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# THE FEDERAL RESERVE SYSTEM AS A CENTRAL BANKING ORGANIZATION

Because the Federal Reserve System is distinctly American, and, unlike the central banks of Europe, is organized on a regional plan, the term "central banking" has not been very commonly applied to it. But it is an extremely useful term, for it emphasizes the essential fact that the functions of the Federal Reserve Banks are different from those of privately managed banks operated for profit. Too often, it seems to me, consideration of the purposes and activities of the Federal Reserve System is approached from the point of view of resemblances, real and imaginary, between the Federal Reserve Banks and privately managed banks. It would be more instructive to emphasize the differences. Central banking is a matter of regulating the supply and cost of credit. The Federal Reserve Banks are engaged in central banking, and privately managed banks are not.

The term central banking, which does not appear in the Federal Reserve Act, is a relatively new expression. It relates to certain specific functions directed at the money market and performed by the Federal Reserve System under the authority of the Federal Reserve Act. In other countries, similar functions are performed by the Bank of Canada, the Bank of England, the Bank of France, and the German Reichsbank, to use only a few of the many possible examples. In discussions by students, it is especially important that the thing which is being discussed be called by a name which clearly and definitely distinguishes it. I feel that recognition of the fact that the Federal Reserve System performs certain central banking functions is properly the first step to be taken toward an understanding of its essential purposes and activities.

Central banking is a public function. Either by statute or custom, every central bank is subject to a certain amount of control by the government of the country in which it is situated, though not every central bank is government owned. The twelve Federal Reserve Banks, for example, operate under the control of the Board of Governors in Washington, but their capital is supplied by the banks which are members of the Federal Reserve System and is not supplied by the government. The capital of the Bank of England, the Bank of France, and the German Reichsbank is furnished wholly by private interests. In Russia, Finland, Sweden, Australia, and New Zealand the government furnishes the entire capital of the central bank and in numerous countries - Canada, Mexico, Argentina, Guatemala, Bolivia, and others - the government furnishes an important part of the capital.

There is a central banking institution in practically every civilized country. The Bank of England and the Bank of Sweden have been in existence more than two centuries; other central banks are more than a century old; still others have been established only in recent years. The older institutions have evolved into their present position as the result of long experience and custom; the newer ones have been expressly established as central banks by law.

The reason for this difference is that the function of central banking has only gradually emerged over a long period of time. Under the economic conditions that prevailed several centruies ago there was no place for a central banking organization as we know it. The modern banking and credit system itself had not developed. The economy under which nations existed was by our present day standards a very simple one. The same thing is still true in many countries. Their industrial and financial development is such that they have little or no occasion for the services of a central banking institution. It is only where there is a diverse and highly developed economy, as in the United States and Canada, to name only two such countries, that a full and active use of central bank facilities becomes desirable and, indeed, necessary. The Bank of England, which is nearly two hundred and fifty years old, was established before the need for central banking in the modern sense had arisen. It was originally regarded as a private institution, operated for profit, and in competition with other banks. It was distinguished by the fact that it enjoyed certain privileges, made loans to the government, and acted as the fiscal agent of the government. In process of time it assumed in some cases, and in other cases had thrust upon it, the obligation to perform those services for other banks and for the money market as a whole which we now recognize as central banking services. In 1848 a Committee of the House of Commons described it as follows:

> "The Bank is a public institution, possessed of special and exclusive privileges, standing in a peculiar relation to the Government and exercising, from the magnitude of its resources, great influence over the general mercantile and monetary transactions of the country. These circumstances impose upon the Bank the duty of a consideration of the public interest, not indeed enacted or defined by law, but which Parliament in its various transactions with the Bank has always recognized and which the Bank has never disclaimed."

This statement indicates, as I said, that the present position of the Bank of England as a central bank was not determined by law, but gradually developed out of experience and custom. In this country history has been different. Here, as in many other countries, the need for central banking operations was met not by the adaptation of institutions already existing, but by establishment of institutions specially created for the purpose.

Yet it might have been otherwise in this country. If the Bank of the United States, which was established in 1791 when Washington was President and Hamilton was Secretary of the Treasury, had had its existence continued, it would be by now one of the oldest central banks in the world. The Bank of the United States was the fiscal agent for the government; its notes provided a circulating medium amenable to central control; it exercised restraint upon the note issues of the State banks. In these respects it had the beginnings of a central bank. But conditions did not then call for a central bank in the modern sense. In the modern sense, the central bank holds the reserves of the banking system and offers rediscount facilities for the replenishment of reserve balances. There were at that time, however, only a few other banks in the United States and the present day practice of maintaining reserve balances had not developed; with minor exceptions, each bank kept its reserves in its own portfolio and vault. By the same token the Bank of the United States was not generally recognized as an institution to which other banks might send their paper for discount when they needed reserve funds. The Bank was an important buyer of bills, of which there was a relatively large supply, incidental first to foreign trade and later to inland trade, but its purchases were not made, apparently, for the purpos of regulating the money or exchange market. Like those of other banks, they were made for investment and profit. The Bank's acquisition of government obligations, the supply of which was relatively small, were also made primarily for investment and profit. In process of time, however, its operations in bills and government obligations, like those of the Federal Reserve Banks and other modern central banking institutions, would undoubtedly have come to be governed not by the profit motive but by the motive of adjusting the supply of funds in the money market to the needs of sound business.

That the characteristics of a modern central bank were not developed by the Bank of the United States is logical, therefore, in view of the rather primitive economic situation then prevailing in the United States. There were few banks, no large scale production, only rudimentary transportation, and little cash capital. Because there was no occasion in such a situation for a modern central bank, the Bank of the United States was very little differnetiated from other banks. Like them, it not only acquired investments for profit, but made loans to private individuals and held their deposit accounts. In these respects, therefore, it was like the Bank of England and others of the older central banks and unlike our present day Federal Reserve Banks.

The charter of the Bank of the United States was not renewed and in 1811 its existence came to an end. The need of the federal government for a fiscal agency was pressing, however, and five years later in 1816 a second Bank of the United States was chartered. As in the case of the first Bank, this institution was not confined to banking services for the government. It cultivated commercial banking business in competition with other institutions, and this fact was to a considerable extent responsible for the political hostility which eventually brought its career to an end. Because the life of the second Bank extended into a period when national development brought about quite different economic conditions from those that had obtained in the first years of the republic, th second Bank came to perform more prominently those services which we now recognize as central banking services. Like the first Bank, it was fisca agent of the government, it sought to exercise a corrective influence upo American banking practice as a whole, it furnished a uniform circulating medium, it put pressure upon local banks to meet their obligations. During the period the second Bank was in operation under its federal charter namely, from 1817 to 1837, intense and revolutionary changes came about. The population of the country greatly increased, a large number of new states were added to the union, transportation was immensely improved, th corporate form of enterprise with its requirement of a large supply of capital funds, such as could be available only in a money market, became common.

In spite of the great services the Bank performed and the prospects that it might in time have performed still greater ones, it became involved in a bitter political controversy with the President of the United States. Andrew Jackson ordered the federal government's deposits withdrawn and curtailed the Bank's services as fiscal agent. The Bank's charter as a federal institution was not renewed. From that time till 1914, a period of approximately eighty years, this country was without a central banking organization.

I need not remind you how important were the developments within the span of those eight decades separating the second Bank of the United States from the Federal Reserve System. The population increased from 15,000,000 to 100,000,000, the number of states from 25 to 48. The settled area expanded from the Mississippi to the Pacific. Gold was discovered in California. The Civil War was fought. Railway transportation had its beginning and spread over the whole country. The telephone and telegraph, the electric motor, the electric light, and the automobile were originated and became powerful factors in American life. Large scale production methods were worked out. The corporate form of enterprise became dominant in business. Cash capital accumulated and a great money market developed.

It was changes such as these, with their profound effects upon monetary requirement, that made the need of a central banking organization imperative. Without such an organization, there was no one recognized custodian of bank reserves, there was no one recognized lender of last resort capable of cushioning the effect of credit stringency, there was no one recognized authority watchful of untoward tendencies in the field of credit and empowered to put corrective measures into effect.

In the absence of any central banking institution to hold reserves, and in the absence of a system of widespread branch banking, the custom of the correspondent relationship had become established. Under this relationship, which of course still continues though modified in significance since the Federal Reserve Banks were established, banks throughout the country maintained their reserve balances with metropolitan correspondents. These correspondents, relatively few in number and situated mostly in New York City, performed indispensable functions for the banking system as a whole. They supplied currency, they cleared and collected checks, they rediscounted the paper of country banks. But these were not their primary functions as privately managed banks, and there was no public obligation to perform them. As much as they could, the city correspondents met the needs of the rest of the banking system, but they were under four very serious limitations. The first was that they were operated for profit and not as public institutions. The second was that they had the needs of their local non-bank customers to meet, and the needs of these customers were often in conflict with the needs of country banks. The third was that they were under inflexible reserve requirements, which diminished their rediscount powers at the very moment those powers were most needed. The fourth and perhaps most important was that they had no ready rource of reserve credit available to them outside their own vaults; there was no central banking institution to which they could transfer some of their earning assets in exchange for additional reserve funds, and such relief as they could get had to be sought in a feverish and exhausted market. They stood at the end of the line, with their backs to the wall and with the credit needs of the whole country converging upon them.

This was a decidedly unsatisfactory situation. It not only meant, as I have already said, that there was no authority charged with responsibility for maintaining an orderly money market, and that there was no lender of last resort with powers flexible enough to meet both individual and general demands for additional reserve funds; it meant that in fact the public interest involved was left largely in the hands of certain metropolitan banks, whose responsibilities were divided and whose powers were incommensurate with the burden placed on them.

In establishing a central banking organization through the provision of the Federal Reserve Act, Congress departed in important respects from the example of previously existing central banks. The most striking departure lay in creating not a single institution, such as the Bank of England, the Bank of France, the German Reichsbank, or the two former Banks of the United States, but a system of twelve regional institutions, or Federal Reserve Banks, each serving a particular district and coordinated in nation-wide policies through a governing Board in Washington.

Another departure lay in the means of providing capital for the Federal Reserve Banks. Other central banking institutions then in existence usually had their capital provided by the sale of shares to the public. This had also been the case with the two former Banks of the United States and when the second Bank's existence as a federal institution came to an end, the government had had great difficulty in realizing upon its shares. Congress provided that the capital of the twelve Federal Reserve Banks should be supplied wholly by the banks that became members of the Federal Reserve System. But it did not thereby put the member banks in control of the Federal Reserve Banks, in the sense in which ownership of a corporation's stock ordinarily gives control. Congress predetermined the amount of capital to be supplied by the member banks, and forbade the sale, transfer or hypothecation by any member bank of the shares of Federal Reserve Bank stock owned by it. This prevented concentration of ownership by purchase of stock. Congress limited the dividends to 6 per cent per annum, and reserved the Federal Reserve Bank surplus, in the event of liquidation, to the United States. It allowed the member banks to elect six out of nine directors, but required that three of the six directors elected by them represent other lines of business than banking. It authorized the governing Board in Washington to appoint the remaining three directors, designating one as Chairman and another as Deputy Chairman of the bank. It also reserved to the Board a large measure of authority over the management and activities of the twelve regional institutions. Thus it retained control of the twelve Federal Reserve Banks as governmental instrumentalities, but relieved the United States Treasury of the burden of supplying their necessary capital.

Another departure from foreign central banking organization lay in providing that privately managed banks become members of the Federal Reserve System and that as such they be required to maintain their entire legal reserves in the form of a credit on the books of the Federal Reserve Banks. In other countries, reserves were kept with the central bank as a matter of option or custom rather than law and the law did not stipulate so specifically what constituted reserves.

Still another departure lay in specifying the proportion of customers' deposits which member banks must maintain in their reserve accounts. This too was mainly a matter of custom and discretion in other countries.

In the matter of powers and functions, however, as distinguished from form of organization, Congress made little if any departure from the essentials of central banking as elsewhere exercised. First, the Federal Reserve Banks were given the power to rediscount and to purchase obligations. This enables them to perform the primary function of a central banking organization, namely, to release funds to the money market and take in exchange the obligations which are already being carried by privately managed banks and others. This may be done by rediscounting for particular banks which need reserve funds, or by purchasing government securities in the open market and thereby supplying funds to the market in general. This power of the Federal Reserve Banks to act as lenders of last resort is not under such limitations as circumscribe the lending operations of privately managed banks. A privately managed bank is bound to lose reserves in the process of making extensions of credit. If its extension of credit takes the form of purchases of bonds, the funds with which it pays for the bonds come out of its reserves and find their way at least in part to other banks. If its extension of credit takes the form of loans, the borrowed money will sooner or later be checked out, with the result that funds are transferred from its reserves to those of other banks. This must be the case so long as the banking business is divided up among different banks. But a central banking organization does not lose reserves when it makes loans or purchases securities except if the funds it gives in exchange for the obligations it acquires are taken out of the country. Otherwise when the central banking organization - in this case the Federal Reserve System - acquires an obligation, it is paid for by a credit entry to the reserve balance of some member bank. Unless gold is withdrawn for export against that reserve balance, the Federal Reserve Banks, in such a transaction, part with nothing. They have acquired certain assets and in exchange therefor have increased their liabilities.

This ability to exercise the lending function to a degree far beyond what competitive, privately managed banks can do is a peculiar and essential feature of central banks. It is the principal occasion for the existence of central banks. Because of it, privately managed banks and the money market as a whole do not find the sources of additional credit running dry just when funds are needed most. They may find the cost of credit rising, but so long as banks have assets that are discountable or salable the additional credit they require will be provided.

In this connection, it is desirable to comment on the supposed relation between the amount of reserve deposits and the ability of the Federal Reserve Banks to make loans and purchase securities. The idea that the ability of the Reserve Banks to extend credit depends upon the amount of their deposits appears to be based on a fallacious analogy between central banking organizations and privately managed competitive banks. The thought seems to be that a central banking institution is enabled to extend more credit when its deposits increase, because a commercial bank is enabled to extend more credit when its deposits increase. Such considerations are beside the point. The Federal Reserve Banks do not have their power to extend credit enlarged by an increase in reserve requirements, because they already have statutory powers to extend credit independently of the volume of reserve deposits on their books. The purpose of legal reserve requirements is not to give lending power to the Reserve Banks, but to facilitate credit regulation; and the Reserve Banks could have built up their present volume of earning assets without any reserve requirements for member banks at all. Their lending power depends upon the amount of their gold certificates and lawful money, which must be sufficient to provide a reserve of at least 35 percent of their deposits. A Federal Reserve bank, in other words, can expand its deposits by the extension of credit so long as its gold certificate and lawful money reserves are 35 percent or more of its deposits. The gold certificate holdings of the Federal Reserve Banks have long been ample to support credit extensions far beyond what there is any reason to expect will be called for. Accordingly, since the Federal Reserve Banks, as central banking institutions, already have ample powers to buy securities and make loans, there is no occasion to seek an increase in those powers, and if such an occasion existed, the object would not be sought by increasing member bank reserve requirements.

I have discussed the fact that a central banking organization supplies funds to the money market by the processes of rediscount and of securities purchases. I have also indicated that though the central banking organization may advance additional credit as required, it may do so at a higher and higher rediscount rate. In other words, without abandoning its role as lender of last resort, the central banking organization may nevertheless restrain the use of credit by the device of raising its cost. It may also restrain it by the device of selling securities in the open market; for just as central bank purchases of securities put funds in the money market, central bank sales of securities draw funds from the market.

The central banking organization, accordingly, has an active and responsible duty to perform no matter what the situation of the money market may be. It throws its weight in the direction calculated to maintain an adequate supply of credit and an orderly market. It seeks at times to encourage and at times to restrain. For several years now the Federal Reserve System has consistently followed a course of encouragement; and to that end it has lowered discount rates and made large purchases of securities. That is, it has employed the primary and customary means available to a central banking organization in maintaining a policy of monetary ease.

Congress gave two other important functions to the Federal Reserve Banks besides the essential central banking functions - rediscount and open market operations - which I have just discussed. These two others are the currency function and the fiscal agency function. They were originally the primary functions of central banks, and so far as I know they are still performed by the central banks of all countries. Currency issue, in process of time, has become of less relative importance because so large a portion of monetary payments is now made with deposit credit transferred by check. Fiscal agency, however, has become a more important function, with the great growth in the volume of government receipts and expenditures and in the size and complexity of the public debt structure.

A central banking institution is only one of the various instrumentalities and agencies which a wise government will provide for the welfare of its people. It is an important instrumentality, but it can contribute no more than its share in a concentrated effort of all agencies of the government toward the maintenance of economic stability.