

INTRODUCTION TO THE
F E D E R A L R E S E R V E S Y S T E M

A Message to New Directors of the
Federal Reserve Bank of Philadelphia

By

Karl R. Bopp

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Since this is the first board meeting for our new directors, I shall attempt a brief but comprehensive statement of the basic nature of the Federal Reserve System. I am sure your experienced colleagues will forgive me if I repeat things that are familiar to them. For my own part, I find that the longer I serve the System the more I find there is to comprehend. I do not recall who first said that knowledge is like an island in a boundless sea of ignorance; the more you learn, the larger your island, the greater its periphery, and so the more you appreciate what remains to be comprehended. I am convinced he could have been someone describing his experience with the Federal Reserve System. In fact, many of your predecessors have told me that once they landed in the System they found themselves increasingly intrigued by its role. They became more and more involved -- with their emotions as well as with their minds. This is as it should be, because the Federal Reserve System is a human institution dedicated to the public interest.

I. Images of the Bank.

The Federal Reserve Bank of Philadelphia has many images. The casual pedestrian on Chestnut Street sees a marble and bronze building. He may conclude it is a cold and forbidding institution because we do not permit him to enter the pleasant and attractive garden. The real reason for the prohibition is that it is

the only way in which the garden will remain pleasant and attractive.

Those who pass by do not see a second image because it is inside. Inside are a thousand individuals, each with achievements, hopes, ambitions -- and frustrations. You have before you a chart which shows the officers and department heads. At the moment most of these individuals are merely names to you. They are much more than names to me. Each is an important person in his own right. I hope you come to know us as individuals in due course. The organization chart cannot reveal the spirit that motivates us. If I were asked to squeeze that spirit into a sentence, I would say we try always to take our jobs seriously but never, hopefully, ourselves.

It is a continuing challenge to help each member of our staff derive satisfaction from doing a job well. The overwhelming majority of us are engaged in operations that are scarcely more than mentioned as service chores in the standard college textbooks on money and banking. We operate around the clock with three shifts in the collections, the guard, and the building departments.

We have 350 people who receive, sort, list, and send checks; 110 who receive, count, and ship cash; 80 who are directly concerned with our responsibilities as fiscal agent for the United States; 35-40 in accounting; an equal number in machine tabulating -- or electronic data processing, as the professionals now call it. We have only 10 in the credit department. That fact alone demonstrates that though the word bank is in our title, we are not an ordinary bank.

Roughly a fifth of the staff are engaged in what might be called internal services, including 14 in personnel -- we have a deep sense of obligation to those who devote their working lives with enthusiasm to the public purposes for which we exist; some 70 in the building department -- incidentally we receive many compliments on our "housekeeping"; about 20 in the cafeteria -- we also have a reputation for good food and absorb about one-half the cost as an important investment in

employee morale; some 40 guards -- frequent winners of trophies for marksmanship. The remainder are in the post office, printing, purchasing, the vault, and telephone. We officers have our silent partners, our secretaries, who prevent us from making many "bloopers."

We have 50 engaged in the examination of our state member banks and 19 who audit this Bank continuously. The audit department is responsible directly to the board of directors and not to the operating management. This is as it should be. I, for one, feel much more secure under this organization than I would if the auditor were responsible to me. After all, we do run a big operation. For example, our vault contains $\$2\frac{1}{2}$ billion of valuables held in custody for member banks, \$0.5 billion of unissued Federal Reserve notes, and $\$7\frac{1}{2}$ billion of unissued Government securities. I am as anxious as you are to be sure all these valuables are indeed where they should be! I also want to be sure that we spend only such moneys as you, after careful study, have authorized in the budget.

In addition, the Board of Governors examines the Bank once each calendar year. The Board's chief examiner and his 35 associates happen to be here at the present time. They will spend about three weeks going over the Bank from top to bottom. The chief examiner will report to the chairman of the board at the conclusion of his examination and separately to the first vice president and me. Incidentally, he reads the minutes of the board meetings to assure that the operating management acts under proper authorization.

I mention these matters at the outset because I have a greater appreciation of their importance than I had when I taught central banking without having had any practical experience. At an early meeting the first vice president and I will give a more complete analysis of the internals of the Bank in connection with my annual report to you.

A third image of the Bank is financial in character. We have assets of

about \$3 billion. Roughly half is in U. S. Government securities. Another third is in gold certificates. Discounts and advances on the other hand represent only a very small fraction of our assets -- illustrating, once more, that we are an unusual bank.

About 60 per cent of our liabilities are in the form of Federal Reserve notes or paper money; one-fourth in deposits, mostly the reserve accounts of member banks. Our paid-in capital is less than 1 per cent of our liabilities. Surplus is maintained at twice capital. Total capital funds amount to only 2 per cent of total liabilities.

Although we are not operated for profit, we are a profitable institution. Current earnings last year were \$63 million. Expenses absorbed less than 15 per cent of earnings. Dividends, which are limited to 6 per cent of paid-in capital, absorbed only 2 per cent of current earnings. Excess earnings of more than \$50 million were paid to the U. S. Treasury.

These three images of the Bank are important. Bob Hilkert, other members of senior management, and I spend a great deal of our time and effort to assure that we have adequate and suitable physical facilities, an enthusiastic staff whose members derive satisfaction from discharging their responsibilities efficiently, and a solvent financial institution.

It is not primarily because of these characteristics, however, that you were willing to join our board of directors. The image to which you can contribute most is the one that will determine our destiny. It is the contribution you can make to national monetary policy.

II. Our Economic System.

I should like to sketch for you what I conceive to be the primary function of the Federal Reserve System in our society. I shall be very general at the outset; but I shall highlight some very specific elements before I conclude.

The basic economic goal of every Government is the maximum utilization of its human and other resources. Societies differ, however, with respect to the relationships that they feel should exist between the Government and the individual and, consequently, on how specific goals are to be determined and achieved.

In dictatorships the State is supreme and the individual is subservient to it. Essentially, the leaders decide who is to produce how much of what goods and services and for whom. They determine the division of time into work and leisure, the allocation of resources to investment and to consumption.

In democracies the State is the servant of the people. Through secret ballots, the electorate determine generally what role they want their Governments to play. Within the limits thus established, each individual decides his own priorities as to specific goals.

The difference in basic philosophies is reflected in the differing role that money plays in the two systems. In choosing among alternative goals and alternative ways of achieving them, even a dictatorship is concerned with costs. Since the factors of production -- land, labor, capital -- are not directly commensurate, some unit of account is needed. Money serves this purpose, even in a dictatorship. It also performs some auxiliary function of allocations within the limits determined by the general economic plan.

In democracies, on the other hand, money is the basic instrument of economic freedom through which individuals make their preferences known. Within very wide limits, each individual has freedom to choose how he will earn his money income. Through the democratic process of the secret ballot, citizens elect representatives to determine how and how much shall be allocated to common purposes through the Government -- and it may be considerable. Again, within wide limits, the individual is free to spend the remainder of his money income as he sees fit. He may also borrow to supplement his income, may save for the future, and may sell

some assets and buy others as he sees fit to secure a maximum of welfare. This is a continuous process. Decisions of today are not only influenced by those of the past but condition the choices of the future. In the process, individuals direct the use of resources to those purposes for which they spend money and away from those for which they do not.

Democratic societies want their economic system to achieve maximum utilization of resources while maintaining a maximum of individual economic freedom. Unfortunately, there is no inherent reason why the total of all the individual decisions to buy or sell, to borrow or lend, to consume or invest, to hoard or spend will add up to the exact amounts that are needed to utilize available resources.

What is desired is some mechanism that will induce individuals of their own volition to adjust their behavior so as to produce the desired total result.

The Federal Reserve System is a vital part of this mechanism. It is, however, by no means the only part. Before I discuss monetary policy, therefore, I should like merely to mention briefly the other major parts. First, we need competitive and functioning markets. Second, we need appropriate fiscal policies. Last year governments at all levels purchased about 20 per cent of our entire output. How much and what is bought as well as the source of the funds obviously have far-reaching effects on the level and composition of total output. Third, we need appropriate management of the debt. We shall be discussing these problems frequently in board meetings.

Appropriate wage-price actions, and fiscal and debt management policies contribute to stable economic growth. Inappropriate policies in these areas aggravate inflation or deflation and impede stable growth. The monetary authorities, unfortunately, cannot operate on the assumption that appropriate policies in all these areas will be followed at all times. We must deal with developments as we find them and not as they might be.

III. The Role of Monetary Policy.

Today I shall discuss monetary policy because it is the area of our primary responsibility. It is easy enough to describe in very general terms the basic purposes of a flexible monetary policy. If governments, corporations, and individuals try to purchase more goods and services than can be produced at existing prices, their efforts will tend not to increase production but prices. It would be appropriate, therefore, to make credit more expensive and more difficult to secure. Although the public would react by using its cash more efficiently, it also would be induced to postpone some of its purchases and thus remove the inflationary pressure. If, on the other hand, the public is not buying as much as can be produced at existing prices, easier and cheaper credit would tend to induce the public to step up its purchases and thus restore production and employment to capacity.

Even this highly simplified model indicates that monetary policy, which is designed to serve the long-run interest of the public, must move against short-run swings of sentiment, restraining when sentiment is too exuberant and encouraging when it is too pessimistic; hence, the money managers cannot expect to be popular. We can endeavor to be understood and, hopefully, respected. We have a small bank and public relations department, headed by a business economist, to indicate our conviction that our future depends on comprehension, not on "back slapping."

A. Objectives of Policy. The real world, of course, is not so simple as the sketch I have given. Those who have been concerned with monetary policy have been interested in having it achieve a number of specific goals. It is helpful to tabulate a number of these goals and the direction in which monetary policy should move to achieve each under specified conditions.

OBJECTIVES AND RELATED PROGRAMS

<u>Objective</u>	Conditions Calling for or permitting an easing of credit	Conditions Calling for or permitting a tightening of credit
1. Full employment.....	Less than full employment.	Jobs in excess of workers.
2. Stable price level.....	Declining prices.	Rising prices.
3. Convertibility of the currency.....	High and/or rising primary international reserves.	Low and/or declining primary international reserves.
4. Adequate growth.....	When growth is inadequate.	When growth is too rapid to be sustained.
5. A fixed rate of interest	When savings are inadequate.	When savings are excessive.
6. Productive credit.....	Increase in monetary volume of output.	Decrease in monetary volume of output.

Inspection will reveal the general relationships between the objectives listed in column 1 and the conditions itemized in columns 2 and 3.

It is reasonable to suppose that frequently -- perhaps even generally -- the conditions listed in columns 2 and 3, especially those under the critically important objectives 1 to 4 will occur at the same time. For understandable reasons a declining price level is often associated with declining employment and output, and increases in a nation's international monetary reserves.

"Frequently," however, is not often enough. Central bankers face tough choices when the several objectives point to conflicting policies. This is no hypothetical dilemma. It is exactly what happened in the United States from roughly the middle of 1953 to the middle of 1954. During that period employment declined by 1 million (and unemployment rose by nearly 2 million), our monetary gold stock declined by \$600 million, and both the consumer and wholesale price levels varied by only 1 per cent. Thus an employment objective would have called for greater ease, a convertibility objective would have called for greater

tightness, and a stable price level objective would have called for no change.

Now, obviously, general monetary policy cannot move in three directions at once.

We are living through a similar set of developments at the present time. There are also differences between the two episodes. The recent loss of gold, for example, is more serious than that in 1953-1954. The differences as well as the similarities between the two periods illustrate the need for judgment in arriving at an appropriate balance over time among several objectives, each of which is desirable in its own right. It is in helping our country resolve such conflicts that you can make a major contribution to the public welfare.

B. Instruments of Policy. I move next to the general tools available to the System to ease or tighten credit. The initial impact of these instruments is on the Government securities market and the commercial banking system from which the effects permeate the economy. Actions of the System influence the supply and availability of reserves relative to demand for reserves and thus affect the cost of credit or the rate of interest. If the System wishes to ease credit it increases the supply and availability of reserves and reduces their cost. If it wishes to tighten credit it decreases the supply and availability of reserves and increases their cost.

The System has three general instruments to influence the reserve position of member banks: open market operations, the discount mechanism, and reserve requirements.

If the System wishes to ease credit it may purchase Government securities in the market. The increased demand will tend to force up prices of the securities and thus reduce interest rates. The purchases also will put additional reserves into the banking system because payment is made by check on the Federal Reserve Bank which, when deposited, adds to reserves. The banking system thus has additional reserves to lend and invest. Because of our fractional reserve system,

the banking system can expand its deposits by a multiple of its excess reserves.

If the System wishes to tighten credit, it can sell securities and thus increase interest rates and withdraw reserves from the banking system leading to a contraction of deposits. Since we have a growing economy with generally increasing demands for money and credit, credit tightening in practice frequently is achieved not by actual contraction but by limiting the growth in reserves.

In a monetary system such as we have in the United States, it is important that there be an "escape valve" to prevent pressure from concentrating at times with undue severity at particular points -- either for reasons independent of monetary policy (e.g., a local catastrophe) or as a result of what is intended as general pressure.

It is for this reason that member banks have the privilege, under appropriate circumstances, of borrowing from their Federal Reserve Banks. Another instruments of policy is the rates that the Reserve Banks charge for such accommodation. The rate is increased to tighten and is lowered to ease credit or to confirm changed conditions that have developed in the money markets.

The borrowing privilege, it should be noted, is not to be used to scalp a profit should the yield on Treasury bills, for example, be above the discount rate. The volume of borrowing probably could be controlled exclusively through the rate. At times, however, this would involve a relatively high rate. And this high rate would apply to the necessitous borrower confronted with pressure that could not be anticipated as well as the "sharp-pencil" management.

Instead of relying exclusively on the rate, the Federal Reserve Banks supervise their loans to member banks to see that they are for proper purposes. We go to great lengths to assure impartial administration of our discount window. Consideration of the report on borrowing is a standard item on the agenda of your biweekly meetings.

Incidentally, if you ever hear rumors of discriminatory treatment, I wish you would tell us about them. For understandable reasons such rumors arise occasionally -- not in periods of easy money, such as we now have, but in periods of restraint. Occasionally country member banks allege that Philadelphia banks receive preferred treatment. We have had enough conversations with Philadelphia members to appreciate that they at times feel we are too gentle with the country members. We do not, incidentally, adjust our administration to changing conditions in the credit market. I described the principles under which we operate before the Pennsylvania Bankers Association in May 1958 and the talk was published in our BUSINESS REVIEW (June 1958). I am asking you to report any allegations of favoritism that come to your attention because it is critically important not only that we remain impartial but that we maintain a reputation for objectivity.

The vast expansion in Government debt and the widespread ownership of that debt have affected the degree to which different discount rates can be maintained at the several Reserve Banks.

I do not suggest for a moment that member banks in a district where the rate is lower would borrow in order to lend the reserves in districts where the rate is higher. Nevertheless, for reasons that we shall develop at later meetings, the net effect of a differential in rates will tend to produce the same result. This, in turn, would mean that the administration of the discount window at the lower rate Reserve Bank would become increasingly difficult. It would also tend to mean that the Reserve Bank or Banks with the lower rate would in fact determine conditions for the whole country. This implication reminds me of a remark by one of your predecessors. After a vigorous discussion in a meeting of the board, Archie Swift said: "I am reminded of my mentor who told me when I was young: 'Always remember that when a dozen people are on one side of an issue and you are on the other, it is possible -- not likely, mind you, but possible -- that they could be right, and you wrong.'" Nevertheless, different rates perform a useful

function at times.

The final general instrument is the power to change the reserve requirements of member banks within limits established by the Act. If the System wishes to ease credit it can reduce requirements and thus release reserves which may be used for a multiple expansion of deposits via loans and investments. The System can tighten credit by increasing requirements.

C. Organization of the System. I move next to the organization of the Federal Reserve System that has been created to administer monetary policy in the United States. The organization can be understood best in terms of our basic heritage. We as a people have an abhorrence for concentration of power. We prefer a separation of governmental powers and a system of checks and balances with full appreciation that it may be, or appear to be, less efficient in the short run.

What was desired was an organization that would not be controlled for partisan political purposes by the administration in power nor by private interests, especially the so-called financial interests. Congress solved this problem by making the System responsible to the Congress rather than to the President and by creating a rather complex organization in which government representatives would have final authority but private individuals would have an influence.

At the apex is the Board of Governors of the Federal Reserve System. It consists of seven members appointed by the President by and with the advice and consent of the Senate for fourteen-year terms. The long terms are designed to insulate the Board from the day-to-day pressures of partisan politics. In the unlikely event that private interests would attempt to seize control of the System, it is perfectly clear that the Board, selected by the Government, has the power to enforce its will. A united Board has authority over all the policy instruments, has power not only to exercise general supervision over the Reserve Banks but also

to remove any officer or director of any Federal Reserve Bank, and may ignore the advice of the Federal Advisory Council. Within these limits, Congress felt that private interests could make a valuable contribution to monetary policy.

The Federal Reserve Banks are organized to blend public and private influences. Each of the twelve Federal Reserve Banks is supervised and controlled by a board of nine directors with three-year terms. There are three classes, each consisting of three directors. Class A are chosen by and are representative of the member banks. Class B are chosen by the member banks and are engaged in commerce, agriculture, or some other industrial pursuit and may not be bankers. To diffuse power it is also provided that member banks be grouped for purposes of electing directors into three groups: large, medium, and small. Each group of member banks elects one Class A and one Class B director. Finally, the Class C directors are appointed by the Board of Governors. The Board of Governors designates one Class C member as chairman and another as deputy chairman of the board of directors.

The general idea was that in establishing discount rates or the cost of credit, the board of directors should have the views of lenders (Class A) and of borrowers (Class B) with a public group (Class C) to resolve any differences that might develop.

I might say that my experience is that directors do not consider themselves as representative of any particular interest. I have known Class B directors to move an increase in the rate, even on occasion when the mover's firm had a security flotation in the offing. Similarly, Class A directors have made a motion to reduce the rate. Action on the rate is preceded by a review of economic developments presented by our vice president in charge of research. He, in turn, has consulted with his staff, which includes professionally trained economists and statisticians. We are the original source of significant economic data.

You directors express your judgments on developments. A motion on the rate is made with reference to the total situation, not as a reflection of a narrow point of view. Ordinarily, though not invariably, of course, votes on the rate have been unanimous. I mention this so that our new directors may have some feel of the spirit that has motivated their colleagues and their predecessors.

The board of directors supervises the Federal Reserve Bank subject to the provisions of the Federal Reserve Act, including the power of the Board of Governors. They select the officers. Their selection of a president and a first vice president for five-year terms is subject to the approval of the Board of Governors. The president is the chief executive officer of the Bank.

The third agency in the structure of the System is the Federal Open Market Committee. It consists of the seven members of the Board of Governors and the presidents of five Federal Reserve Banks. The president of the Federal Reserve Bank of New York is a permanent member. The other four presidents are selected in rotation by the directors of the other eleven Banks which are divided for this purpose into four groups. We are grouped with Boston and Richmond and I happen to be the current member. All presidents attend and participate in the meetings, but only the members vote.

The Federal Open Market Committee usually meets every three weeks in Washington. Regional and national judgments are brought to bear on national monetary policy. Extensive and intensive preparation goes into these meetings. Principles of monetary policy as well as their application to current developments are analyzed. Professional economists at both the Board of Governors and the twelve Reserve Banks prepare analyses. In addition, each president has the views of his own directors. He does not go as an instructed delegate, however, but votes as his judgment dictates.

The whole gamut of monetary policy is discussed. The immediate result is

a directive to the manager of the Open Market Account as to his operations until the next meeting.

The complexity of the System is illustrated when we relate the several instruments of policy to the agencies that have been described. The Board of Governors has exclusive control over the reserve requirements of member banks and over margin requirements for purchasing or carrying listed securities, the sole selective credit control instrument. Discount rates are established by the directors of the Reserve Banks subject to review and determination by the Board of Governors. Open Market operations are determined by the Federal Open Market Committee.

The fourth agency is the Federal Advisory Council. It was designed to give the commercial banking community an opportunity to express its views directly to the Board of Governors. It consists of one banker from each Federal Reserve District elected annually by the board of directors. The established custom in this District is for an individual to serve three terms. The Council meets quarterly with the Board of Governors. Our member reports to this board after these meetings.

The fifth part of the System is the member banks. National banks are required to be members and qualified state chartered banks may become members. Member banks are required to subscribe 6 per cent of their capital and surplus to the stock of the Reserve Bank in their District. Half of this has been paid in and the other half is subject to call. The stock is unique in character. It does not convey residual ownership of assets, which revert to the United States in the event of liquidation. A cumulative 6 per cent dividend is paid. Each member may nominate and has one vote in the selection of the Class A and Class B director for its group.

There you have in capsule form the unique blend of public and private interests that comprise the Federal Reserve System.

In conclusion, I should like to emphasize two features on which continuation of the present structure of the System depends.

The first feature is the dual role of my position as president of a Federal Reserve Bank. On the one hand, I am the chief executive officer of this Bank and as such am responsible to you, the board of directors. On the other hand, I am a regular attendant and, in rotation, a statutory member of the Federal Open Market Committee. As such I am responsible to my conscience and cannot go as an instructed delegate.

As president, I have a responsibility to keep you informed so that you may reach the best decisions on monetary policy, especially the discount rate of this Bank. As a Committee member I acquire certain sensitive information that I am not at liberty to disclose. For my own part, I have never found that this dual role creates any difficulty or irritation. I am sure it never will so long as the nature of our relationships is understood. It is to develop understanding that I mention it specifically today at the first meeting with new directors.

The second feature relates to you as directors. In our meetings, we deal with many matters that must remain confidential. I cite action on the discount rate as the most important single example of many. You establish the rate on Thursday morning subject to review and determination by the Board of Governors. The Board typically announces its action at 4:00 p.m., after the close of the financial markets in New York. There is thus an interval in which such highly important knowledge must be held in confidence. This is true especially when we happen to be among the first Reserve Banks to make a change in the rate. Furthermore there is always the possibility that the Board will not approve the rate you have established. A "leak" on the rate could result in a complete reorganization of the Federal Reserve System with elimination of all private elements. When I consider how much the directors of this Bank have contributed to monetary policy

and its application to current developments, I am firmly convinced that this would be a tragedy.

In the long run, of course, the future of the System depends on the quality of our monetary policy. A central bank can remain independent within Government not as a matter of right or of law but only as it maintains the confidence of the public. In a very real sense, the future of the System as we know it is in the hands of each -- and of all -- of us.

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