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THE UNIVERSITY OF CHICAGO

Department of Economics

March 16, 1933.

Hon. Henry A. Wallace,
Secretary of Agriculture,
Washington, D. C.

Dear Mr. Wallace:

During the past week, we have tried to formulate and agree upon a specific program which would provide, both for emergency relief, and for permanent banking reform. The results of this effort are contained in the five-page statement which we enclose. This document is strictly for your private use; and we request that every precaution be taken against mention of it in the press.

The program defined in the statement is one which we believe to be sound, even ideal, in principle. What its merits may be, in the light of political consideration, we frankly do not know. We are sensible, moreover, of an obligation not to broadcast publicly any statement which might impair confidence in Administration measure, or impair their chances of successful operation.

On the other hand, we feel that our statement may deserve thoughtful consideration, among people of interests like our own; also, that it may suggest measures which might usefully be incorporated in other, and perhaps less impractical, schemes. Moreover, most of us suspect that measures at least as drastic and "dangerous" as those described in our statement can hardly be avoided, except temporarily, in any event.

Please feel free to use the document in any manner consistent with complete avoidance of newspaper publicity. If you feel disposed to send us your comments, favorable and adverse, upon the proposals, we shall be grateful indeed for your cooperation. Communications may be addressed to any member of the group.

Sincerely yours,

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| G. V. Cox | F. H. Knight |
| Aaron Director | L. W. Mints |
| Paul Douglas | Henry Schultz |
| A. G. Hart | H. C. Simons |

By Frank H. Knight (Sgd.)

We hope you are <u>one</u> of the forty odd who get this who will not think we are quite looney, I think Viner really agrees but doesn't believe it good politics. F.H.K.

It is evident that drastic measures must soon be taken with reference to banking, currency, and federal fiscal policy. In such a situation, it seems desirable that there should be some statement of opinion by academic economists, especially by groups whose members hold substantially similar views. We therefore submit the following general recommendations.

(a) That further decline in the volume of effective circulating media be prevented, preferably by some sort of federal guarantee of bank deposits;

(b) That guarantee of bank deposits be undertaken only as part of a drastic program of banking reform which will certainly and permanently prevent any possible recurrence of the present banking crisis;

(c) That the Administration announce and pursue a policy of bringing about, and maintaining, a moderate increase (say, of - and not to exceed - fifteen per cent) in the level of wholesale prices, pending later adoption of some explicit criterion for long-run currency-management.

It seems appropriate to translate these general recommendations into more detailed proposals. The proposals below are admittedly inadequate and tentative at many points; but they should serve to define what we conceive to be objectives of sound policy:

(1) That the federal government immediately take over actual ownership and management of the Federal Reserve Banks;

(2) That the Federal Reserve Banks should guarantee the deposits of all Members Banks which were open for business on March 3rd, 1933 (or on the last day preceding any moratorium then in effect), the Reserve Banks being granted full supervisory control over the management of these institutions;

(3) That the Federal Reserve Act be further amended, to permit issue of Federal Reserve Notes in any amounts which may be necessary to meet demands for payment by Member-Bank depositors;

(4) That Federal Reserve Notes be declared full legal tender for all debts;

(5) That numerous and generous arrangements be made for relief of non-member institutions, not included under the guarantee, including: (a) generous loans by the Reserve Banks and/or the R.F.C., such loans to be made on the basis of what bank assets are likely to be worth after the proposed increase of wholesale prices has been effected; and (b) provision for continuance of moratoria and limitations upon withdrawals if and where expedient;

Stockholders of the Federal Reserve Banks should, of course, be reimbursed by the government, preferably at par-value of their holdings. The Reserve Banks, though owned by the government, should remain separately incorporated, like the R. F. C.; and their management (The Federal Reserve Board) should be independent of the Treasury.

The precise technique of control, exercised by the Reserve Banks over the guaranteed institutions, should be left largely to the decision of the Reserve authorities. The powers, however, should be broad. The Reserve Banks should be free to take over, in return for Reserve Notes, such assets of Member Banks as they might need, as basis for note-issue, or for their open-market operations.

It is entirely improbable that the note-issue required in connection with the guarantee arrangements would be of substantial magnitude. With the guarantee, deposits would be quite as desirable as Notes; and the banks, instead of requiring currency from the Reserve Banks, would probably attract substantial amounts of currency and receive new deposits from present hoarders of currency. Thus, the Reserve Banks might actually receive substantial amounts of currency, instead of being required to increase their issue. In any event, new issue would be fully covered by government securities (and perhaps other assets) now in the hands of the Member Banks.

(6) That the Federal Reserve Banks be instructed, over such period as may prove necessary for orderly liquidation, to dispose of all assets of the Member Banks, to pay off all deposit liabilities, and upon final settlement with the stockholders to declare the corporations dissolved;

(7) That banking legislation be enacted providing for

incorporation of a new kind of institution.

(a) which alone shall be entitled to accept funds subject to check or to payment on demand;

(b) which shall be required to maintain reserves of 100 % in lawful money and/or deposits with the Reserve Banks;

(c) which shall serve exclusively as institutions for deposits and transfer of funds;

(8) That additional legislation be enacted, providing for incorporation of a distinct class of institutions, in the general form of investment trusts, and subject to government regulation and examination, which institutions shall perform the functions of existing banks with respect to savings deposits;

(9) That losses incurred by the Reserve Banks in liquidating particular Member Banks be collected, so far as legally possible, from stockholders of those banks.

(9a) That the Member Banks, under Reserve Bank supervision (and the non-member institutions), should continue to make loans and accept deposits, pending the development of reasonably adequate facilities by other institutions, and in general to make such renewals of loans as seem consistent with most successful ultimate liquidation.

The primary objective of these proposals for permanent reform is that of effecting a complete separation, between different classes of corporations, of the Deposit and the Lending functions of existing commercial banks. The now typical commercial bank would, in effect, be broken up into at least two distinct corporations, say, a Deposit-Bank and a Lending Company. The Deposit-Bank would serve exclusively as a depositary and agency for transfer of funds (checking); it would be prohibited from lending or investing depositors' funds; it would derive earnings solely from service-charges. The Lending Company, on the other hand, would engage in the business of short-term lending, discounting, and acceptance; it would be prohibited from accepting demand-deposits, and even from providing their short-term creditors, if any, with any effective substitute for checking facilities; thus, it, like other corporations, would be in position to lend and invest only the funds invested by its stockholders (and, perhaps, bondholders). Considerable specialization might develop among these Lending Companies. For investors preferring the savings-deposit form, the facilities of the Postal Savings System would still be available. Incidentally, the liquidation of existing commercial banks, during the transition period, would probably be effected in part by sale of their assets to newly incorporated Lending Companies.

It is contemplated that the loss of circulating media consequent upon the gradual liquidation of existing Member Banks would be offset by corresponding increase in the Deposits and Notes of the Reserve Banks. Here likewise, however, no substantial increase in the issue of Federal Reserve Notes is likely to occur. During final liquidation of a particular institution, the holders of Demand Deposits would be paid off, in Notes or in drafts upon the Reserve Banks; and these, in turn, would promptly be deposited in the New Deposit-Banks, which in turn would deposit them with the Reserve Banks. Savings-depositors might be induced to accept direct transfer to the Postal Savings System, or to take government bonds in exchange; but no restrictions need be placed upon payment in currency or drafts. At the end of the transition period, the total of reserve Notes in circulation would probably be much smaller than at present. Our circulating media, as heretofore, would consist largely of demand deposits of private institutions; and these deposits would be backed dollar for dollar, by currency and, predominantly, deposits of the Reserve Banks. The liabilities of the Reserve Banks, in turn, would be supported by assets, largely or exclusively government bonds, acquired through liquidation of the member institutions.

(10) That the Administration announce and pursue a policy of bringing about, by fiscal and currency measures, an increase of fifteen (15) per cent in wholesale prices, as measured by the present Bureau of Labor Index of Wholesale Prices:

(11) That adequate and detailed preparations be made for preventing any further increase of prices than that originally determined upon and announced.

Adoption of the proposed guarantee arrangements, far from being inflationary, would actually involve, by comparison with conditions of the recent past, a marked reduction in the quantity of circulating media. Expansion of Reserve-Note circulation, if it occurred, could not exceed the contraction of Member-Bank deposits. The inevitable reduction in the "deposit-circulation" of the non-member institutions would represent a net reduction for the whole banking system. Thus, measures of the kind contemplated in (10) above would probably be necessary, if only to prevent contraction of the country's supply of media of exchange.

The proposal for increasing the price level contemplates additional issue of Federal Reserve Notes against federal securities, for the purpose of covering the fiscal deficit and of meeting forthcoming maturities. It is not unlikely, given the stimulus of the guarantee arrangement, that quite moderate measures might suffice to bring about the specified price-level change. Substantial increase of federal, emergency expenditures might, however, prove necessary.

In order to stop the increase of prices at the point determined upon, it is only necessary to prepare for impounding of currency -- by sale of Reserve-Bank assets and/or new federal issues in the open-market, by reduction of emergency expenditures of the government, and, as a drastic move unlikely to prove necessary, by the levy of some form of sales tax. Balancing of the federal budget should prove continuously less difficult, as revenues rise from improvement of business, and as demands for unemployment relief abate.

We wish to emphasize especially the importance of proclamation by the President as to the precise objective of Administration measures with reference to the price-level. Such proclamation will enormously facilitate the tasks, both of bringing about the increase, and of stopping it at the proper time.

It is worth noting, that the measures required for raising the price-level may be rather drastic, if there occurs a large immediate loss of circulating media in the form of demand-deposits. If policies adopted toward the non-member banks result in the "freezing" of a large part of their deposits, substantial increase of federal emergency expenditures (for unemployment-relief and for public works) might be required even to maintain the present level of prices. These considerations would seem to argue for prompt and generous assistance to the non-member institutions.

(12) That the following measures be taken with respect to gold:

(a) Suspension of the free-coinage of gold and a lowering of the price obtainable for gold at the Mint;

(b) Absolute embargo upon the import of gold;

(c) Prohibition of the export of gold by <u>private</u> individuals or institutions;

(d) Commandeering of all gold coin and gold certificates by the government, in exchange for Federal Reserve Notes;

(e) Suspension by Presidential Proclamation of enforcement of all gold-clauses in debt-contracts;

(f) Substantial sale and export of gold abroad by the government and/or the Reserve Banks;

The measures outlined above would, we feel, meet the immediate emergency, provide a permanent solution of the banking problem, and bring about marked improvement in production and employment. Their adoption, however, would leave one major problem still to be faced, namely, that of long-run currency management. Within our group, there are slight differences of opinion as to what constitutes the most desirable policy. Some of us favor a stabilizing of the total quantity of circulating media; some, a stabilizing of total "circulation" ("MV") per period; some favor more complex formulas (e.g., stabilizing per-capita "circulation"). The criterion of price-stabilization seems to us quite satisfactory, however, as a short-run expedient.

At all events, the problem of long-run currency management is one which need not, and probably should not, be settled for some time. Ultimately, it may even prove expedient to return to gold, especially if it appears that popular movements for "cheap money" cannot be checked without recourse to the old symbols.