting for contingencies and on the other may lead to at least temporary curtailment of necessary activity in case the contingency funds are inadequate to meet developing but unforeseen needs.

The Reserve Banks operate in their local communities under conditions which make them competitive, but no more than necessarily so, with other enterprises for employees. Their budgeting processes are tightly controlled. There is no incentive to spend up to budgeted amounts; the incentive, on the contrary, is to watch costs and produce savings. The Reserve Banks compete among each other to produce lower costs and improve efficiency. The record indicates that they have done so in general. For example, the Minneapolis Bank today has 6 per cent fewer employees than it had three years ago despite a continuing rise in the volume of work done. As another more concrete example, the cost to the Withheld Tax operation at Minneapolis is today less than 1 cent per receipt greater than in 1957. Postage costs alone have risen more than the total per receipt cost increase; clerical salaries in the Twin Cities have increased almost 20 per cent in that period.

I also oppose the audit proposal on two grounds: one, it too would weaken the insulating features noted above; and two, it is unnecessary and duplicative and therefore would be unduly expensive.

I do not believe it necessary to state in detail the reasoning underlying the above points. Chairman Martin has already outlined to you the present Reserve Bank and System audit procedure. The Board has the responsibility for such audit and examination of the Reserve Banks as it needs to carry out its supervisory responsibility, and it exercises that responsibility thoroughly and completely. The Congress deliberately removed the Board itself from General Accounting Office audit some 30 years ago.

Concluding comment

I am just a little older than the Federal Reserve System and I have spent almost half of my life in it. I have worked in research, in operations, in credit policy and in management. I have seen the System change to meet changing conditions, through evolution and through change in law. I believe it is better fitted for its job today than it was when it was created. But its creators were wise men who saw that this institution could derive basic and enduring strength from its federal structure, from its ability to draw upon the private sector to aid its public purpose, and from its insulation from political pressures. I hope sincerely that the System will not suffer loss of that strength.

Current conditions . . .

Economists, government policy makers, and the business community are carefully observing developments on the economic scene. The questions uppermost in their minds are: "How large will the responses be to the recently passed personal and corporate tax cuts, and how soon will they occur?" It is too early yet to observe any of the forecast effects, because the economy requires some time to assimilate and develop a pattern of responses to such sudden income changes. The search for answers to these two questions, however, will be the major concern of a substantial number of persons during the near future.

The pace of economic activity appears to have accelerated somewhat during February — perhaps in anticipation of income and profit increases induced by the tax cut.

National retail and manufacturers' sales both rose during February; retail activity within the district also appears to have increased. Production in February showed the largest monthly increase since October of 1963, rising to a new high of 127.6 per cent of the 1957-59 average rate.

Employment, both nationally and within the district, expanded during February; indeed, the rate of unemployment in the nation declined to 5.4 per cent, the lowest rate since October of 1962.

Reflecting this quickened tempo of economic activity, personal income, both for the nation and district, rose to new highs.

The following selected topics describe particular aspects of the district's current economic scene:

1963 STATE FARM INCOME

The preliminary estimates of state farm incomes made by the U. S. Department of Agriculture depict drops in 1963 marketing receipts from 1962 levels for all district states except Montana. In that state an estimated decline of 7.7 per cent in livestock receipts was offset by a 10.4 per cent rise in crop receipts, leaving total marketing receipts 1.3 per cent higher. A 6 per cent rise in crop receipts in Minnesota was not sufficient to offset the 4 per cent drop in livestock receipts since the total was off 1.3 per cent from 1962. Crop and livestock receipts were lower in both Dakotas, with South Dakota experiencing the greatest relative fall in the total figure.

An increase in government payments to farmers during 1963, however, eased some of the impact on total farm income. Program payments totaled $267 million in 1963, 10 per cent higher than those paid in district states a year earlier. As shown in Table 1, all the states received larger payments except Montana. Of the total 1963 government payments to farmers in district states, about 40 per cent came under the Feed Grain Program. Soil Bank and Wheat Program payments accounted for 24 per cent and 23 per cent of the total, respectively, with the conservation program and Wool and Sugar Acts contributing the remainder.

TABLE 1—DISTRICT CASH FARM INCOME

(million dollars)

	Farm marketing* receipts	Government payments	Total cash receipts
Minnesota			
1962	$1,458	$ 90	$1,548
1963	1,439	101	1,540
North Dakota			
1962	637	73	710
1963	616	80	696
South Dakota			
1962	671	53	724
1963	636	60	696
Montana			
1962	400	26	426
1963	405	26	431
4 States			
1962	3,166	242	3,408
1963	3,096	267	3,363

*Preliminary estimates for 1963.

Total cash receipts in the four full states thus amounted to an estimated $3,363 million in 1963, down 4.4 per cent from 1962.

In spite of the drop in aggregate farm receipts, the realized gross income per farm for 1963 was greater than that for 1962 in each of the district states except South Dakota (Table 2). Unfortunately, production expenses rose to a greater extent, resulting in a drop in realized net income per farm in each state. The largest relative fall (12 per cent) in that income category occurred in South Dakota. Realized net income per farm in Minnesota was off 6 per cent, while Montana and North Dakota recorded 2 per cent declines from 1962 levels.

TABLE 2—PER FARM INCOMES*

	Realized gross income	Realized net income	Total net† income
Minnesota			
1962	$10,983	$3,297	$3,087
1963	11,192	3,091	3,791
North Dakota			
1962	14,004	5,273	8,943
1963	14,182	5,159	4,920
South Dakota			
1962	13,480	4,577	6,349
1963	13,261	4,011	5,203
Montana			
1962	14,517	4,667	7,550
1963	14,844	4,557	6,309

*Preliminary for 1963.

†Includes changes in inventories.

Total net income per farm, that is, net income including changes in inventories, reflects a somewhat different pattern of change among the states. Using that measure of income, the per farm position in Minnesota improved 23 per cent over 1962. Changes in inventories, on the other hand, reduced the total net farm income figure in North Dakota by 45 per cent. Adverse changes in inventories reduced per farm total net incomes in Montana and South Dakota by 16 per cent and 18 per cent, respectively.

CREDIT

Credit extended by district member banks decreased during February despite an improvement in reserves. Over the four weeks ended February 26, total credit declined $15 million (see Table). This contrasts with the $38 million advance registered during the corresponding weeks of 1963 and the $16 million average gain of the past four Februarys.

Loan expansion during February was particularly weak. A $9 million gain at country banks offset by a $2 million decline at city banks brought the total advance to only $7 million. Loan expansion last February was substantially sharper: $22 million at country banks and $46 million at city banks for a total gain of $68 million.

FEDERAL RESERVE BANK OF MINNEAPOLIS

50th Anniversary