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THE FEDERAL RESERVE SYSTEM

The invitation to come here this evening and talk to you about the Federal Reserve System was very gratifying to me. I admire the work of the American Institute of Banking and am pleased when I can associate myself in its activities. The majority of you, I understand, are students in the Institute's courses or may become students. But whether you think of yourselves as bankers or as students of banking, the Federal Reserve System is surely an important subject of interest to you. The System is a matter of daily contact to those banks which are members of it; it influences the conditions under which banks that are not members operate, and it has a bearing on the economic welfare of every person no matter what his work may be.

What is the Federal Reserve System?

From one point of view this question may be answered by saying that it is a system comprising about 6,400 member banks, twelve Federal Reserve Banks, the Board of Governors in Washington, the Federal Open Market Committee, and the Federal Advisory Council. That answer tells what parts the System is made up of - it describes its structure - but gives no idea of the System's purpose or how it functions. The primary purpose of the System is to control and direct, so far as it can, the supply and use of money in a manner that will promote economic stability.

I use the word money in a broad sense to include whatever serves for the purpose of effecting monetary payments. In this broad sense there are two kinds of money. The first is paper currency and coin. The second is bank deposits.

From the standpoint of the individual bank customer these two kinds of money are practically interchangeable. If a person has currency, he can take it to your bank and receive deposit credit on your books in exchange for it. If he has deposit credit he can give you a check and get currency. This process of interchanging the two kinds of money makes up a substantial part of the routine activity of a bank.

Our monetary system is so flexible that people who deal with banks are wholly free to determine for themselves whether they want to make a given payment or purchase with currency or with a check. If they are paying a bill by mail, or if they want a record of the payment, or if the amount is relatively large, they will usually choose to write a check. But for small miscellaneous purchases, they will use currency and coin.

There is at least one important qualification, however, to the interchangeability of currency and deposits so far as reserves are concerned. When a member bank's deposits are reduced by withdrawals of currency which it has to replace by procuring more currency from its Federal Reserve bank and having it charged to its reserve account, the reserves of member banks as a whole are reduced. When, however, a member bank's deposits are reduced by the drawing of checks which are deposited in other banks, the reserves of member banks as a whole are not reduced; there is merely in such a case a shifting of reserves from one bank to another.

The function of supplying currency and coin did not always work as smoothly, automatically, and dependably as it does now. Some of you bankers remember how it was thirty years ago this fall, in the panic of 1907. It made no difference how large your reserve balances were, you could not get all the currency you wanted. The central reserve city banks were then required to keep 25 percent reserves, all of which had to be in cash in their own vaults. There was no means of getting cash quickly or infallibly as there now is. The reserve city banks were afraid that if they paid out the cash which their country correspondents demanded, their reserves would fall far below the legal requirement. Country banks felt that the same thing would happen to their reserves. Banks everywhere hoarded their cash. This made the public's demand for currency still more intense.

It was that experience and others occurring in the panic of 1907 which gave impetus to the formation of the Federal Reserve System, and the provision for currency issue by the Federal Reserve banks. Today, a member bank with <u>sound assets</u> can convert them into currency as promptly as any conceivable demand from its customers makes necessary. It makes no difference whether the demand for currency originates in alarm or whether it originates in sound business activity, the Federal Reserve notes and other money in circulation can readily expand until the demand is met.

The task of supplying this kind of money represented by currency and coin no longer offers any great problems therefore. But when we turn to the other kind of money - namely, that represented by bank deposits - we find a very different situation in almost every respect.

At the present time there are about 15,000 banks in the United States. Suppose that tomorrow morning everyone of these banks receives an application from some one of its customers for a loan of $10,000. That means 15,000 times $10,000 or $150,000,000. Suppose every application is granted and every borrower takes deposit credit for his loan. That means an increase of $150,000,000 in bank deposits that morning. Each bank might deny every other request received, yet the single loans made by each respectively would add up to $150,000,000. This additional amount would immediately be available for making payments and purchases by check.

This enlargement of the supply of the means of payment would have occurred as the result of 15,000 separate decisions: 15,000 bankers would separately and simultaneously have said "yes"; none of the 15,000 would have had any idea of what the others were doing. Yet acting independently, individually, and on the basis of separate and distinct transactions, the banks would have increased by $150,000,000 the aggregate amount of deposit credit transferable by check.

As a matter of fact a loan of $10,000 is too large for many banks and is small for others. Yet in reality bank loans and consequently bank deposits might increase by much more than $150,000,000 in a given day.

A collective movement in the opposite direction would be quite as possible. Suppose the reserves of banks were in general low and that all 15,000 banks said "no" instead of "yes". The result would be that 15,000 bank customers throughout the country would simultaneously fail to get in the aggregate the $150,000,000 they wanted.

I use these figures merely because I wish to indicate emphatically the collective force potential in the independent action of thousands of bankers each acting on his own initiative. Each transaction at each bank seems of importance only to those immediately concerned. Collectively, however, the effects may be very great, especially because there are times when prevailing conditions impel all bankers to take the same general attitude simultaneously.

The Federal Reserve System brings a regulative and compensating force into this situation. It sets up twelve Federal Reserve banks whose operations are in a way reciprocal to those of the member banks. It brings member banks and Federal Reserve banks together into a system whose collective powers are much greater and more effective than the powers of member banks standing alone.

Thus, money in the form of member bank reserves on deposit with the Federal Reserve banks has many times the power of money in other forms. Every increase in the volume of member bank reserves makes possible an increase many times greater in the volume of bank deposits. Every decrease in member bank reserves decreases by many times more the ability of member banks to extend credit. For this reason reserves are often spoken of as high powered money.

This fact that, for example, a billion dollars on deposit with the Reserve banks can serve as a basis for many times that amount of credit is commonly overlooked by bankers who think of their business only from the point of view of the individual institution. From the point of view of the individual banker, it is of course not true that a given increase in his reserves will enable him to extend credit to many times the amount. Only when one considers the banking system as a whole, and gets away from the point of view of the individual banker who realizes that he can only lend what he actually has, is it possible to realize how, in the banking system as a whole, credit can be extended many times in excess of the amount of a given increase in member bank reserves. In other words, the limitation upon the individual banker who runs his bank in competition with other banks is not a limitation that holds for all banks taken together as one great unit.

Before the establishment of the Federal Reserve System there were no institutions performing the essential functions of the Federal Reserve banks. City correspondents performed some of them for their country correspondents, but they were themselves privately managed institutions like other banks - operated for profit, and necessarily bound by the interests of their stockholders and their local customers. They were influenced by the same kind of considerations as their country correspondents, and could not be expected to change their objective and operate - the way the Federal Reserve banks do - as central banking organizations. It is true that from the standpoint of individual member banks, the Federal Reserve banks may be considered as filling much the same place as city correspondents. But beyond the field of direct relations in which the services of Federal Reserve banks and city correspondents are similar, is a broad field in which the Federal Reserve banks are unique. The Federal Reserve System has made possible a consistent and dependable monetary function that previously was not performed. Its purpose is to supply currency and control the volume of member bank reserves. In the discharge of these purposes, it exercises two important powers, namely, the power to discount the paper of member banks and the power to buy and sell obligations in the open market.

The basic fact in the relation between the individual member bank and the Federal Reserve bank is that the member bank is required by law to own stock in the Federal Reserve bank and to maintain its legal reserves with it. The member bank uses this account as a means of procuring currency and clearing and collecting checks, but the real importance of the account lies in the fact that it determines the ability of the member bank to extend credit. When the member banker makes loans or purchases investments, the tendency is for his reserves to be reduced thereby. Consequently he can make extensions of credit only so long as his reserves are up to the required minimum. If he is gaining in his clearings with other banks, or collecting loans, or selling investments, or letting them run off as they mature, his reserves may be maintained while he continues new extensions of credit. But if he cannot maintain adequate reserves by these means, then there is always the Federal Reserve bank from which he may borrow.

I emphasize the word "always". Under Section 13 of the Federal Reserve Act, a Federal Reserve bank may discount commercial, agricultural and industrial paper for a member bank or lend to a member bank on the security of such paper or on the security of government obligations. But extensions of credit by the Federal Reserve bank are not limited to this class of "eligible paper", so-called; for under Section 10(b) of the Federal Reserve Act, the Federal Reserve bank may also lend to a member bank on <u>any</u> satisfactory security. These terms mean that a member bank can always borrow from the Federal Reserve bank, provided only it has good assets to offer as security.

I have just been speaking of Federal Reserve System functions from the point of view of relations between individual member banks and their Federal Reserve banks. I turn now to Federal Reserve System activities that have to be considered from the point of view of member banks collectively - or I might better say, from the point of view of the public's interest.

First, there is the currency function, which is more than a matter of meeting the requirements of individual banks; for by supplying the individual needs of banks the needs of the country as a whole are supplied, and we have a national system serving every one. In itself the function of supplying the public with currency at its convenience and of accepting from it, at its convenience, such surplus currency as it does not for the moment require, is a routine service function. But it is one in which privately managed banks as well as Federal Reserve banks perform a part and upon which the people are dependent for the currency and coin they use.

The Federal Reserve System also performs an important service to the public in facilitating the clearance and collection of checks. This is more than merely a matter of settling items between banks. Checks are a means of payment which the country as a whole uses and depends on. Banks make the use of checks possible, and the Federal Reserve System greatly improves and facilitates that use.

But as I have already indicated, the real importance of the Federal Reserve System does not lie in these familiar activities, but in the power which its discounts and its open market operations give it over the volume of member bank reserves.

The volume of these reserves determines the ability of member banks to extend credit. This volume of reserves is itself subject to the open market policy of the Federal Reserve System. Discounts and loans, as I have indicated, are transactions initiated by individual banks for the replenishment of their reserves. Open market operations are transactions initiated by the Federal Reserve System for the purpose of influencing member bank reserves in general - sometimes increasing them, sometimes decreasing them. When the Federal Reserve banks buy bills and securities, the transaction has the effect of augmenting the reserves of member banks, for the funds with which the securities are purchased find their way into the member banks' reserve accounts. When the Federal Reserve banks sell bills and securities, the transaction has the effect of decreasing member bank reserves, for the funds paid to the Reserve banks for the securities come out of the member banks' reserve accounts.

Since purchases and sales are made in the open market, their effect is general. Some banks will feel a given transaction less directly than other banks, but the effect in any event is to make reserves in the aggregate either more abundant or less abundant. Their effect is general, and they tend to counter-balance those conditions when banks as a whole have insufficient reserves to enable them to meet the requirements of their customers, or when their reserves are large and a tendency to speculative demand for credit develops.

The responsibility involved in the exercise of these powers is obviously very great. It is one thing to receive the application of an individual member bank for funds, to examine the paper which it offers for security, and to grant it the funds which it requires. It is quite another thing to judge the need of banks in general for more funds and to determine upon the extent and nature of the open market purchases to be made in order to supply them with funds. Moreover, the increase or decrease of member bank reserves is not a dollar for dollar increase in the ability of member banks to extend credit. Member bank deposits may, as you know, increase by many times the amount of the given increase in reserves. Consequently, a given increase in reserves resulting from the System's open market purchases enables member banks as a whole to extend credit many times in excess of the reserve increase. Correspondingly, a decrease in reserves which may be brought about by Federal Reserve bank sales of securities in the open market will reduce by an amount many times greater the ability of member banks to extend credit. As a usual thing, the exercise of these powers is not directly felt by the individual member bank. For this reason a banker who judges the functions of the Federal Reserve System from the point of view merely of his routine contacts with it as a source of his currency supply or as a means of check collection and clearance will have a distorted and inadequate idea of the System's services. In other words, the services which are most familiar to the the member bank are those which in reality are of incidental importance beside the function of controlling the volume of member bank reserves and thereby the ability of banks to extend credit and expand deposits.

Under the Federal Reserve System, banking is drawn into one interrelated organization in which such measures can be taken for banking as a whole. The System gives nation-wide unity to the banking and monetary function. It makes possible the application of broad, regulatory, and corrective measures. In doing this the Federal Reserve System has not diminished the importance of the individual bank's position nor of individual relationships. On the contrary, the position of the individual bank has been improved, for as I have said, the Federal Reserve bank is always ready and able to meet the individual banker's needs. That is its business. But aside from this improvement in individual relationships, there has come the addition of a general over-all inter-relationship which knits individual banks for certain essential purposes into one unified system.

I do not mean to imply by this language that all banks are members of the Federal Reserve System, for as you know, they are not. More than half the banks are outside the Federal Reserve System. Yet in common with business and the people and general they share the benefits of the banking and monetary improvements achieved by establishment of the Federal Reserve System. The general welfare is served not only by the better methods of currency distribution and check collection which the System has effected, but by the means of making the supply of bank funds at all times adequate for the requirements of the country. The latter is of universal importance, for economic activity relies on the use of borrowed funds, with the result that people who are not borrowers themselves are nevertheless dependent as employees and as consumers upon the use of borrowed funds by others.

Down on Chestnut Street a short distance from where we are meeting this evening, the labors of the Constitutional Convention were carried on and a hundred and fifty years ago this month those labors were concluded. Their result was the formation of the present union of American states, an event for which we are all profoundly grateful. The Federal Reserve Act is to be regarded, it seems to me, as doing for banking very much the same kind of thing that the Constitution did for our country. It unified forces and interests that were suffering from disunity. It gave strength and consistency to individual institutions whose interests would otherwise at times fall into dangerous conflict. That is the significance of the word "Federal" in the System's name.

A banker who is a student of his profession, as you are, will always have his interest directed upon his institution partly as a unit operating on its own base and partly as a unit in a country-wide monetary mechanism. He will see his bank not alone as a local institution dealing with its own customers, but as one member of a great organization upon which the country depends for its essential monetary needs. To concentrate exclusively upon the internal functions of one's own institution would be like studying the eye or the hand or the heart without reference to the rest of the body.

In your American Institute of Banking courses you have the opportunity to study your institution from this external, social point of view. You learn to what extent your own bank is an independent entity and to what extent it is one element in a country-wide economic instrumentality. And you will see more and more how your individual institutions as members of the Federal Reserve System are essential units in an association of banks for the stabilization and control of the monetary medium with which they operate.

There is no field of social science which offers more to the student than the study of money and banking. The monetary function is a complex one, and perhaps for that reason it is one of the easiest for people to misunderstand. Bankers themselves must study their own business in order to understand it. And by this I mean not merely understanding what goes on in the transit department, the discount department, the credit department, the collection department, the bookkeeping department, and so on: I mean what goes on in the banking world at large as loans and investments rise and fall, as reserves increase and decrease, and as funds move from region to region and from one financial center to another.

The courses in the American Institute of Banking, by developing in the profession a better understanding of these matters, not only make you as individuals more valuable to your various institutions, but make you more responsible members of a profession engaged in functions essential to economic society.

But study is hard. I know what it is like to have to forego relaxation after the day's work at the bank and devote oneself in the evening to text books and classes instead. Yet the sacrifice and the exertion are worth it. Study rounds out the experience that comes from the job. It makes the difference between a hap-hazard, perfunctory command of one's work and an intelligent, comprehensive and vital command of it. As you begin the new season's courses, I wish to assure you of my warm sympathy with your ambitions and my heartiest good wishes for a full harvest of rewards.

And to the American Institute of Banking and the American Bankers Association my most cordial congratulations.