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THE FEDERAL RESERVE SYSTEM AND BUSINESS CONDITIONS

Mr. Althaus tells me he thinks you would be interested in having me give you a general idea of what the Federal Reserve System is, as well as a brief indication of business prospects.

The Federal Reserve System is largely concerned with credit. So is your organization. But when you and I use the word "credit", we use it in quite different ways. To you credit means the reliability of your customers. Can you trust them to pay on the first of the month for the goods you let them have today? To us in the Federal Reserve System, the term credit applies to the funds which banks furnish the community either by direct loans or by the purchase of securities. Furthermore, we have a distinction between what we call member bank credit and Federal Reserve bank credit. Member bank credit consists of the funds that are furnished to the community by banks that are members of the Federal Reserve System-that is, by such banks as you carry your accounts with. Federal Reserve Bank credit applies to the funds which Federal Reserve banks supply either by direct loans to member banks or by the purchase of securities. Another distinction is that you are very largely interested in the credit of individuals. The Federal Reserve authorities on the other hand are primarily interested in the aggregate volume of bank credit being used and in the uses to which it is being put. In a broad sense, the credit that you are interested in merges with the credit we are concerned in, but from the point of view of our day to day activities, the two present more differences than resemblances.

Before I tell you more about Federal Reserve functions, let me briefly describe the structure of the Federal Reserve System. The Federal Reserve System comprises both such banks as you and I keep our checking accounts with and also the twelve Federal Reserve banks. About 6,300 banks throughout the United States are members of the Federal Reserve System. They are privately owned and privately managed corporations. Many of them were in operation long before the Federal Reserve System was organized.

These banks that are members of the System are in competition not only with one another but with other banks that do not belong to the System. There are, in fact, more banks outside the Federal Reserve System than there are belonging to it, but the nonmembers, as we call them though very numerous are relatively small. Around 80 or 85 per cent of the banking business of the country is done within the Federal Reserve System.

The country is divided into Federal Reserve districts and each member bank deals with the Federal Reserve bank in its district. Banks here in Washington are in the fifth Federal Reserve district and they deal with the Federal Reserve Bank of Richmond. Each member bank owns stock in its Federal Reserve bank in proportion to its own capital and surplus and maintains its required reserves with its Federal Reserve bank. The twelve Federal Reserve banks perform many services for their member banks and for the public, particularly in providing currency for circulation and in facilitating the clearance and collection of checks. The Federal Reserve banks also act as fiscal agents of the United States Government. They carry the checking accounts of the United States Government and do the servicing of the public debt. This includes handling subscriptions for issues of Government securities, paying interest, redeeming matured issues, and making conversions.

The twelve Federal Reserve banks are regional institutions. Each of them has a board of directors, representing not only the banking interests of the district but its agricultural, industrial and commercial interests as well.

Coordination of the activities of the twelve Federal Reserve banks is effected through the Board of Governors here in Washington. The Board consists of seven members appointed by the President of the United States with the consent of the Senate. The Board, besides co-ordinating and supervising the operation of the Federal Reserve banks, has important regulatory powers as the administrative head of the whole System.

The members of the Board together with five representatives chosen by the twelve Federal Reserve banks constitute the Federal Open Market Committee. This committee directs the open market operations of the Federal Reserve Banks, which I shall explain later.

In order that they may perform their duties properly, the Federal Reserve authorities require all the accurate information they can procure as to the state of banking and business not only in the United States but in the world at large. Such information as relates to banking is secured from examination reports and from reports of condition which member banks themselves submit to the Reserve authorities. Much of the essential financial information required is reflected in the operations of the Federal Reserve banks, for no important monetary trend can fail to manifest itself in one or more of the general accounts on the books of the Federal Reserve banks.

From sources outside the Federal Reserve System, the Federal Reserve authorities draw information as to production, prices, international trade and exchange, domestic trade, pay rolls, and employment. Most of this information is procured in cooperation with other agencies.

Although the Federal Reserve authorities make every reasonable effort to procure such information as will guide them in determining monetary policy, it goes without saying that there are many facts that are inaccessible. Nobody knows how much money is going to be spent by purchasers this spring; nobody knows what the prices of commodities are going to be six months from now; nobody knows exactly how many people are out of jobs at this moment. With respect to all such conditions, approximate and generalized information is the best that can be procured. Moreover, after the information is procured, it is not always possible to determine readily and exactly what course of action it calls for. The parts of our economic life are so closely interrelated and the factors determining it are so numerous that the unexpected is a quite frequent happening. Employment influences production and production influences employment. Demand influences supply and supply influences demand. Political and international conditions affect business and business affects political and international conditions. Causes and effects are interwoven with one another so that the effect produced by one cause becomes itself the cause of other effects.

Bearing in mind these easily recognizable difficulties in the way of interpreting current information so as to determine the proper policy, you will be able to understand under what conditions the Federal Reserve authorities exercise the powers that I now wish briefly to describe.

The first of these is the power to conduct open market operations, which I have already referred to. These are purchases or sales by the Federal Reserve banks of securities and other obligations. They are made not for the purposes of investment or profit but to expand or reduce the volume of funds in the money market. For example, a purchase of several million dollars worth of government obligations has the effect of putting that much money into the market and enlarging the reserves of banks. At times such operations may be called for in order to increase the available supply of credit; at other times they may be called for merely to maintain a stable condition. In a broad sense, the mechanism of these actions is very simple. When you are long on inventory and short on funds, you try to get the public to buy, and that turns your goods into cash. When the banks are long on investments and short on reserves, the Federal Reserve authorities buy securities and that turns the banks' investments into cash reserves.

In recent years the effectiveness of open market operations has been greatly circumscribed by the enormous accumulation of excess reserves of member banks. These excess reserves in turn have resulted from the movement of gold into the United States. Prior to the year 1934, the stock of monetary gold in the United States had never amounted to much more than four and one-half billion dollars. At the present time, it is more than 14 and one-half billion dollars. Over 3 billions of this increase is accounted for by revaluation, but a large part - perhaps the larger part - has come to the United States because of disturbed political and economic conditions elsewhere in the world. It has taken refuge here. It did not come because it was needed and it so far exceeds the requirements of the economic life of our people as to create a serious problem. More than one half of the monetary gold in the world is now in our possession. We have far more than we need and other countries have less than they need.

The effectiveness of any action that the Federal Reserve authorities may take is conditioned by the presence of these enormous reserves. Member banks now have reserve balances with the Federal Reserve banks of 9 billion dollars. Of this about 5 and one-half billions represent required reserves and 3 and one-half represent excess reserves. Purchases of securities by the Federal Reserve banks tend to maintain or increase this excess. On the other hand, since the Federal Reserve banks own only about 2 and one-half billion of securities, it is obvious that if they sold the whole amount it would no where near absorb the excess.

Another important power of the Federal Reserve authorities is that of discount. When a member bank needs additional reserve funds it may borrow them from its Federal Reserve bank. There have been times in the past when member banks borrowed very heavily from the Federal Reserve bank. There have been times in the past when member banks borrowed very heavily from the Federal Reserve banks, but under present conditions, as I have just described them, member banks in general have such a large volume of excess reserves that there is little occasion for them to borrow.

At times when there is an active demand for credit, the power of the Federal Reserve authorities to set the discount rate may be of considerable importance; a higher or lower rate will, of course, tend to influence the amount of borrowing. In recent years, the discount rates of the Federal Reserve banks have been extremely low. At present they range from 1 to 2 per cent. These are the rates at which member banks may borrow from the Federal Reserve banks; they are not, you understand, rates on borrowing in general.

The monetary policies of the Federal Reserve authorities are one of many important factors which help to make any given business situation what it is. Not one of these factors can be neglected; not one of them can be depended upon to accomplish all that is desired. In recent years, the Federal Reserve authorities have pursued what is called an easy money policy. They have endeavored to maintain such credit conditions as would be most favorable for active business and increased employment.

The economic prospects, so far as we can see them, are reasonably encouraging at the present time. A year ago activity and prices had been declining for several months, but we had not reached the end of the decline. Quite naturally, therefore, many people were wondering whether the decline was to be another long depression like the one which began in 1929. Now, however, we have seen not only a slowing down in the decline during the first half of 1938, but a sharp advance in business generally during the second half of the year.

Total income payments are about the same now as they were at the end of 1937, and only 6 per cent below the peak reached in the middle of that year. Pay rolls have risen sharply since midsummer but are still substantially below the 1937 peak, while payments for work relief are higher.

In industrial concerns, volume of output has been at a fairly high level for three months now. Since the beginning of the year there has not been the usual seasonal increase and the Board's adjusted index has declined somewhat but is still about 25 per cent higher than a year ago. This, of course, is an encouraging sign. There was in 1937-1938 less decline in nondurable manufactures such as textiles and shoes than in durable goods, and their output in the past few months has been nearly as great as the peak level reached in 1937. Output of durable goods such as steel and automobiles has shown sharp recovery since midsummer but is still considerably below the high level reached in 1937. Steel output last week was 53 per cent of capacity and the average so far in February is 53 per cent as compared with 31 per cent in the corresponding period of last year. Automobile assemblies are now around 84,500 a week and they were about 55,000 during the first part of February, 1938.

In building construction there has been a sharp reversal in movements during the past year. Residential building was declining in the latter part of 1937 and with incomes being reduced, many thought there would be a further reduction in 1938, but instead with prices of materials reduced and with down payments and current financing charges materially lowered early in 1938 by amendments to the Federal Housing Act, there was a more than seasonal increase in the spring and currently contracts for private work of this type are double those of a year ago. Also, contracts on projects of the United States Housing Authority are now being awarded in increasing volume.

Nonresidential construction shows a marked rise in public works contracts. By the end of 1938, when all projects had to be under way, work had been started on PWA projects to cost 1 billion 600 million dollars and to be substantially completed by July, 1940. A large part, but of course not all of this, represents an increase over a year ago when many of the projects started under earlier programs were being completed. There is, however, a continued low level of contracts for factories, commercial building, and other private nonresidential building.

In domestic retail trade, there was little decline until the end of 1937, except for automobiles and house furnishings; since midsummer there has been a sharp increase and the current level in most lines is about the same as a year ago. Department stores' sales by dollar volume have been about the same as a year ago with prices somewhat lower. Mail order sales and sales at variety stores are about the same as at the end of 1937, but retail automobile sales in the month of January, 1939 were above the sales of a year ago.

In foreign trade, during the month of December, the exports on a value basis were lower than a year ago by about seventeen per cent and imports were lower than a year ago by about eighteen per cent. Export trade decline is less than anticipated in some quarters and import decline stopped soon after industrial recovery in this country began in 1938. Excess of exports is still unusually large and is around 100 million dollars per month.

Inventories of consumers' goods dropped considerably by the middle of 1938, after a long period with trade reduced only moderately, while production was sharply curtailed. Inventories in other lines are also reduced and improvement in the inventory position generally contributed much to the rise in orders and activity in the middle of 1938. Currently stocks are substantially lower than at the end of 1937, but information is not available to indicate just how much lower. At department stores dollar volume of stocks is about 8 per cent smaller than a year ago.

Commodity prices in general are moderately lower than a year ago and the index is 77 per cent of the 1926 average as against 81 per cent in January, 1938. There was a decline in commodity prices in the early part of 1938 and since the end of September there has been some further decrease in the general index. Some industrial materials currently are about the same as a year ago after a marked rise in the middle of 1938. Agricultural products are lower than a year ago owing partly to increased carryovers, ample crops and also owing to increased supplies of livestock and dairy products.

Including Government payments, farm income is estimated at 7 billion 632 million dollars for the calendar year 1938. This is down by one billion dollars from 1937, which was the highest since 1929.

On the whole, therefore, there are signs of improvement. Of course, I do not wish to darken the picture by going over the things which must prevent us from being too optimistic. You know well enough just what they are, but I should like to emphasize the fact that just as the Federal Reserve authorities cannot lay claim to having brought about the improvement mentioned through their sole effort, so also they can give no assurance that their policies only will make this improvement continue. Within the province of monetary matters, the Federal Reserve authorities have as their objective to maintain as favorable conditions as they can and business need feel no fear that sound and healthy activity will find any lack of the bank credit necessary to support it.