ANNUAL REPORT OF THE FEDERAL RESERVE BOARD.

FEDERAL RESERVE BOARD,
Washington, D. C., January 15, 1915.

The SPEAKER OF THE HOUSE OF REPRESENTATIVES.

SIR: Less than six months have elapsed since the Federal Reserve Board entered upon its duties, but so much of fundamental importance and interest has taken place in the transformation of our banking system during this period that it seems advisable not to delay for a twelvemonth the report which, under the terms of section 10 of the Federal reserve act, this Board is required annually to present.

The first steps, particularly the fundamentals of the regional structure of the new system, had already been provided for by the Reserve Bank Organization Committee when the members of this Board took the oath of office on the 10th of August, 1914. The country had been divided into 12 districts and in each of these districts a city had been designated by the Reserve Bank Organization Committee as the location for a Federal Reserve Bank. Some dissatisfaction with the conclusions of this committee had been expressed by affected districts, but this Board, though fully alive to the vital bearing which the proper districting of the country would have upon the successful operation of the Federal Reserve System, thought it best to postpone a consideration of this question in order not to delay the organization of the Federal Reserve Banks. This decision was confirmed by recognition of the extraordinary conditions then obtaining throughout the country and the urgent need of bringing to the relief of the business and banking community in a time of great financial stress the facilities of the new banking system. The Board accordingly addressed itself with energy from the very beginning to the further steps to be taken in preparation for an early launching of the new system.

The difficulties of the undertaking were of course greatly aggravated by the economic disturbances occasioned by the European war which extended to every part of the country and fear was expressed by many that the new system could not safely be put into operation before the 1st of January, 1915. Nevertheless, conditions were so far controlled and steadied by the series of unusual relief measures described below, and the work of organization was so far advanced that the Board on October 26 issued notice to the member banks of the Federal Reserve System calling upon them to pay in their first installment of capital stock as of date of November 2. At about the same time the Secretary of the Treasury, acting under the authority conferred upon him by section 19 of the Federal reserve act, fixed November 16 as the date for opening the Federal Reserve Banks and for readjusting the reserves of the member banks in accordance with the new requirements established therein.

The work of the Board may therefore be divided for the purposes of review into two periods: (1) previous to November 16, covering the preliminary steps in the organization of the new system, together with such incidental, though highly important responsibilities as were assumed by the members of the Federal Reserve Board in the effort to deal with the grave situation precipitated by the European war; (2) from November 16 to date, covering the early operations of the several Federal Reserve Banks.

EARLY PROBLEMS OF BOARD.

The condition with which the Board was confronted when it began its work on the 10th of August had such a considerable bearing upon the policy pursued that it is well worthy of further notice. Seldom, if ever, has the banking and business community of the country found itself in a situation of such uncertainty and perplexity. The outbreak of hostilities in Europe led immediately to a serious rupture of international financial relationships, not only in the affected areas of Europe, but throughout the whole commercial world. The United States was directly and profoundly affected by the suspension of communication with Europe, involving as its most serious consequences the temporary breaking down of the export trade and the collapse of the financial markets, with resulting shock to the credit system. There had been extraordinary efforts on the part of European holders of American securities to realize by sales in the New York market. The securities markets were badly demoralized, prices fell with alarming rapidity, and the country was exposed to a serious and disastrous drain of gold.

The whole situation demonstrated afresh, and to a striking degree, the dependence of our banking system upon the call-loan market because of the large proportion of the country's banking reserves which were invested in call loans protected by stock-exchange collateral. Stock exchanges throughout the country closed, and call loans were thus made unavailable. Emergency currency was issued by the Secretary of the Treasury and clearing-house certificates in large volume were issued by clearing-house associations in the principal financial centers. Moreover, the tendency to hoard cash, frequently experienced in former periods of stringency, was again being manifested by country banks, some of which curtailed accommodation to an extreme degree, thereby adding greatly to the embarrassments of their customers and city correspondents. Much doubt was expressed as to the ability of borrowers to meet their maturing obligations, securities of high grade were unmarketable, while a situation existed in the foreign-exchange market which was altogether unprecedented. The conditions thus briefly outlined created an impression of profound alarm throughout the business community and gave rise to frequent expressions of the belief that the organization of the reserve system should be deferred until the return of more normal conditions, both for the success of the system and in order that the existing situation might not be complicated and aggravated by the injection of new and incalculable elements into it.

The board immediately after taking office undertook as nearly as possible to ascertain the exact basis for this view and secured from

a great variety of sources expressions of opinion with reference to the policies that would best be pursued in the face of the situation. Fruitful and interesting as these expressions were, there was nevertheless so much diversity of opinion that the Board in the end found that it would have to be guided by its own estimate of conditions and its own judgment as to the course to be pursued. As the result of the most careful analysis that it could make, it concluded to proceed forthwith with the organization of the new banks—that is, as early as was consistent with their stability and efficiency—and with the selection of competent operating staffs. The Board was also, however, firmly of the opinion that in undertaking thus early to establish the Federal Reserve Banks it would be necessary to enlist the hearty cooperation of all the member banks in two matters which were deemed of fundamental importance: (1) payment by the member banks in gold out of their own vaults of the reserves they were required to contribute to the new banks, thus diffusing the burden of providing the cash resources of the Federal Reserve Banks; (2) the adoption of a discount policy which would prevent the accumulated strength of the banks from being dissipated and protect their resources from being used to finance operations not calculated to add to the strength or solidity of general banking conditions.

CHOICE OF DIRECTORS.

Before the banks could be set in actual operation, however, it was necessary for the Board to complete the organization prescribed in the Federal reserve act by the appointment of three Government directors in each of the several institutions. Pursuant to the requirements of law, the Reserve Bank Organization Committee, consisting of the Secretary of the Treasury, the Secretary of Agriculture, and the Comptroller of the Currency, had already taken preliminary steps, resulting in the election by the banks of six directors in each Federal reserve district, and the results of these elections were reported to the Federal Reserve Board upon its organization.

There remained to be appointed by the board three Government directors for each district, the first of whom was to be designated Federal Reserve Agent and Chairman of the board of directors, the second as Deputy Reserve Agent and Vice-Chairman. Particular importance was felt to attach to the choice of all the Government directors, and especially of the Federal Reserve Agents. The Federal reserve act specifically designates the Federal Reserve Agent as the representative of the Federal Reserve Board at the bank to which he is accredited, and invests him with very large responsibilities. It was not, in the opinion of the Board, the intent of the act to constitute the Federal Reserve Agent the operating head of the bank, but, rather, that he should be vested with the function of promoting the general interests and purposes of the system, assuring himself and this Board of the sound and impartial administration and efficient operation of the bank to which he was accredited, and giving both to the Federal Reserve Board and to the executive officers and his fellow directors of the bank, over whom he had been appointed Chairman, the benefit of his advice and knowledge. The office is undoubtedly one which calls for exceptional qualifications, and is, therefore, difficult to fill, since by the very terms of the act, "tested banking ex-

perience" is made a prerequisite, while consideration for the general welfare of the bank's administration requires that the incumbent be a man of solidity, independence, and tried character.

Believing that the choice of the Government directors was a matter of fundamental importance and that errors made in their selection would produce serious consequences in the later working of the banks, the Board deemed it essential to scrutinize every name submitted for appointment or suggested from any source, with the utmost care. The process was one which required time and necessitated visits by members of the Board to various and distant parts of the country, as well as the invitation of competent advisors to Washington for consultation. As the outcome of these investigations and deliberations, the Board announced to the public at different dates early in October the three selections made for Government directors for each of the reserve banks, or 36 in all.

In Exhibit G, hereto attached, will be found a complete list of the directors of the Federal Reserve Banks.

In order to obtain persons of satisfactory banking experience, as required by law, it was found necessary to give to Federal Reserve Agents salaries commensurate with, or approximating, those prevailing in the banking community in each district for men of similar attainments, abilities, and experience. In a number of cases it was found possible to attract to the service of the Reserve Banks men of high qualifications at a rate of compensation substantially lower than they had been receiving or were in a position to obtain. The action of the appointees in accepting office on short notice and at the compensation established was the more to their credit in that in not a few cases it was necessary for them to incur substantial financial sacrifice because of the unfavorable conditions under which they were obliged to dispose of their holdings of bank stock, the Federal reserve act making it mandatory that each Federal Reserve Agent and each director of Class C should divest himself of ownership of this class of securities. A list of the compensation thus established for each Federal Reserve Agent, as well as a list of salaries of governors of reserve banks submitted to the Federal Reserve Board by the several member banks and approved in accordance with law, is herewith submitted as a part of Exhibit G.

As soon as the directors of the several banks had been chosen, they proceeded to select the nucleus of a suitable staff, in order that the banks might be ready to begin active operations when qualified to do so. The Board particularly enjoined upon them the choice of a suitable chief executive officer in each institution, with the suggestion that this officer be given the title of governor in order to differentiate his functions from those of the president of a member bank. A tentative plan of organization, which has been approximately conformed to in the establishment of each bank, was, moreover, suggested, and is hereto attached as part of Exhibit C.

PURCHASE OF PAPER.

Recognizing that, in view of the urgent character of the situation regarding the establishment of the banks, it was not possible to formulate in advance of their opening a complete set of regulations with reference to their conduct and operation, the Board determined to confine itself in the beginning to those matters which were

deemed absolutely essential to setting the banks in motion upon a basis of reasonable efficiency. It was felt that the regulations relating to discount operations and commercial paper in general were fundamental and that they should be prepared and issued at once. The result was the preparation of a letter addressed to all Federal Reserve Agents, sent to them under date of November 10 as Circular No. 13, in which the board set forth its views with reference to the policy deemed advisable to be followed by the banks in the beginning. It was recommended that the Federal Reserve Banks confine themselves strictly to dealings in short-term, self-liquidating paper growing out of commercial, industrial, and agricultural operations, in the restricted senses of the terms, and that particular care be taken not to discount or purchase paper which had been issued primarily for the purpose of providing capital investment for any business. In Exhibit E, hereto attached, is given a complete file of the regulations and circulars thus far issued by the Federal Reserve Board. The full text of Circular 13, aforesaid, with the accompanying regulations, will be found in its proper place in this exhibit.

As already noted, it was deemed essential that, so far as possible, the capital and reserves to be paid into the Federal Reserve Bank at the time of organization should be taken from its own vaults by each of the contributing member banks. Inasmuch as the act provided that the capital should be paid in gold or gold certificates, it was to be expected that the bulk of such payments would, in any event, be made from the vaults of the member banks. Reserves, however, might of course be paid in any form of lawful money and the act itself had expressly provided that one-half of the reserve installments might be received by the Federal reserve banks in the form of rediscounted paper. It was, therefore, thought proper to appeal to the sense of common interest and spirit of cooperation of the member banks, in order to induce them to refrain from establishing reserves through some means other than that of a direct deposit of cash from their own vaults, and to pay in, so far as possible, the sums that were due from them to the Federal Reserve Banks on reserve account in the form of gold or gold certificates. With this in mind, the Board transmitted to the member banks on October 28 a circular (No. 10) in which the banks were advised and urged to make their payments in gold or its equivalent taken from their own vaults. As a special inducement, the Federal Reserve Banks were authorized to pay the express charges upon cash amounts thus remitted to them by member banks.

There was, of course, at no time any provision of law prohibiting member banks from drawing upon their correspondent banks for the means wherewith to make these payments, but it was believed that they would be willing to forego the exercise of this right and events fully justified this belief.

On Monday, the 16th of November, the date already fixed by the Secretary of the Treasury, as above indicated, the new banks opened their doors for business. The statement issued on the following Saturday showing the condition as of the evening previous, indicates how fully the member banks had complied with the reserve suggestions that had been made to them.

The statement referred to will be found tabulated, with the succeeding weekly statements issued by the board in accordance with

law, in Exhibit K, hereto attached, and from it will be seen that, at the end of the first week's operations, there had been paid into the reserve banks a total of $227,880,000, of which a very large percentage was either in gold or gold certificates. It should be added that this great transfer of funds was accomplished without the slightest danger or halt to business, and without any inconvenience to the banking community. Subsequent to the payment of the reserves, inquiry was made of each Federal Reserve Agent regarding the method of paying reserves adopted by each bank. The results of this inquiry are presented in tabulated form in Exhibit L.

As has already been observed, doubt had been expressed in various quarters whether it would be practicable to open the new banks before the new year. There was also criticism in some quarters because they were not opened earlier than they actually were. The fact is that the banks were opened at the earliest practicable moment. Events have since shown that the opening of the institutions was wisely timed to synchronize with the restoration of activity in our export trade. Subsequent development showed that it was possible for the Federal Reserve Banks to begin business with substantially the whole of their reserve deposits in gold and without pressure on general business or credit conditions.

DISCOUNT POLICY.

With the system thus established, the question of a discount policy immediately became urgent. The board had been appealed to by the authorized representatives of the several Federal Reserve Banks for some 10 days prior to the official date set for the opening of the institutions, to make suggestions to them with regard to their discount policy, for it was generally appreciated that the adoption of a fairly uniform and consistent policy to be pursued by all the banks would go far to insure the smooth working of the system. Under the provisions of paragraph (d) of section 14 of the Federal reserve act, the Federal Reserve Board is authorized to review and determine the rates of discount to be charged by each Federal Reserve Bank. The act gives power to each bank:

> To establish from time to time, subject to review and determination of the Federal Reserve Board, rates of discount to be charged by the Federal reserve bank for each class of paper, which shall be fixed with a view of accommodating commerce and business.

In response to a telegraphic inquiry, each bank submitted its views with respect to the rate of discount thought to be advisable for its district. Upon tabulation and comparison of these results it was found that they did not vary greatly, the rates ranging from 5 to 7 per cent for 90-day paper. A study of the existing state of affairs satisfied the Board that at the start and until the banks could get a firm footing it should act with prudence and conservatism, and it was consequently voted to fix the rates of discount at from 5½ to 6½ per cent. The rates thus initially established were subsequently lowered from time to time upon application by the respective banks, the lowest rate thus far approved being 4½ per cent for 30-day paper. A complete tabulation of all rates of discount thus approved for each of the banks will be found in Exhibit M, hereto attached.

READJUSTMENT OF RESERVES.

Reference may be made to another feature of the Federal reserve act in connection with the money market conditions prevailing at the time. Section 19 of the Federal reserve act provided for a readjustment of member bank reserves upon a new and lower basis, cutting the percentage of required reserves in central reserve cities from 25 to 18 per cent of outstanding demand deposits and 5 per cent of outstanding time deposits, the required percentage in reserve cities from 25 to 15 per cent demand deposits and 5 per cent of time deposits, the percentage of reserve in country banks from 15 to 12 per cent of demand deposits and 5 per cent of time deposits. This readjustment by the terms of the law took effect immediately upon the establishment of the new banks, i. e., on November 16. From the beginning of the war in Europe there had been an abnormal reserve situation in most of the financial centers, New York banks particularly being most of the time considerably below their reserve requirements because of the heavy drafts made upon them by interior banks and by the public.

The change in reserve requirements, however, brought a material change in this condition and released, not only in New York but throughout the country, a very considerable amount of funds which had previously had to be held idle by the banks in order to bring or keep themselves within the requirements of the law. Precisely what amount of reserves was thus released throughout the country has not been accurately estimated and probably can not be, owing to the fact that reserve accounts in the existing system of correspondent banks are so closely and complexly intertwined. It is, however, an undoubted fact that the release of actual cash was very large and that the increase of lending power on the part of member banks was correspondingly larger. Member banks were thereby enabled to extend loans to their customers very much more freely, with a commensurate decline of discount rates as a consequence. While hesitation in making loans was shown by many of the banks during the weeks preceding November 16, and the prevailing rates on commercial paper did not go below 6 per cent in New York, and averaged considerably higher in many parts of the country, the opening of the reserve system enabled the banks in the larger centers, in view of the very great relief given to them through the release of reserves, to reduce this rate, and within two weeks after the new banks had come into existence prevailing interest rates for the best paper fell as low as 3½ and 4 per cent, while bank acceptances (which had been legalized by the Federal reserve act) were marketed at a still lower rate. In some parts of the South banks were able to obtain accommodation at rates as low as 4½ per cent, and in certain instances lower rates have been reported.

The reduction of reserve requirements was only a part, however, of the beneficial effects of the new system. Appreciation of the fact that when the new lending power should all have been absorbed there would still remain the great credit potentialities of the Federal reserve banks, furnished a basic element of confidence which helped to lower the abnormally high rate of interest that had existed.

When the financial anxiety which prevailed during the latter part of the past summer and the difficulty which was then experienced in getting banking accommodation at reasonable rates, even upon

security of undoubted solidity, are recalled, the substantial improvement which has taken place since becomes evident and is a remarkable tribute not only to the recuperative power of American commerce and industry but also and largely to the beneficial operation of the new banking system. Those whose habit it is quickly to forget the past, may think that this swift recovery was something automatic, but the most casual survey shows that it was the added strength brought to our banking organization through the establishment of the new system that has made possible the notable reduction in interest rates which began in the latter part of November.

Because of the greater ease and material relief thus afforded the member banks, they were easily able to meet the demands of their customers from their own resources or those of their correspondents, and there was consequently little occasion to resort to the Federal reserve banks for accommodation. It was therefore considered safe to reduce the discount rate of Federal reserve banks, and reductions were successively made upon application until the low point was reached on December 23, when a rate of 4½ per cent for 30-day maturities was approved for the Federal reserve bank of New York. Corresponding reductions were subsequently approved for other Federal Reserve Banks.

It should, in a word, be emphasized that the effect of the Federal Reserve Banks and the reserve system as a whole on discount rates is by no means fully disclosed in the rates and the transactions of the Federal Reserve Banks themselves.

GOLD EXCHANGE FUND.

At this point and in this connection, a review may suitably be made of the series of relief measures which were undertaken, and in which the Federal Reserve Board has been an active factor, for the purpose of improving and helping the situation in which the country found itself in the weeks and months preceding the establishment of the Federal reserve banks, as a result of the European war. One of the earliest and most trying consequences of the war was the development of a highly abnormal and artificial condition in the foreign exchange market.

This situation was due essentially to the fact that a large current balance was at the time owing to Europe, foreign holdings of American securities had been placed on the market, foreign credit facilities had been withdrawn, and our export trade had suffered a serious shock from the disorganization of shipping and the breaking down of European credit machinery immediately after the outbreak of the war. Furthermore, a large amount of American securities had been issued payable in Europe, and were about to mature.

These conditions exposed our banks to a drain of gold severe enough to endanger our entire banking structure. This, on the other hand, made it difficult for those who had to discharge obligations due in Europe to procure gold or remittances at prices equivalent to the shipment of gold. The consequence was that rates for drafts and cable transfers rose to prices which were equivalent to a substantial premium on gold.

In order to cope with this extraordinary situation, it was felt that joint action on a comprehensive plan would become necessary. The

Federal Reserve Board, in conjunction with the Secretary of the Treasury, therefore, took the initiative in calling, September 4, a conference of representatives of the clearing houses of all the reserve cities. The conference had a twofold purpose. On the one hand, it sought to establish, so far as that could be done, the aggregate amount of the actual current indebtedness of the United States to Europe, and, on the other hand, to devise a means of cooperation in dealing with the situation.

The investigation undertaken by the Federal Reserve Board and the conference above mentioned disclosed the opinion that the current indebtedness of the United States to foreign countries was to be stated at approximately $500,000,000, a sum the maturity of which was spread over a period of months. The conference also resulted in the formulation of a plan of relief. A committee of bankers appointed at this conference subsequently recommended a plan for the formation of a gold fund of $100,000,000, which was approved by the Board on September 19, and a letter was sent to the presidents of the clearing house associations throughout the country under date of September 21, 1914, in which subscriptions aggregating this sum were asked. The Federal Reserve Board had been requested to allot the pro rata of the contributions to be made to each clearing-house district, and such allotment was made. Action upon these allotments was prompt and effective, and a total of over $108,000,000 was subscribed.

As had been expected, the beneficial effect of the establishment of this fund became evident almost immediately, notwithstanding that only a comparatively small percentage of the amount subscribed was actually called for, and not more than $10,000,000 was actually exported to furnish a basis for selling foreign exchange. By the time of the opening of the Federal Reserve Banks, the premium had disappeared and the danger of immediate gold exports had been removed.

At the end of September, however, there still existed a disruption of trade, the cotton market was still completely disorganized, sales and shipments of the staple had stopped, the cotton exchanges remained closed both in the United States and in England, and it appeared impossible at that time to foretell what bearing these and other abnormal conditions would have upon the future development of the balance of international payments. The desire was consequently expressed by leading bankers that means be found for discussing and further dealing with these pending problems. It was therefore suggested that a free exchange of views between representatives of Great Britain and the United States—the two countries primarily involved—would be to their mutual advantage if it could be arranged.

At the instance of the Secretary of the Treasury, an invitation was therefore extended to the British Government to send representatives to this country. The purpose of this invitation was to secure the exercise of the good offices of the two Governments concerned in bringing about a better understanding between the bankers of the two countries and the restoration as speedily as possible of normal conditions of exchange. The British Government designated Sir George Paish and Basil P. Blackett, Esq., as its representatives. These gentlemen proceeded to Washington and on October 23 held a first conference with the Secretary of the Treasury and this Board. Subsequently other conferences (some of them attended by repre-

sentatives of bankers from the main financial centers of the country) were held and the situation was discussed in great detail. Meanwhile, more normal conditions of commerce had been reestablished and negotiations which led to the adoption of the so-called cotton-loan fund plan, to which reference will be made hereafter, had produced most beneficial results. It had become possible to reopen the cotton exchanges both in the United States and in England, and the staple which has so vital a bearing upon the volume of our trade balance had begun to move from producers to consumers, both at home and abroad.

In these circumstances the occasion for further negotiations disappeared, and on January 7, 1915, it was officially announced that conditions had so far righted themselves that any further negotiations for the solution of the problems involved could be left to private initiative.

COTTON LOAN FUND.

Almost immediately after the outbreak of war, it was seen that unless hostilities should terminate within a very much shorter period than seemed likely, serious injury would be inflicted upon the cotton-producing States. As early as August 26, 1914, the Secretary of the Treasury had called a conference in Washington of representatives of cotton producers, manufacturers, bankers, merchants, and railroad men, in which the Board participated. As is well known, about 60 per cent of the total cotton production of the United States is annually sent abroad. An unusually large acreage had been planted, the season had been favorable, and a very large crop was approaching maturity. These circumstances would in any event have depressed the price of cotton, even under ordinary conditions. The closing of the cotton exchanges, both in the United States and in England was, however, precipitated by the chaotic conditions following the sudden interruption of the movement of cotton and the apprehension that, with most of the great cotton-consuming countries involved in war, a normal demand for the staple could not be expected. Prices collapsed, quotations were unobtainable, and with the markets utterly demoralized, sales were made sporadically at various points in the South at 5 cents per pound—and even lower have been reported. As the cotton planter is so largely dependent upon credit in the raising of his crop, it was necessary to provide some means of assisting him to secure such accommodations as he might require to meet the obligations he would ordinarily have provided for by the sale of his product in the open market.

Various plans of relief were brought to the attention, both of this Board and of the Secretary of the Treasury by bankers and business men, among them a suggestion for the establishment of a cotton-loan fund somewhat similar in character and management to the gold-exchange fund. Many conferences were held regarding the problem, with the ultimate result that the banks of the city of New York agreed to pledge a subscription of $50,000,000 to such a fund, provided that an equal amount be raised through the clearing houses in other than cotton-producing States. The plan provided that to the $100,000,000 thus to be raised should be added a further sum of $35,000,000 to be contributed by banks in the cotton-producing States, provided that the $100,000,000 should be called for in proportion as the $35,000,000 should be subscribed and paid in. The

Board was asked to pass upon this plan and gave it official sanction on October 24, 1914. Details of this cotton plan will be found in Exhibit N, hereto attached.

During these negotiations the Federal Reserve Board became convinced that, as in the case of the gold fund, it would be impossible to raise the money necessary to relieve the cotton situation under any plan devised simply for the general good, unless the members of the Board, even though not acting in their official capacity, should give their support and sanction to the undertaking. While very reluctant to assume any additional responsibilities, the members of the Board, acting in their individual capacity, felt impelled by the same sense of public duty which had actuated them in the case of the gold fund to respond to the call and to act as the central committee of the cotton loan fund, being satisfied that the necessities of the case demanded such action, and that public opinion would approve this step.

The opening of the Federal Reserve Banks on November 16 released a large amount of reserve funds, thereby enabling member banks to make new loans and grant extensions which otherwise would have been impossible. It became evident that the formation of the cotton fund, like that of the gold fund, had rendered material service by restoring confidence, thus stabilizing values and establishing a basis for extension of credit on cotton as collateral. With the cotton fund at hand to supply long-time loans and with short-term credit much more freely extended by member banks in view of the reduction of their reserve requirements, it was possible for the Federal Reserve Banks to begin operations in full confidence that the provision thus made for safeguarding the situation would relieve them from undue strain, while fully protecting such cotton producers as are willing to pay a moderate rate of interest for long time loans on cotton. As with the gold exchange fund, the help extended was largely that which comes from cooperative effort and from the knowledge on the part of the community that there is a source of assistance which may confidently be looked to. In such situations, the beneficial effects can not be measured by the actual amounts that are loaned or the tangible results that are obtained, but they are none the less real and of large consequence.

CURRENCY SITUATION.

A phase of the banking and currency situation deserves to be especially noted because of the light it throws upon the extent of the demands for circulating notes to which the Federal Reserve Banks may be subjected during their initial period of operation. As has been shown in the annual report of the Secretary of the Treasury, one immediate result of the war was the issue in many cities of clearing-house certificates. Furthermore, a large volume of emergency currency was issued by the Secretary of the Treasury, under the provisions of the act of May 30, 1908, which had been amended and extended by the Federal reserve act, and which was still further amended by Congress early in August so as to allow the freer issue of notes in the manner indicated.

The total amount of the emergency currency issued aggregated about $380,000,000. The channels of circulation were thus filled before the end of the summer, notwithstanding the fact that large

amounts of lawful money had been withdrawn and hoarded both by banks and individuals. Under these conditions it seemed reasonably certain that the Federal Reserve Banks upon their organization would not be instantly called upon for a substantial issue of Federal reserve notes. This view was all the more justified by the fact that many banks had placed their best paper with the national currency associations as security for emergency currency, and by the further circumstance that the tax on this currency at the lower rate established by Congress would not, for several months approximate the rate of discount which probably would be charged by Federal Reserve Banks. With the organization of the Federal Reserve Banks the pressure for note accommodation passed away almost as quickly as it had come. Gold reappeared in circulation at an early date and the retirement both of the clearing-house certificates and of the emergency currency was begun. In those cities where rates of interest on clearing-house certificates were very high, the Federal Reserve Banks materially aided the retirement of such emergency certificates.

The emergency currency issued under the act of May 30, 1908, as amended, is now being rapidly retired by natural processes. Some $280,000,000 have already been withdrawn, thus leaving in circulation less than $100,000,000 at the date of this report. It is expected that with the lower rates of discount now prevailing at the Federal Reserve Banks and with the continued increase in the rate of taxation to which emergency currency is made subject, there will be a gradual conversion of such currency into Federal reserve notes so far as the existing notes are not redundant. Had the Federal Reserve Banks been in operation at the beginning of August they would naturally have supplied the great volume of currency which was called for, and they would have derived the profit for the service rendered.

OPEN-MARKET OPERATIONS.

The Federal reserve act provides in section 14 for open-market operations by Federal Reserve Banks, to be engaged in whenever such employment of their free funds would appear desirable. For reasons already given, the Board did not believe that it was necessary at the outset to make provision for the exercise of these functions. As soon, however, as the first pressure connected with the establishment of the system had passed, the duty of investigating and preparing for open-market operations was taken up, and the banks were on December 18 given authority to purchase Government bonds within the limits of prudence, as they might see fit.

On December 23, copies of a tentative set of regulations relating to the purchase of certain warrants, revenue bonds, etc., issued by States, municipalities, and other political subdivisions, were likewise transmitted to the banks.

Drafts of regulations governing the purchase of acceptances in the open market have been prepared and will shortly be issued. Other open market operations will be provided for by regulation as rapidly as possible. When this has been accomplished, there will be ample employment for all funds which experience may demonstrate the Federal Reserve Banks can safely and properly invest, at times when their funds should not be absorbed in responding to strictly agricultural, commercial, or industrial demands.

PLACE OF RESERVE BANKS.

The question, however, naturally suggests itself and must be frankly faced: What is the proper place and function of the Federal Reserve Banks in our banking and credit system? On the one hand, it is represented that they are merely emergency banks to be resorted to for assistance only in time of abnormal stress; while on the other, it is claimed that they are in essence simply additional banks which should compete with the member banks, especially with those of the greatest power. The function of a reserve bank is not to be identified with either of these extremes, although occasions may arise when either of such courses may be imperative. Its duty plainly is not to await emergencies but by anticipation, to do what it can to prevent them. So also if, at any time, commerce, industry or agriculture are, in the opinion of the Federal Reserve Board, burdened unduly with excessive interest charges, it will be the clear and imperative duty of the Reserve Board acting through the discount rate and open market powers, to secure a wider diffusion of credit facilities at reasonable rates. The Federal Reserve Banks are the holders of a large part of the banking reserves of the nation, the foundation of its banking structure. Nothing should be permitted in the operation of the Reserve Banks which would weaken this foundation. The resources of a Reserve Bank, to be useful for its peculiar purposes, should always be readily *available*. It follows, therefore, that they should be mainly invested in such short-term liquid investments as can be easily converted into cash as occasion may require. This conception of a Reserve Bank, moreover, implies that its investments should be marshaled in a steady succession of maturities, so that it may at all times as nearly as possible prove equal to the situation.

The ready availability of its resources is of supreme importance in the conduct of a Reserve Bank. Only then can it become a safe and at the same time flexible instrument of guidance and control, a regulator of interest rates and conditions. Only then will it constantly carry the promise of being able to protect business against the harmful stimulus and consequences of ill-advised expansions of credit on the one hand, or against the menace of unnatural restrictions and unnecessary contractions on the other, with exorbitant rates of interest and artificial stringencies. It should at all times be a steadying influence, leading when and where leadership is requisite, but never allowing itself to become an instrument for the promotion of the selfish interest of any private or sectional group, be their aims and methods open or disguised. It should never be lost to sight that the Reserve Banks are invested with much of the quality of a public trust. They were created because of the existence of certain common needs and interests, and they should be administered for the common welfare—for the good of all.

The more complete adaptation of the credit mechanism and facilities of the country to the needs of industry, commerce, and agriculture—with all their seasonal fluctuations and contingencies—should be the constant aim of a Reserve Bank's management. To provide and maintain a fluid condition of credit, such as will make of the Reserve Banks at all times and under all conditions institutions of accommodation in the larger and public sense of the term is the first responsibility of a Reserve Bank.

It should not, however, be assumed that because a bank is a Reserve Bank its resources should be kept idle for use only in times of difficulty, or, if used at all in ordinary times, used reluctantly and sparingly. Neither should it be assumed that because a Reserve Bank is a large and powerful bank *all* its resources should be in use all the time or that it should enter into keen competition with member banks, distributing accommodation with a free and lavish hand in undertaking to quicken unwisely the pace of industry. Such a policy would be sure, sooner or later, to invite disaster. Time and experience will show what the seasonal variations in the credit demands and facilities in each of the Reserve Banks of the several districts will be and when and to what extent a Reserve Bank may, without violating its special function as a guardian of banking reserves, engage in banking and credit operations. The Reserve Banks have expenses to meet, and while it would be a mistake to regard them merely as profit-making concerns and to apply to them the ordinary test of business success, there is no reason why they should not earn their expenses, and a fair profit besides, without failing to exercise their proper functions and exceeding the bounds of prudence in their management. Moreover, the Reserve Banks can never become the leading and important factor in the money market which they were designed to be unless a considerable portion of their resources is regularly and constantly employed.

There will be times when the great weight of their influence and resources should be exerted to secure a freer extension of credit and an easing of rates in order that the borrowing community shall be able to obtain accommodation at the lowest rates warranted by existing conditions and be adequately protected against exorbitant rates of interest. There will just as certainly, however, be other times when prudence and a proper regard for the common good will require that an opposite course should be pursued and accommodations curtailed. Normally, therefore, a considerable proportion of its resources should always be kept invested by a Reserve Bank in order that the release or withdrawal from active employment of its banking funds may always exercise a beneficial influence. This is merely saying that to influence the market a Reserve Bank must always be in the market, and in this sense Reserve Banks will be active banking concerns when once they have found their true position under the new banking conditions.

It would be a mistake, therefore, and a serious limitation of their usefulness to regard the Reserve Banks simply as emergency banks. Regulation in ordinary times, as well as protection in extraordinary times, may be expected to become the chief service which these institutions will perform. The Federal Reserve Board is fully alive to its opportunity and responsibilities in this respect, but it must counsel patience in awaiting the fruition of the new system. It will take time for the new banks to develop the technique of control and skill and experience in its application. The ascertainment of the correct base from which comprehensive operations should begin; the establishment of a normal level from which expansions and contractions will freely take place will have a most important bearing upon the future development and success of the system. Impatience to show results should not be permitted to tempt those in charge of the Reserve Banks into precipitate and unwise action.

The vast and complex structure of modern banking and credit systems is one of extreme delicacy of balance and adjustments, and it must never be overlooked that it is highly sensitive to all manner of disturbances, as recent events have painfully demonstrated. The banking systems of the larger nations are closely related to one another, and financial distress or collapse at one point quickly transmits shock to all others. Safety for us in critical times will depend on the confidence our system commands, the strength of its reserves, and its power to bring them into action promptly and effectively if needed.

In dealing with new districts and entirely changed banking methods, time and experience alone can supply the data necessary for charting the course to be pursued. This consideration, if nothing else, would suggest the greatest patience and prudence even if the European horizon were less clouded than it is to-day. None the less, the Board realizes that where extraordinary conditions warrant extraordinary measures, it is the foremost duty of the Board and the banks to act promptly and boldly.

CLEARING OF CHECKS.

The Federal reserve act, in sections 13 and 16, provides in general language for the collection and clearing of checks without, however, undertaking to define more precisely the exact extent or character of these operations. It does, however, prescribe the character of the items that may be received on deposit by Federal Reserve Banks and clearly contemplates the performance of certain clearing functions by such banks for their members. It also contemplates clearings of undefined extent among the several Reserve Banks and authorizes the Board itself to act as a clearing house for the several Reserve Banks, or to designate one of these banks to perform this service.

From the beginning, the Board has regarded the organization of these clearing functions as one of the most important responsibilities with which it is charged under the act, as well as one of its most difficult and intricate problems. The whole scheme involves very considerable and thoroughgoing innovations in existing methods, however substantial the benefits that will accrue from a well organized system of clearings national in its scope. The Board has, therefore, deemed it wise to move carefully in a matter involving dislocation in established practices and arrangements and depending for its success, in a large degree, upon the harmonious cooperation of the several banks involved.

It was the general opinion of the directors of the several Federal Reserve Banks, expressed at their conference held just before the opening of these banks, that transit and clearing operations should be restricted to easily manageable proportions in the beginning. Since the opening, a few of the Reserve Banks, acting in accordance with authority granted them by the Board, have in greater or less degree widened the scope of their clearing activities. At this time the whole matter is still to be regarded as in a condition of development, but with sufficient experimentation going on to materially assist the Board in reaching sound conclusions.

It must be remembered that the problem presented to the Board is one of great novelty and calls for the application of a high degree of technical skill in order that there may not result undue disturbance

and violent derangement of customary commercial and banking methods. Committees representing the executive officers of the various banks are studying the subject, and the Board is giving much of its own time and thought to an analysis and comprehension of the many elements involved in the question. It is believed that substantial progress will be made in the near future in the development and formulation of an effective plan for the solution of this problem.

Habit of long standing in the American business world has established the check in its preference as the most important and convenient constituent in the circulating medium. To give it wider currency and a freer flow to and from every part of the country, so far as this can be done without opening the way to abuses, is in line with the further development and requirements of the American business system and will receive the most careful attention of the Board.

ADMISSION OF STATE BANKS.

From the opening of the new banks, the Federal Reserve Board has been keenly anxious to settle the conditions upon which State banks may be admitted into the system. The Federal reserve act especially provides for such admission, and it has been supposed in many quarters that the process of admission would involve few difficulties. Investigation has shown that owing to the differences in State laws, the comprehensive character of the charters enjoyed by some State banks, and the complex conditions of competition between such institutions and their national competitors, the determination of these conditions was far from being easy if an equitable adjustment was to be found. A problem of somewhat similar difficulty was presented by the provisions of the Federal reserve act authorizing the board to make regulations under which national banks might exercise the functions of trustee, executor, etc. Both these subjects have been, and are, under very careful investigation, and conferences have been had with both National and State bankers, while competent legal advice has also been sought. It is expected that at least a tentative solution of the problems at issue may be arrived at in the near future.

Since the passage of the Federal reserve act, there have been converted into National banks 93 State banks and trust companies, with a capital and surplus of $9,151,306. There have been admitted to the system as members thereof 9 State banks and 4 trust companies, the aggregate capital and surplus of the 13 institutions being $17,884,000. Those State institutions which have already been admitted to the system have entered upon the understanding that they are to accept any regulations the Board may make regarding the conduct of the business of member banks. There are pending at the present time applications from 51 State banks and trust companies. These applicants have preferred to await the issuance of regulations governing the admission of State banks.

FEDERAL ADVISORY COUNCIL.

The 12 members of the Advisory Council are selected by the boards of directors of the Federal Reserve Banks. When the list was completed the Federal Reserve Board sent out an invitation to the

members to meet, which they did in Washington on December 15 and 16. At this meeting the members of the Council indicated their views on some pending questions and took others under advisement to be reported upon later. The membership and organization of the Council are described in Exhibit F.

ADMINISTRATION.

In organizing its staff the Board has sought to observe economy and to keep the personnel within the narrowest limits consistent with efficiency. The Reserve Bank Organization Committee had established a staff of about 75 persons, and the Board determined to take over as a nucleus of its own force such members of this staff as were deemed necessary for the conduct of its work. After careful investigation, a total of about 40 persons were thus transferred and given a permanent status in the Board's organization. There had been many applicants for appointments to the staff of the Board, the total aggregating more than 1,200, and in order to give applicants in places distant from Washington an equal opportunity and provide fairly for a distribution of such appointments as might later be made, an examination conducted (on a basis prescribed by the Board) by the Civil Service Commission was given on behalf of the Board on December 9. Returns from this examination had not been received up to December 31, but future appointments will be made from the list of eligible persons established as a result of this examination, save in so far as there may be a need for officers of highly special or technical attainment. In Exhibit C, hereto attached, will be found a complete report prepared by the Secretary of the Federal Reserve Board, in which are given the names, salaries, and other details relating to the staff at the main offices in Washington.

As at present organized the Board's staff comprises four divisions—one dealing with correspondence, one with bank audit and examination, one with reports and statistics and a law department in charge of a general Counsel. The Board has appointed two administrative officers, to be known as Secretary and Assistant Secretary, and has appointed to these positions, respectively, H. Parker Willis, as the former, and Sherman P. Allen, as the latter. The general management of the staff of the Board is under the direction of the Secretary's office. The Board appointed as counsel M. C. Elliott, previously the Counsel of the Organization Committee. Apart from the Correspondence Division, the name of which sufficiently indicates the nature of its duties, the Board's work is now carried on by the Division of Audit and Examination and the Division of Reports and Statistics. A discussion of the functions of the former division will be found in Exhibit C.

A uniform accounting system has been adopted by the banks and one of its results is the furnishing of daily statements which are forwarded to Washington, and detailed lists of all bills purchased and discounted. From this it will be possible to make credit analyses which will serve to show the distribution of the funds of the Federal Reserve Banks among the different classes of business which are applying for them. This work will fall to the Division of Reports and

Statistics. Neither that division nor the Division of Audit and Examination is as yet fully organized, but they will be developed rapidly as the system expands and its wants become definitely recognized.

EXPENSES OF BOARD.

An assessment of four-tenths of 1 per cent was levied on the capital of the Reserve Banks to meet the estimated expenditures of the Board during the six months beginning November 1, 1914, on which date the total capital was $107,760,100. The money derived from this assessment is deposited with the Treasurer of the United States, subject to check by the Governor of the Board, countersigned by the Secretary.

In preparing the estimates for the first six months, it was necessarily difficult to foretell the expenses of every kind and nature incident to the development of the system, but it is believed that the levy made will be sufficient to cover all expenses for the period named. It should be observed in connection with this statement of expenses that nearly 50 per cent of the total assessment upon the Federal Reserve Banks has been for the preparation of a large supply of Federal reserve notes. This expense will probably not need to be repeated in the near future. The following statement will show the receipts and expenses of the Board to date:

Estimated expenses for six months beginning November 1, 1914, including $208,560.25 for purchasing paper, making dies, and printing and engraving Federal reserve notes; also salaries of the members of the board from August 10 and of its secretary and assistant secretary from September 14 to October 31, 1914, and for liabilities incurred incident to the organization of the board and of the Federal reserve banks	$431,040.00
Total capital of reserve banks November 1, 1914	107,760,100.00
Assessment, four-tenths of 1 per cent	431,040.00
Amount received on account of above assessment up to December 31, 1914	259,613.87
Disbursements to December 31, 1914	52,833.93
Balance with the Treasurer of the United States to the credit of the board December 31, 1914	206,779.94
Expenses of the board to December 31, 1914: [1]	
Salaries	45,256.14
Equipment (including furniture, adding machines, typewriters, etc.)	6,034.59
Miscellaneous	2,689.45
Printing	3,171.33
Stationery	2,027.36
Postage	51.00
Total	59,229.87

The Reserve banks are still in the first stage of growth and both the volume of business which they can develop and the expenses which their operation will entail are matters of estimate. Much of the expense thus far incurred by the banks has been for their initial organization, including such items as equipment, note issues, etc., and owing to the fact that the banks were necessarily opened before complete regulations governing their operation could be framed and before their functions could be fully developed, their staffs had to be organized on the basis of prospective rather than immediate needs.

[1] This includes actual disbursements and liabilities incurred for which vouchers have not been presented.

The Board is, therefore, not able at this time to make a definite report on the normal expenses of the reserve banks.

CONCLUSION.

Five months have elapsed since the introduction into our financial system of the most far-reaching change that has been made in the field of American banking since the passage of the National Banking Act. Less than two months have gone by since the Federal Reserve Banks actually opened for business. The system, however, is in operation and has already produced results of the most noteworthy character. There is much yet to be done, but the work can not be regarded as experimental in the sense that there is any uncertainty as to the outcome. The only question is as to how rapidly it will be possible to develop the full capabilities and resources of the Federal reserve system. Its potentialities are vast and should contribute immeasurably in the future to the solidity, stability, and flexibility of the American credit system.

W. G. McAdoo,
Secretary of the Treasury, Chairman.
John Skelton Williams,
Comptroller of the Currency.

C. S. Hamlin, *Governor.*
F. A. Delano, *Vice Governor.*
P. M. Warburg.
W. P. G. Harding.
A. C. Miller.