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Speech of

Chester C. Davis, Member,
Board of Governors, Federal Reserve System,

at the
ceremonies in connection with the opening
of the new Federal Reserve Bank Building,

Helena, Montana,

Friday, June 17, 1938.

It affords me profound satisfaction to be here today as you dedicate this new building for the Helena Branch of the Federal Reserve Bank of Minneapolis. I bring you the greetings and best wishes of the Board of Governors of the Federal Reserve System, and their hope that in the future this new building will enable the System to serve you more efficiently than it has been able to do in the past.

This building expresses, in concrete and steel, the faith of the Federal Reserve System in the future greatness and prosperity of Montana. Every banker among you knows that the needs of the moment may not require this structure, perhaps not even the institution it houses. But no modern state can carry on its business efficiently without a system similar in function and purpose to the Federal Reserve; and the Federal Reserve System itself cannot be sure that it will serve the United States well unless it is in immediate, at least overnight, touch with all its member banks.

It seems appropriate for me to talk to you briefly, today, about the nature of the Federal Reserve System - what it is, and how it works.

The broad policies of the Federal Reserve System are formulated by the Board of Governors, in Washington. Administration of credit and service functions and member bank relations within the district is through the 12 Federal Reserve banks. These Reserve banks are brought closer to their territories by means of 25 branches located with a view to ready accessibility in territory not conveniently reached from the main banks. The Minneapolis district - District No. 9 - is one of the largest, geographically. It comprises the Upper Peninsula of Michigan, Northern Wisconsin, all of Minnesota, the Dakotas and Montana. The Minneapolis bank has only one branch, and this is it.

Each Federal Reserve bank is managed by its board of directors. But Federal Reserve banks are not ordinary corporations. While they are self-sustaining, they are not operated for profit. The manner of electing their directors and the qualifications of persons eligible to be elected are prescribed by law. Of the nine directors, six are elected by the member banks. Only three of the nine may be bankers.

The Board of Governors of the Federal Reserve System appoints three of the non-banker directors, one of whom is designated chairman of the board of directors and Federal Reserve Agent.

These 12 Federal Reserve banks together with their 25 branches serve the public through 6,350 privately owned and managed banks comprising about 85 percent of the country's total commercial banking resources. National banks must, and state banks may, be members.

Each member bank must invest in the capital stock of the Reserve bank of its district a sum equal to 3 percent of its own capital stock and surplus. But it is by no means correct to say that the member banks <u>own</u> the Federal Reserve banks in the usual meaning of the term. Federal Reserve stock cannot be transferred; it cannot be cancelled except as a member withdraws from the Federal Reserve System, and the income the stock yields to its owner, the member bank, is limited to six percent per annum, which may, of course, be changed by act of Congress.

Most of you are well acquainted with the mechanical services which the Federal Reserve banks render either directly or through their branches - discounting paper; clearing and collecting checks and transferring funds; holding reserves of member banks; and providing and distributing currency as business requires it. As a government agency, the System receives subscriptions for and delivers Government securities; cashes interest coupons and pays off maturing Treasury obligations.

So much for the general structure of the Federal Reserve System and the more tangible functions of the Federal Reserve banks. Against this background I want to sketch in broadest terms the aims of Federal Reserve policy.

It is the aim of the Federal Reserve System to maintain sound banking and to promote the orderly functioning of industry, agriculture and trade in so far as these objectives may be achieved by monetary means.

Federal Reserve policy influences the volume of bank reserves, and the volume of bank reserves in turn is the measure of the banking system's capacity to expand credit. The greater part of the money supply consists of checking deposits that arise out of the extension of bank credit. The extent to which commercial banks are able to grant credit at any given time depends upon the volume of their reserves. Whenever the need arises the Federal Reserve banks can, and do, take steps that tend to increase or decrease the volume of bank reserves. In this way the Federal Reserve System exerts an influence upon the country's supply of credit and hence upon economic activity in general.

The details, of course, are a bit involved. The Federal Reserve can increase bank reserves in the aggregate either by discounting paper for particular banks, or by purchasing government securities and bankers' acceptances in the open market. On the reserves created in this way, commercial banks as a whole, through making loans and purchasing investments, can expand their deposits by several times the actual amount of reserve funds. Here's how that works: On the average, member banks are required to keep on deposit at the Federal about 14 percent of their total deposit liabilities. This is another way of saying that the addition of one billion dollars to reserves, for example, enables the commercial banking system to expand its loans by approximately seven billions. Conversely, when such action is in the public interest, the Reserve banks can reduce the volume of member bank reserves and thus contract the supply of bank credit and tighten interest rates.

Many well-informed men, even among commercial bankers, find it a little difficult to grasp this mechanism. It is hard to realize that the nature of the banking system as a whole is different from that of an individual bank. But the banking system as a whole, is something quite different from the sum of its parts. If, in a certain city, the First National loses a million in deposits to the Second National, the effect on these two banks is very real. But the mere fact that credit has been shifted from one set of books to another has no more effect on the banking system as a whole than does shifting your purse from the right hip pocket to the left.

The Federal Reserve bank is in the position of all banks taken together and considered as a whole. Whatever the required reserves of the member banks of the Ninth District may be, they are on the books of the Federal Reserve Bank of Minneapolis. Today these reserves may be credited to the First National, tomorrow to the Second National. The aggregate outstanding credit remains unchanged by such transfers.

This makes it clear that the Federal can do what the individual banker cannot do. That is, it can expand its deposits - its member bank reserves - by lending to its customers or by investing in Government securities without the fear that those deposits will be withdrawn. The law requires member banks to maintain with the Federal a certain proportion of their deposit liabilities. These deposits can be transferred from one bank's account to another's on the Federal's books. They cannot be permanently withdrawn.

A commercial bank's customers, as you well know, borrow when they need additional funds. And when they check out those funds, the commercial bank may lose deposits to another bank. However, the credit remains outstanding somewhere in the banking system until the loan is repaid.

But suppose the Federal extends credit by purchasing government securities. In payment it simply writes checks on itself and turns them over to the sellers of the securities. Recipients of these checks naturally deposit them with their banks for credit, and the banks in turn send them along to the Federal to be added to their several reserve accounts. In that way the Federal Reserve System may create new reserve credit that flows into member bank reserve accounts.

Now I had not intended to get quite so involved in the principles of central banking, but the excursion is justified, I think, by the widely-held notion - even among bankers - that the Federal Reserve banks derive their power to own investments from the reserve deposits of member banks. Such is not the case. That ability of reserve banks to buy investments - to extend credit - is derived from a statutory grant and the credit they sell in the form of Federal Reserve notes or of deposits is not derived from the deposits entrusted to them by member banks. That is a characteristic inherent in the very nature of central banking.

In other words, the Federal Reserve System does not use the reserves deposited with it by member banks when it buys investments. Its ability to buy and hold earning assets in its portfolio is not affected in any way either by the increase or decrease in reserve requirements. It is, rather, the other way around. Through the purchase of securities in the open market, the Federal creates reserves for the banking system. I am stressing this point because so many bankers felt, and said, when the Board increased reserve requirements, that we did so in order to increase the System's holdings of government bonds, and other earning assets. This opinion was not only incorrect; it shows complete misunderstanding of the nature of open market operations.

The Federal Reserve banks, unlike privately managed banks, do not expand their loans and investments merely for the sake of increasing their earnings. Federal Reserve authorities do not reckon a year good or bad in terms of profits. Their object is to maintain a healthy banking system, and beyond that, a healthy and productive economy in so far as these things may be done by monetary means.

It is for the purpose of assuring that the Reserve banks will be operated for this public purpose that their activities in all but local matters have been placed under the control of governmental bodies - responsible to Congress and representing the interests of the country as a whole, including all the various groups of our people, whether they are engaged in agriculture, in trade, in industry, or in banking and finance.

Let me express again my happiness and satisfaction to be with you today. Recent years have tried Montana more severely, perhaps, than has been true of many other parts of the country. Most of its citizens draw their living directly from the ground, and climatic and economic disturbances affect them directly and powerfully. This is just as true, however, on the upswings as on the down. In closing, I can wish for Montana and her people no greater good fortune than that they may soon enjoy production and its returns in a measure that matches their hardihood.

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