# SPEECHES OF

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WASHINGTON, D. C.

RELATING TO

# THE BANKING ACT OF 1935

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THE BANKING ACT OF 1935

It is the policy of the Federal Reserve Board not to have its individual Members speak publicly except when to speak publicly is a duty in the interest of furthering the purposes for which the Federal Reserve System was created. That policy is also my personal policy adopted firmly when I became a Member of the Federal Reserve Board two years ago. I take it, therefore, that it is my duty to speak here publicly on the subject of the Banking Act of 1935. It is, of course, a pleasure for me to see you and be with you.

Let me state at the outset that I speak here not for Governor Eccles, nor for the Federal Reserve Board - I speak only for myself. I did not write, nor did I help write the Banking Act of 1935. I shall therefore make no attempt to discuss the philosophy of the Act. However, I studied the bill with its specific amendments, and after a complete study of these, I expressed my opinion to the Senate Subcommittee of the Banking and Currency Committee on last Monday - June 3rd, 1935.

I said that it is essential to preserve our regional Federal Reserve System, which consists of twelve Federal Reserve banks with nine directors in each Bank, together with a Federal Reserve Board in Washington. In this particular respect, our System is different from that of most countries because of our extensive area, and because of our political and economic structure of states and districts - based upon industrial, agricultural, commercial and financial conditions and needs which are widely different in the various parts of the United States. The System is composed of separate essential parts. These parts, however, must be cohesive for the best functioning of the System.

To make for an efficient administration of the Act by the System and to arrive at the purposes for which the Act was passed by Congress, it appears necessary for the Federal Reserve Board to have a more direct contact with the various sections of our extensive area.

To be effective, the whole Federal Reserve System must be one. This end is not difficult to attain: personal contact of the members of the Board with the directors of the twelve Federal Reserve banks seems one of the best direct avenues.

"Bank powers of the boards of directors of the twelve Federal Reserve banks should be retained, and in some respects, increased and extended, at least by regulation of the Federal Reserve Board.

While, of course, it is sound to have the Federal Reserve Board and its principal offices in Washington, and while it is sound for the Board to hold its meetings in the capital because of the national scope of its considerations, yet it would be desirable from a practical standpoint for the Federal Reserve Board to meet at least four times a year in at least four parts of the country - the East, West, North and South - to meet with and understand better the directors of the Federal Reserve banks and their officers, as well as the conditions and needs of commerce, industry, agriculture and finance in the respective Districts. It would also seem wise to provide by law that each Member of the Board should be assigned by the Federal Reserve Board to the task of keeping himself especially familiar with conditions in at least two of the Federal Reserve Districts each year, in order that he might act as a liaison officer between the Federal Reserve banks, their directors and officers, the representatives of commerce, industry, agriculture and finance, on the one hand, and the Federal Reserve Board in Washington, on the other hand. Provision could be made to have Members of the Board rotate in their District assignments, so that eventually each Member of the Board would have covered by direct contact all of the sections of the country and would know their needs thoroughly. Without this, it is next to impossible for the Board Members to appreciate fully the needs and requirements of the Federal Reserve banks and of the country as a whole; without this, the Federal Reserve Board inclines too much to theory and bureaucracy; and without this there is bound to be misunderstanding between the Federal Reserve banks and the Federal Reserve Board leading to differences of opinion on authority; and without this a cry is heard on the one hand that the private interests wish to control the System and direct its operations for their own selfish purposes; and that on the other hand, political interests wish to control the System and direct its operation in accordance with their own political ambitions.

Members of the Board, when assigned by the Board to several districts, would keep personally in touch with the boards of directors and the officers of the Federal Reserve banks in those districts. They would thus become familiar with the management of such Federal Reserve banks, with their viewpoints, and with the problems of their districts. They would also know men in the industrial, commercial, agricultural and financial fields of the districts. They would not be compelled to depend entirely on the Board's staff for information having to do with the internal management of the banks, as well as with the general agricultural, commercial, industrial and financial and banking conditions of the districts; thus there would be a better opportunity for sound and practical rulings of the Board on all questions when they are presented by the banks to the Federal Reserve Board under the law. It is specifically stated in the Act that the Federal Reserve Board has general supervisory responsibilities, but in order to supervise, one must be in direct contact with those supervised. Otherwise, one is compelled to act upon information obtained from other sources.

Of course, in all cases, the Board, as a whole, would act officially on all these matters, but the Board would have the benefit of the information obtained by the individual Member assigned to the specific district.

It would also seem desirable to have the boards of directors of the Federal Reserve banks meet once every year with the Federal Reserve Board in Washington, or if this could not be accomplished with the directors who are farther removed from Washington, the Federal Reserve Board could arrange to meet them at a point more accessible at least once every two years to discuss frankly and completely matters pertaining to the operation of their banks and the conditions in their districts, as well as problems of a national character.

The execution of many of the powers vested in the Federal Reserve Board could, under the provisions of the Banking Act of 1935, be decentralized under regulations of the Federal Reserve Board so that they could be carried into effect by the Federal Reserve banks without the reference of many individual matters to Washington, and thus obtain desirable and effective administration. This will be facilitated by the provision in the bill authorizing the Board to delegate its powers to individual Members or other representatives. To make for a constancy and a permanency of the work of the Board by its individual Board Members, I recommend that there be a specific requirement in the law that the Board assign its work to individual Board Members, each Board Member to have a specific task assigned on which he is to specialize and through which he is to keep in touch with the Federal Reserve banks and the country, and on which he is to report to the Federal Reserve Board with recommendations. This seems to me to be very important, from the standpoint of good administration. This bill provides for that generally.

On the other hand, it has been my experience that the Federal Reserve Board does not wish to, nor should it, assume any more powers than it can properly use for the effective administration of the System, and whenever powers are granted to the Federal Reserve Board having to do with matters that could be handled better by the directors and officers of the Federal Reserve banks, the Federal Reserve Board should be able to give the twelve Federal Reserve banks the power of determination of many important matters.

It is good organization for the Federal Reserve Board to recognize this fact and to avail itself of the commercial, agricultural, industrial and financial experience of the directors of the twelve Federal Reserve banks, as well as the technical and banking experience of their officers, who are the vehicles through which the policies of the System are executed.

There are many powers now in the Federal Reserve Board, however, which in my opinion should be placed, now or later, in the regional Federal Reserve banks. This would expand the authority and responsibility of the directors of each Federal Reserve bank and make for more prompt and efficient administration of the Federal Reserve System. The general supervision should be retained, but the direct and ultimate action in these matters should be taken by the directors and officers of the Federal Reserve banks.

The detailed matters which might be delegated to the Federal Reserve banks (or the Federal Reserve Agents, if their offices are not abolished) include the following:

1. Admission of State banks to membership in the Federal Reserve System.

2. Expulsion of such banks from membership for violations of the law or the Board's regulations.

3. Waiver of six months' notice of voluntary withdrawal of State banks from membership.

4. The granting of voting permits to holding company affiliates of member banks.

5. The revocation of voting permits for violations of the law or the regulations.

6. The issuance and revocation of permits authorizing officers, directors and employees of member banks to serve not more than two other banks (if the provision for individual permits is not repealed as proposed in the bill).

7. The issuance and revocation of permits for officers, directors and managers of security companies to serve as officers and directors of member banks (if the provision for individual permits is not repealed as proposed in the bill).

8. The granting of trust powers to national banks.

9. The cancellation of such powers at the request of national banks.

10. Approval of reduction of capital stock by national banks (if the requirement of the Board's approval is not repealed as proposed in the bill).

11. The granting or permission for member banks to invest amounts exceeding their capital stock in bank premises or in the stock of corporations holding their bank premises.

12. The approval of the establishment of branches by State member banks (if this power is transferred from the Comptroller of the Currency as proposed in the bill).

13. Authorizing national banks to establish foreign branches.

14. Authorizing national banks to invest in the stock of banks or corporations principally engaged in international or foreign banking.

15. Permitting interlocking directorates between member banks and foreign banking corporations in which they own stock.

16. Approval of compensation of officers and employees of Federal Reserve banks.

In addition to the above, where action by the Board is required under the law, numerous matters are presented to the Board for consideration in connection with banking supervision and requiring action on individual cases; for example, reductions of capital stock of State member banks, consolidations of State member banks with other banks, and whether or not individual banks should increase the amount of their capital and surplus in relation to their deposit liabilities. In some cases of this character, the Board has already authorized the Federal Reserve Agents to act on its behalf in the individual cases within certain prescribed limitations.

Some, or perhaps all, of the powers enumerated above, and perhaps others too, it seems to me, should be vested directly and ultimately in the Federal Reserve banks. This would make for efficiency and good relations between the Federal Reserve Board and the Federal Reserve banks.

It is quite natural that the Federal Reserve banks know more about that subject-matter because they are directly and constantly in contact with it. It is also natural, however, that the Federal Reserve Board should supervise and coordinate and bring to the attention of the Federal Reserve banks any incorrect or improper administration of these powers. This would make for unity.

I also stated that:

I can understand that this Banking Act offers much opportunity for extreme interpretation. However, with the amendments offered, it seems to me to meet existing conditions and to serve a definite purpose without being extreme in either direction. It deserves at least having each section considered on its merits. It seems to serve the definite purpose of a better administration of the Federal Reserve Act.

Now to proceed, I have been taught that to know a thing one must know the parts of which it is composed. Let us, therefore, take this bill apart and look at the parts separately.

Section 202 of the Banking Act of 1935 is related to a section in the Banking Act of 1933, which provides that all insured nonmember banks shall become members of the Federal Reserve System by July, 1937. This provision of the Act of 1933 was repealed in the House bill, but it should be restored because it is of great importance that all banks which are insured be subject to Federal supervision. It is a step in the direction of unification of bank supervision which is an essential to the proper discharge of the responsibilities of both the Federal Deposit Insurance Corporation and the Federal Reserve System.

It has been said that the provision for giving the Board authority to waive requirements for admission under this bill would lower the standards of the Federal Reserve System and that it might be better to retain those standards and have the Federal Deposit Insurance Corporation bring the banks up to the standard before they are admitted. The weakness of this argument is in the fact that the Federal Reserve banks and member banks are affected by conditions that develop in nonmember banks. An unsound banking situation affects the entire community, and since the Federal Reserve System has to stand the consequences of unsoundness in nonmember banks, it should have authority to admit all insured banks and gradually to bring them up to its standard.

The suggestion that has been made that banks with deposits of less than $500,000 be permitted to remain outside of the System, even though they are insured, may be a reasonable compromise because it would bring into the Federal Reserve System about 97 percent of all the deposits and would leave outside only such small banks as may find it difficult to earn expenses without charging for exchange, which the Federal Reserve System does not permit. This compromise would also provide for keeping within the System banks with $500,000 or more of deposits that are now members. It would no doubt be better to have all the banks come into the System, but the compromise would be an important step in that direction and would appear to be the minimum of what ought to be required at this time.

Section 203 of the proposed bill provides that members of the Federal Reserve Board shall be persons well qualified by education or experience, or both, to participate in the formulation of national economic and monetary policies. This is a change from the existing requirement of law which reads: "In selecting the six appointive members of the Federal Reserve Board . . . the President shall have due regard to a fair representation of the financial, agricultural, industrial and commercial interests and geographic divisions of the country." This enumeration of interests does not give the President any definite directions and does not appear to be the proper principle on which Board members should be selected. It would seem that they should be selected on the basis of their qualifications to perform the functions that the Board is required to perform rather than on the basis of representing certain interests. The worst composition of a Board would be in the nature of a group of representatives of special interests who might be at odds with each other. It is vastly better to say that Board members shall be qualified to do their work. While this is not a guarantee of the appointment of efficient Board members, it may exert an influence in that direction and make it difficult to appoint persons without appropriate training or experience.

It has been said that under the proposed bill the President will have the power to appoint all the members of the Board from one district, but there is nothing in the bill to justify this statement. The requirement that not more than one member be from the same district is retained, with only the exception that it need not apply to the Governor of the Board. The reason for that is that the President ought not to be prevented from appointing as Governor a man preeminently qualified for the position, merely because some other member of the Board may be from the same district.

While it would seem that the proposed qualifications of Board members are desirable, it might be wise in addition to provide that at least two of them shall have had experience as executive officers in a Federal Reserve bank or a commercial bank. There was a provision requiring two trained bankers in the original act, but it was repealed in 1923. In view of the necessity of deciding many technical banking problems, and particularly technical Federal Reserve Banking problems, it might be a useful indication to the President to say that at least two members shall have had that background. It may also be desirable to say that the Board members shall be qualified by education or experience to participate in the formulation of national economic, monetary and banking policies. The addition of the words "and banking" would be a recognition of the numerous duties of the Federal Reserve Board that deal with technical banking problems and of the general responsibility of the Board for doing what it can to maintain sound banking conditions.

There has been a good deal of criticism of the provisions relating to the position of the Governor of the Federal Reserve Board. This criticism has been directed at provisions that exist in the present law as much as at those in the proposed bill. The President always has had the power to designate a member of the Board as Governor and to terminate this designation. In drafting the bill this power of terminating the designation has been stated a little more clearly. In the bill as originally introduced the President was given the power to remove the

Governor not only from the Governorship, but also from membership on the Board. This has been changed in the bill as it passed the House, a change which would seem to be desirable. In the form in which the bill passed the House there is no increase of the power of the President over the Governor of the Board, and the only change in the matter is that a Governor, who resigns, upon not being redesignated as Governor, would not be obliged to stay out of the banking business for two years, but would be permitted to resume it at once. This is desirable in the interest of obtaining successful men from the banking field as Governors of the Federal Reserve Board.

In view of all the outcry against the proposed increase of political domination of the Federal Reserve System, it is worth repeating that the provision about the Governor in the bill as originally introduced was the only shadow of an excuse for this criticism, and that with the elimination of this provision, which was not intended to increase political power, but could be so interpreted, there is nothing in the bill that in any way increases the power of the Administration over the Federal Reserve Board. There is, on the other hand, a great deal that increases the Board's independence - increased salaries, retirement allowances, definition of qualifications, with other amendments offered such as: removal only by impeachment, appointment for a term longer than 12 years. All these and others add to the possibilities of having an independent Board in law as well as in fact. In addition to that the Board is given a definite objective, and this increases the Board's power to resist political pressure because this pressure is likely to be exercised in a direction that is not consistent with the objective to be prescribed by law as a guide to Federal Reserve policy. Other very good amendments to make the Board independent in law have been offered to the Senate Sub-committee.

All of the Federal Reserve Board members have testified before the Senate Sub-committee of the Banking and Currency Committee. Certainly no one can say that they did not show independence.

Section 204a of the Banking Act of 1935 provides that the Federal Reserve Board may assign to its members or its representatives the performance of such of its duties as do not involve the formulation of national policies. On the face of it this is a minor provision, but it has important consequences, because it will enable the Board to be relieved of a large amount of routine duties which do not permit it to give its entire time to the study of economic conditions and the formulation of credit policies. It is expected that this provision would help to make the Board more of a policy making body and less of an administrative organization. It will also enable the Board to delegate duties to the Reserve banks and thus to increase their responsibility and independence in local matters.

Section 204b of the Banking Act of 1935 provides the objective towards which the powers of the Federal Reserve Board shall be used. This objective reads as follows: "It shall be the duty of the Federal Reserve Board to exercise such powers as it possesses in such manner as to promote conditions conducive to business stability and to mitigate by its influence unstabilizing fluctuations in the general level of production, trade, prices, and employment, so far as may be possible within the scope of monetary action and credit administration."

I recommended the striking out of the following:

"to promote conditions conducive to business stability and"

The wording of this objective is not necessarily the best that can be devised. The general purpose of it, however is clearly in line with what every other central bank does, what the more recent ones are being required to do by their charters, and what the Federal Reserve System has tried to do without specific legislative direction. The criticism that has been made of this objective has been entirely unjustified. There is nothing in it that will give the Board any power to limit the amount of credit to be extended to any one industry or to expand it for another industry. The authority of the Board over the loaning activities of the member banks will not be in any way affected. The objective is merely a statement of a direction by Congress that the Federal Reserve Board must do what can be done through its powers towards bringing about a sounder and more stable condition of business. It has also been suggested that the objective should be modified to read: "It shall be the duty of the Federal Reserve Board to exercise such powers as it possesses to aid in the maintenance of sound banking conditions and business stability and to mitigate by its influence injurious fluctuations in the general level of production, trade, prices, and employment, so far as may be possible within the scope of monetary action and credit administration." The purpose of this change is to introduce into the objective the requirement that the Federal Reserve System shall work towards sound banking conditions as well as towards business stability. This has always been one of the functions of the System, and while it would be understood to continue to be one without being included in the objective, it should be stated explicitly.

Section 205 of the Banking Act of 1935 provides for giving the Federal Reserve Board full authority over open-market operations after consultation with a committee of five governors of the Federal Reserve banks, elected by the twelve governors. This provision has been subjected to severe criticism on the ground that it increases the powers of the Board as against the powers of the Reserve banks. It is true that this proposal adds open-market operations to the instruments of monetary policy, which are now possessed by the Federal Reserve Board. This is done on the theory that the three principal instruments; namely, raising or lowering of the discount rate, changes in reserve requirements, and open-market operations should all be in one body that is clearly defined and that has inescapable responsibility for the policies it adopts.

There has been criticism of this provision on the ground that the Federal Reserve Board, which has no financial interest in the Reserve banks, will by this provision acquire control over their funds. This would seem to be a good argument for those who advocate having the Government buy the stock in the Federal Reserve banks. It could be argued that, if an investment of $146,000,000 with an assured 6 per cent return entitles the member banks to have a dominant say in the formulation of national monetary policies, then the only rational conclusion would be that they must not be permitted to hold the stock.

While this is not my argument, nor am I using it, it is nevertheless an argument that is used by those who advocate the Government purchasing the stock in the Federal Reserve banks from the member banks.

At the time the Federal Reserve Act was enacted, the conception of money was largely limited to currency, and over currency the Federal Reserve Board was given complete control. This conception has since had to be expanded to include bank deposits as money, and the Board's power to regulate the volume of deposits is in harmony with its power over currency issues. The fact is that it was intended in 1933 to give the Board this power, but in the course of legislation the section dealing with this matter was distorted and there was created what appears to be an impossible situation where the governors on the Open Market Committee are the only ones who can initiate an open-market policy. The Board has the power to approve or disapprove of the policy, and the policy after having been recommended by the governors and approved by the Board may still be nullified by refusal of the directors of the Reserve banks to participate in its execution. At present the following are included in the open-market operations of the Federal Reserve System:

1) The twelve Governors of the twelve Federal Reserve Banks
2) The eight Federal Reserve Board Members at Washington
3) The 108 directors in each of the twelve different Federal Reserve banks of the country.

In a matter which is of vital national importance and in which timeliness and speed may be decisive, it is obviously undesirable to have a complicated machinery calculated to bring about delay; it is better to have a clear-cut fixation of responsibility on a national body appointed for that purpose.

There has been criticism on the ground that this bill would give the Board the right to authorize or even compel the Reserve banks to buy obligations directly from the United States Government. That is another line of criticism that is not in any way related to the bill. There is nothing in the bill that changes the situation in this respect. The power to buy directly from the Government now exists: it has been used regularly but never for extended periods. There is nothing in the proposed bill that would change the legal situation in this respect. If the critics wish to prohibit direct borrowing, they should offer an amendment to the Federal Reserve Act to that effect.

It is generally assumed that the Federal Reserve Board is responsible for open-market policies. Few people, even today, are aware of the fact that the present Open Market Committee consists of twelve men who represent the twelve Federal Reserve banks, and that the Federal Reserve Board merely approves or disapproves, but does not initiate open-market policies. Few people also realize that each Federal Reserve bank has the right to refuse to participate in an open-market operation after it has been adopted by the twelve Governors and approved by the Federal Reserve Board. It may be contended that the Federal Reserve Board should not have this power because it is in Washington - the Government's capital - and because its members are appointed by the President with the advice and consent of the Senate. It may be said that political pressure might be used against the Board and that the Board might be influenced by such pressure in its monetary control. On the other hand, it is argued that the Governors are appointed by the directors of the Federal Reserve banks, six of whom are elected by member banks, private interests, and that such Governors may be guided in determining open-market policies by the private interests of the member banks, and not by national needs and requirements of the country. Both views are most extreme. Authority must be vested where responsibility rests. That is logical. Since open-market policy is a national question, authority as well as responsibility for this policy should be located in one place, and in the Federal Reserve Board, which is a national body. This seems to be in the essence of the purposes of a Federal Reserve Board. This seeme to be the surest way of establishing the fact whether the System or the Board is, or is not, functioning in accordance with the purposes for which it was created. It removes the opportunity for excuses.

Of course, the Board would feel that its own research organization should be extended and strengthened and given more active functions to perform and the membership of the Board would feel the need of keeping more closely in touch with current developments which might affect open-market policy and the interpretation thereof, but the Board would be in far better position to determine when and in what circumstances to initiate an open-market policy on the basis of a coordinated view of all the factors entering into the monetary situation - reserve requirements, discount rates, lendings of member banks, the Government's fiscal policies, etc., - and could take action promptly on its own responsibility in whatever direction seemed best to meet the needs of the situation at the time.

However, to make the parts of the System more cohesive a provision might be made for a sufficient representation of the Regional Banks on this committee for the sake of unity in the System so long as the tendency is in the direction of making the System one and not two.

In the interest of unity, the Open Market Committee might consist of the six appointive Members of the Board and five Governors - and five Governors are to be designated by the twelve Governors of the twelve Federal Reserve banks and to be chosen from five sections of the country - namely - the North, South, East, Middle West and the Far West. While the Secretary of the Treasury and the Comptroller of the Currency might continue as Members of the Board they should have no vote on Open Market Committee policies. Their membership on the Federal Reserve Board is valuable in many respects, especially at this time, but the Act might provide that they have no power of a vote on open market operations, but might be called by the Open Market Committee for information that the Committee might wish to have the consideration of adopting open market policies. I so testified before the Senate Subcommittee last Monday.

Section 206 of the Banking Act of 1935 relates to eligibility of paper for discount at the Reserve banks. In place of elaborately defined and restrictive rules prescribed by law about the character and maturity of paper available for discount, the bill proposes to give power to the Reserve Board to prescribe by regulation the kind of commercial, agricultural and industrial paper that will be eligible for rediscount by a member bank with the Reserve banks and also authorizes a Federal Reserve bank, subject to the Board's regulations, to make advances to any member bank on a promissory note secured by any sound asset of such member bank.

This proposal in some respects represents the greatest departure in the bill from the conceptions that prevailed at the time that the Federal Reserve Act was adopted in 1913. Even though there is considerable merit to this amendment, yet because it is so radical a departure from the Federal Reserve Act as originally written, and because it affords an element that might tend toward an extreme, which perhaps would be undesirable, I made the following recommendation to the Senate Sub-committee:

"Notwithstanding any other provision of law, when it deems it in the public interest, a Federal Reserve bank may recommend, and by an affirmative vote of not less than five of its appointive Members, the Federal Reserve Board may authorize any Federal Reserve bank, for limited periods to be recommended by the Federal Reserve bank and prescribed by the Board, but which may be extended by the Board from time to time upon application of the Federal Reserve bank, to make advances to member banks which have no further eligible and acceptable assets available to enable them to obtain adequate credit accommodations through rediscounting at the Federal Reserve bank or by any other method provided by this Act. Such advances may be made on the promissory notes of such member banks secured to the satisfaction of the Federal Reserve bank, and shall be subject to such regulations and shall bear such rates of interest as may be prescribed from time to time by the Federal Reserve Board upon recommendation of the Federal Reserve bank." My recommendation places in the Federal Reserve banks the power of making the request.

Section 208 of the Banking Act of 1935 deals with the question of collateral against Federal Reserve notes. It follows the example of practically all central banks, except the Bank of England, in providing that all the assets of the Federal Reserve banks shall be the collateral back of all of its liabilities. The segregation of collateral against notes has not served a useful purpose and so far as one can predict never will, because it becomes restrictive only at a time when restriction is harmful and does not in any way restrict at a time when restriction may be desirable. It has, therefore, a perverse restrictive effect. The reason for that is that at a time when credit expansion is proceeding at a rapid rate there is plenty of commercial paper available as collateral, because the banks are borrowing heavily from the Reserve banks. Therefore, collateral requirements do not restrict. At a time, however, when the Reserve banks are pursuing a liberal policy of purchases in the open market, in order to prevent deflation, as was the case in 1931, a point is soon reached where there is a shortage of collateral and gold has to be impounded back of Federal Reserve notes, and then the deflationary process is aggravated by technical restrictions on the Reserve banks. That is exactly what had happened prior to February 1932, when the Congress had to adopt the Glass-Steagall Act which permitted temporarily the use of Government securities as collateral against Federal Reserve notes. Collateral requirements against Federal Reserve notes should be abolished. If it is the wish of Congress to restrict the amount of Government securities that Federal Reserve banks may purchase, that should be done directly, as is done in some of the foreign central banks. To aim at it through indirection by requiring commercial collateral or gold against Federal Reserve notes works at the wrong time and in the wrong circumstances. It does not protect the Reserve bank against excessive holdings of Government securities, and does prevent them from doing their share in fighting a deflationary movement.

Section 209 of the Banking Act of 1935 clarifies the power of the Reserve Board to raise or lower reserve requirements of member banks. This power was granted to the Reserve banks under the Thomas amendment to the Agricultural Adjustment Act of 1933, but under the provisions of that act the Reserve banks can change reserve requirements only when the President proclaims an emergency and gives his approval to the action. To proclaim an emergency in banking, as Mr. Owen D. Young said the other day, is to bring about an emergency. It should not be necessary to proclaim one. It is, therefore, best to give the Board authority in the matter and to make that authority as elastic as possible by permitting changes in reserve requirements in financial centers alone when a speculative situation may develop there without having developed in the country districts.

Fantastic interpretations of this reserve requirement provision have been made by opponents. Some believe that this is a move to establish a 100 percent reserve plan without direct authorization by Congress. A 100 percent reserve plan is an absolute impossibility without a very large amount of readjustment in a great many lines of banking legislation and the danger of it being introduced surreptitiously by this provision is purely imaginary. Limitations on the extent to which the Reserve Board could raise or lower these requirements may be devised and have been proposed. I feel that some ceiling should be established. It would be reassuring.

On March 4, 1935 the demand plus time deposits, calculated in accordance with the provisions of Section 324 of House Bill 7617, were approximately twenty-nine billion, five hundred million dollars. If the maximum limitation were fixed at, say 25%, the required reserve would work out at about seven billion, four hundred million dollars, which is about five and one-half billion dollars more than the existing reserve requirements.

Others feel it would be better to have no such limitations, however, because in the face of the enormous possibilities of expansion on the basis of existing excess reserves and potential additions to them, the amount by which reserve requirements may have to be raised to combat inflation is hard to predict. It may be best to leave the matter flexible in the hands of the Federal Reserve Board. My position is clear - I prefer a formula of some kind, or at least a ceiling.

There has also been the theory expressed that through this method of increasing reserves the Reserve Board may acquire the power to tell the member banks how to invest their deposits. This statement is based on a complete misunderstanding of our financial mechanism. Take, for example, the present situation. The member banks have about $2,400,000,000 of excess reserves. If the Federal Reserve Board should decide that reserve requirements be increased by that amount, then these reserves instead of being excess reserves would become required reserves. This would in no way change the Reserve banks' ability to discount paper or purchase Government securities.

The proposals about real estate loans are in the nature not only of liberalization, but also of increased flexibility by permitting the

Federal Reserve Board to prescribe rules and regulations under which real estate loans may be made. This proposal is in line with the proper functioning of our banking system.

The real estate provisions of this bill appear to be clearly in the right direction and would serve the public good. More specifically they might contribute to revival in the building industry, which at this time is a fundamental requisite of recovery.

Because there are so many wrong impressions on this particular amendment, let me read it as it now appears in the House Bill that has been passed.

"Subject to such regulations as the Federal Reserve Board may prescribe, any national banking association may make real estate loans secured by first liens upon improved real estate, including improved farm land and improved business and residential properties. The amount of any such loan hereafter made shall not exceed 60 per centum of the appraised value of the real estate; but this limitation shall not prevent the renewal or extension of loans heretofore made and shall not apply to real estate loans which are insured under the provisions of Title II of the National Housing Act. No bank shall make such loans in an aggregate sum in excess of the amount of the capital stock of such association paid in and unimpaired plus its unimpaired surplus fund, or in excess of 60 per centum of the amount of its time and savings deposits, whichever is the greater. The Federal Reserve Board is authorized to prescribe from time to time regulations defining the term 'real estate loans' and other terms used in this section and regulating and limiting the making of real estate loans by member banks, with a view to preventing an unreasonably large proportion of each bank's assets from being invested in real estate and real estate loans, preventing such loans from exceeding a reasonable percentage of the appraised value of the real estate in view of the circumstances existing at the time and otherwise requiring the banks to conform to sound practices in making real estate loans."

Because this particular amendment has received more attention from Governor Eccles than from anybody else responsible for the writing of the Bill, and because you were expecting to hear Governor Eccles here today, I should like, with your permission, to quote Governor Eccles' testimony on this amendment before the Senate Sub-committee of the Banking and Currency Committee:

"As you know, real estate loans are not a new form of investment for our commercial banks. They have been lending on real estate mortgage security for decades. Liberalization of the real estate loan provisions, combined with the broadened eligibility requirements for borrowing at the Federal Reserve banks, may encourage activity in the construction industry, which is essential to recovery.

"Criticism of these provisions has come largely from those who believe in the separation of savings banking from commercial banking. Whatever may be said in favor of such a separation as a desirable thing in theory, it is not feasible so long as we have thousands of small banks that cannot make a living on the basis of their demand deposits alone. The member banks have 10 billion dollars of time deposits which represent the people's savings. So long as they have time deposits for which they must pay interest, they of necessity must participate in financing long-term undertakings that will yield enough to pay for doing the business. The law places no limits on what the banks may do in the purchase of bonds or of other long-time paper; there is no reason for singling out real estate loans for special restrictions.

"Our banks have been losing a large part of their business to the Government, which has sold its bonds to the banks and has used the funds to make mortgage and other loans, many of which the banks should be in a position to make themselves. Unless the banks regain some of the business which has been taken over by the Government credit agencies, there will not be sufficient business to support the banking system. There will also be great pressure for a constantly growing public debt incurred in part in taking over business that could be done by the banks.

"I note that the Banking and Currency Committee of the House in reporting out the bill has made two changes in the recommendations on real estate loans. In the first place a limitation has been inserted that aggregate real estate loans shall not exceed 100 per cent of the capital and surplus or 60 per cent of savings deposits, whichever is the greater. I think this rigid limitation is undesirable. It would be much better to leave this matter to the discretion of the Federal Reserve Board because the aggregate amount that may be safely loaned on real estate varies with banks, localities and periods of time.

"The second change in the bill as reported by the House Committee is the elimination of the provision applying the regulations on real estate loans to State member banks, as well as to national banks. This is a serious omission, because under it national banks would be at a competitive disadvantage as against State member banks, many of which are under little or no limitation in regard to their real estate loans. Furthermore, the Federal Reserve System, which has a vital interest in the solvency of State member banks, would be given no authority over real estate loans that the State member banks may make. This is inconsistent with provisions in the Banking Act of 1933 which in dealing with investment securities placed State member banks on the same basis with national banks. One of the important advantages in having State banks members of the Federal Reserve System would be lost if there were no uniformity in such matters."

When I undertook just two or three days ago the duty and the pleasure of coming here I did so frankly, not only to do what appears to be my duty but to have the pleasure of meeting you and hearing you. I have already met and listened to a great many of you - I hope to listen to more of you before I leave this convention this afternoon. I have been frank - I have tried to speak dispassionately and, of course, objectively - as dispassionately and objectively as one can speak when one is an interested part of the System affected by the proposals discussed.

I repeat, therefore, that on the whole, there is nothing extreme in this bill with these amendments. It is a bill that provides for a definite allocation of responsibility and therefore a better administration of the Federal Reserve Act of 1913. It deserves consideration. It is being discussed almost everywhere, and that is as it should be. Discussion makes for sound legislation.

Speech delivered before
Essex County Bankers Association
Newark, New Jersey
September 26, 1935

# THE BANKING ACT OF 1935

A little more than three months ago I had the privilege of speaking before the New York Bankers Association at Lake George, and my subject then was the same as it is today - The Banking Act of 1935. At that time, however, the Act was not law. Today it is. Accordingly, it is possible to discuss it again, but from a different point of view - to speak not of what its provisions may be, but of what they are. I wish first to take up the changes made by the Act in the general organization of the Federal Reserve System, and then certain changes which most directly affect your operations as bankers and as members of the Federal Reserve System.

The changes that the law makes in the organization of the System may be described as fundamental, but not revolutionary. They are changes which closely follow the dictates of experience, and they are adaptations to present day needs which are too well supported by realities to be called experimental. Many conceptions which formerly prevailed have undergone a great change as a result of what has happened in more than twenty years of actual operation under the Federal Reserve System. In consequence, Congress has amended the law and certain readjustments have been made in the organization of the System. To make clear the purposes behind these changes let me mention some of the things we have learned from experience.

To begin with, we recognize today that the elasticity of the currency, while it is important, is not a governing factor in the supply of credit. When people borrow they do not usually want currency, and when they want currency they do not always borrow to obtain it. Fluctuations in currency demand, except when there is hoarding, are largely seasonal, and reflect seasonal changes in the volume of retail trade and of payrolls. To meet currency requirements is not a major problem, for deposits have largely taken the place of currency, and the duties of the Federal Reserve System can not be regarded as entirely discharged merely by supplying commerce, industry and agriculture with the cash they require for retail transactions and payrolls. That is merely a beginning. The real tasks of the System are much greater and more complex.

Again, the idea that the Reserve banks lend to one bank the funds deposited by another is now found to be quite inaccurate. The lending power of the Reserve banks does not arise from the receipt of member bank deposits, except to the extent that those deposits consist of gold. On the contrary, member bank deposits with the Reserve banks are created by the Reserve banks. The reserve banksrediscount paper or purchase bills or securities and enter corresponding credits to the accounts of the member banks. The lending of funds and the creation of deposits is not dependent, therefore, on the previous deposit of funds. It depends upon the power of the Reserve banks to acquire assets by purchase or discount, and their power to issue notes or create deposits in payment for those assets.

Furthermore, the idea was once held that a discount by the Federal Reserve bank, say of $1,000, for example, made it possible for the member bank to extend that much more credit and only that much. If this were true the control of credit expansion would be a relatively simple matter. But it is not true. A thousand dollars borrowed and placed to the credit of a member bank enlarges its reserves by only that much, but it makes possible a much larger expansion of member bank loans and deposits. This is because the bank's reserves need be only a fraction of its deposits. In practice it works out that on the average, member banks need borrow only about one-fifteenth of what they create in deposits by loans to their customers.

Again, there is no necessary, direct connection between any particular piece of discounted paper and the use to which the proceeds thereof are placed. Yet this connection was formerly assumed to exist and it was considered an important factor of credit control. The thought was that the Reserve banks would shut off speculation by refusing to discount the notes of speculators. Of course, that is very far from the facts. In the first place, as I just said, you bankers do not borrow at the Reserve bank in order to lend, and even if you did, the kind of paper you borrowed on wouldn't necessarily indicate what kind of loan you expected to make. The fact that a banker borrowed on bills of lading would give the Reserve bank no assurance that he did not on the same day buy some mortgages or lend to a stockbroker, or employ his funds in some other way that might at the moment be contrary to general policy.

You are entirely familiar with these commonplace facts about your own business, for they have been repeatedly demonstrated in banking operations as you have known them under the Federal Reserve System. But they are things that could not be seen so clearly until we had the actual experience. In the absence of that experience it was natural to suppose that member banks would deposit their funds in the Reserve banks, that the receipt of those funds would give the Reserve banks power to lend, that as the demand for money increased member banks would borrow of the Reserve banks to meet that demand, that they would draw out currency for the purpose, that loans would be repaid by currency, and that the Reserve banks by discounting only commercial paper would insure that Reserve bank credit was being used for the legitimate requirements of commerce and not for speculation.

As a result of experience, however, it has become clear that things do not work just that way. The relationships and the sequences are different. Accordingly, our legislation has had to be amended. A good many minor changes have been made in the Federal Reserve Act over a long period of time, but in the last few years circumstances have demanded more thorough revisions of the original Act than before. Congress has made these revisions in the Banking Act of 1933 and in the Banking Act of 1935. These two measures, without any violent break with the past, but in obedience to economic developments, have adapted the original Reserve System legislation to the needs of the present, and also to the needs of the future, insofar as those needs can be foreseen. The effort has been to modify the mechanism so that it may perform the functions which time and change have thrust upon it. It has been recognized that in meeting the requirements of contemporary business life the Federal Reserve System can not rely principally on the power to furnish currency when it is needed and to retire it when it is not; nor can it rely on discrimination against one class of paper or another - when and if offered for discount - on the theory that by so doing it is diverting credit away from speculative uses and toward commerce. It has been recognized that the Federal Reserve System's power over credit lies primarily not in the things I have mentioned, but arises chiefly out of its ability to influence the total volume of bank deposits. And it has been recognized that the System must not be thought of as waiting more or less passively, like the fire department, until a crisis arises and it receives an application for help. The Banking Act of 1935 is based on a recognition of these facts. Perhaps the most important thing attempted in it is a more definite fixing of responsibility for the country's credit policy. If the System is expected to act, it must be given the power to act effectively. This principle has been followed in the authorization of a new Open Market Committee.

Open Market Operations are, of course, not new, but they were not of established or recognized importance when the Federal Reserve Act was adopted. For years, ever since the war, they have had a powerful and direct bearing on the volume and cost of money. They are the means of controlling, in the mass and in the most practicable way, the credit operations of the banks of the country. Until the new law was adopted, however, the machinery for the formulation and execution of open-market policies was ineffective. The Open Market Committee, comprising representatives of the 12 Reserve banks, might propose purchases or sales of United States Government securities in the open market, and the Board might approve those proposals; but any Reserve bank might refuse to participate in the proposed program. A policy might be adopted, but its execution depended on the independent action of twelve boards of directors comprising in the aggregate 108 persons. Such an arrangement was likely to result in delay and to afford opportunities for obstruction in matters where prompt and decisive action was required in the public interest.

Under the Act of 1935, beginning March 1, 1936, authority over open market operations will be vested in a new Open Market Committee consisting of the seven members of the Board of Governors of the Federal Reserve System and five representatives of the Reserve banks selected regionally: one from the Boston and New York districts, one from the Philadelphia and Cleveland districts, one from the Richmond, Atlanta, and Dallas districts, one from the Chicago and St. Louis districts, and one from the Minneapolis, Kansas City and San Francisco districts. The Reserve banks will have representation on the Committee, but a majority of the Committee will be made up of Board members. Open market transactions, as under the old Act, are to "be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country". The Committee, in the language of the new act, is to "consider, adopt, and transmit to the several Federal Reserve banks, regulations relating to the open market transactions of such banks". Not only will Federal Reserve banks be forbidden to engage in open market operations, except in accordance with the regulations of the Committee, but they also will be forbidden to "decline to engage" in such operations except in accordance with the directions and regulations of the committee. Open Market policy will now be determined, therefore, by a responsible statutory body, able to give it the consistency and definiteness that the importance of the function makes necessary.

It is also required by the law that complete records be kept of the action taken by the Board and by the Committee in all matters of policy. These records are to show the underlying reasons for the action, and are to be published in the annual reports of the Board. They will give the public an opportunity to study the decisions of the Federal Reserve System, in much the same way that Supreme Court opinions may be studied. This opportunity should be extremely helpful in clarifying the public discussions of national credit policy. It will also accentuate the individual sense of responsibility, for members will be called on not only to take firm positions on matters of national policy, but to explain those positions to the public.

In the matter of discount rates, the law prescribes a new procedure under which rates must come up for consideration by the Reserve banks and by the Board every fourteen days or oftener. In effect this means that rates must be newly established every two weeks at least, though the new rates may, of course, be the same as the old.

Under the new law, the authority of the Board to alter the amount of reserves which member banks must carry against their demand and time deposits is restated in clearer terms than before. The old law authorized the Board to change required reserves only when an emergency existed as a result of credit expansion, and the approval of the President of the United States was necessary. The new law authorizes the Board to make changes on the vote of four of its seven members "in order to prevent injurious credit expansion or contraction". The legal reserves can not in any event, however, be reduced below present requirements, nor can they be increased to more than twice what they now are.

Since the Board of Governors constitutes a majority of the Open Market Committee, and since it also has authority over discount rates, over member bank reserve requirements, and over margin requirements on securities loans, it is under more definite responsibility with respect to the national credit policy than ever before. At the same time, the law preserves the regional autonomy of the Reserve banks in their relations with member banks. Generally speaking, it leaves the Reserve banks with responsibility for member bank relations, and gives the Board, with the help of representatives of the Reserve banks, responsibility for national credit and monetary policies.

The law also makes important changes in the constitution of the governing body of the Federal Reserve System, which is no longer known as the Federal Reserve Board, but as the Board of Governors of the Federal Reserve System. The Secretary of the Treasury and the Comptroller of the Currency cease to be ex officio members February 1, 1936, and thereafter the Board is to consist of seven members appointed by the President. The term of office is to be fourteen instead of twelve years. As at present, not more than one member may be appointed from any one Federal Reserve district, and the President, in selecting the members, is to "have due regard to a fair representation of the financial, agricultural, industrial and commercial interests and geographical divisions of the country".

After March 1, 1936, the chief executive officer of each Federal Reserve bank will be a "president", instead of a governor, and the title "vice-president" will replace that of deputy governor.

I think I have covered sufficiently the more prominent changes which the Banking Act of 1935 makes in the organization of the Federal Reserve System. Those changes in general tend to place more definite responsibility where it belongs. Changing conditions in our economic life have thrown greater responsibilities upon the System; and in order to meet those responsibilities in a direct and positive way, the System's organization has been made more closely knit and more effective.

I wish to speak now of those features of the Banking Act of 1935 which more directly affect your individual operations as bankers.

The first of these is the broadened lending powers which the Act gives you, both directly and indirectly.

Indirectly, the Act tends to broaden your powers by giving the Reserve banks authority to make advances to member banks on any satisfactory security. The former provisions still stand as to the character of paper that is eligible for discount - paper that must originate in connection with industrial, commercial or agricultural transactions - and they also still stand as to advances to member banks on notes secured by Government obligations or by eligible paper. The new provisions do not alter the old ones, except by adding to them. The only conditions aside from the requirement that advances under the new law be secured to the satisfaction of the Reserve bank, are that they bear a rate of interest at least one-half percent above the Reserve bank's discount rate and have maturities of not more than four months. At a time like the present, when you have excess reserves, this new provision in the law may not seem very important. But times may change. If they do, this new provision means that, assuming your assets are good, the Federal Reserve bank will be able to advance you money on them, no matter what the type of paper, or in what kind of transaction they originated. Borrowing from the Federal Reserve bank is now possible on other than technical conditions of eligibility alone. And this is very important. Many banks in recent years would have had much less trouble if they could have taken to the Reserve bank some of their assets which were good, but not legally eligible, instead of having to sacrifice them on a demoralized market.

Apart from its practical bearing upon what paper individual banks may use in borrowing at the Reserve bank, the new provision of the law is significant in that it recognizes an actual condition of American banking. This is that American banks do not specialize in one type of credit as against another. They deal in credit of all sorts. They combine long term and short term functions. They cannot confine themselves to short term commercial paper, for there is not enough of such paper to fill more than a small part of their portfolios. They accept the savings and time deposits of their communities and under such circumstances it must be expected that they will also hold the long term obligations of their communities. To disregard these living facts of American banking is futile; and the new provisions for eligibility simply make the Federal

Reserve Act cognizant of the realities and adapt the powers of the Reserve banks to those realities.

In a more direct way, the new Act broadens your powers by liberalizing the conditions under which National banks may make real estate loans. The old stipulation that the real estate upon which such loans are made must be situated in the bank's Federal Reserve district or within a hundred miles of the bank, is removed; and loans which are amortized are permitted in amounts up to 60 percent of the appraised value of the property and for as much as ten years, provided installment payments are sufficient to repay at least 40 percent of the principal in ten years.

The permissible aggregate of real estate loans which a national bank may hold is changed by the new law from 25 percent of its capital and surplus or 50 percent of its savings deposits, whichever was greater, to 100 percent of its capital and surplus or 60 percent of its time and savings deposits, whichever is greater.

In general connection with this subject of enlarged lending powers I wish to mention also the provisions of section 13b of the Federal Reserve Act relating to loans which you may make for working capital purposes. This section is a year older than the new act, but its provisions belong logically with these more recent ones I have just been discussing.

Under this section you may make loans with maturities not exceeding five years to establish industrial and commercial businesses in need of working capital. These loans are eligible for discount at the Federal Reserve Bank. Nor is that all. If you wish to hold the loan yourself, but wish to be assured that you can dispose of it at any time if need be, you can procure a commitment binding the Federal Reserve bank to take it off your hands. Moreover, if and when you dispose of the loan you can do so without recourse for as much as 80 percent. In other words you have a loan which is insured 100 percent as to liquidity and 80 percent as to loss. This arrangement is not restricted to member banks; it is open to nonmembers as well.

As of September 11, the Federal Reserve Bank of New York had received and acted on 881 applications for working capital loans aggregating $63,000,000. Of these, 330, aggregating $29,000,000, had been approved. Of the amounts outstanding, $7,500,000 was in the form of loans made by the Federal Reserve Bank itself direct to the industrial or commercial borrower, because you local bankers refused to make them. There was also outstanding about $10,000,000, which local banks and other financing institutions in the Second Federal Reserve District had made, and which were protected by the commitments I have just described.

These loans have been made to all kinds of enterprises, industrial and commercial. In many cases they have been loans which bankers have not been accustomed to making, and which would not be made were it not for the fact that the Reserve bank stands behind the bank which makes them. But as it is, they constitute secure and liquid assets, yielding a good rate of interest.

Here again as in the case of the advances made by the Reserve banks on any good assets, and as in the case of real estate loans, the present legislation recognizes two important principles. One is that the local bank may be called on to meet the general credit needs of the community; the other is that the assets the local bank acquires should meet the general criterion of soundness, rather than technical limitations as to maturity, origin, and nature of the underlying transaction.

I think I have now covered the changes of most general interest, that have been brought about by the Banking Act of 1935, but there are numerous other provisions that it may be worth while to run through even though you may be familiar with them.

First there is the matter of deposit insurance, which is continued on what was originally intended as the temporary plan. Insured banks are subject to an annual assessment at a fixed rate - one-twelfth of 1 percent of deposits - instead of being under an unlimited liability as would have been the case under the old permanent plan. Insurance covers deposits up to $5,000 for any one depositor, instead of $10,000, as the old permanent plan contemplated.

After July 1, 1942, no state bank with average deposits of $1,000,000 or more may be an insured bank without becoming a member of the Federal Reserve System. This postpones required membership for seven years. In this connection the term "state bank" does not include mutual savings banks or Morris Plan banks.

The former prohibition against a member bank's purchasing and holding more than 10 percent of a particular issue of investment securities has been eliminated, but the total of the obligations of one obligor which may be purchased and held by a member bank is reduced from 15 percent of the bank's capital and 25 percent of its surplus to 10 percent of its capital and surplus. Banks are not required to dispose of securities lawfully held at the time the law was enacted. It is also made clear, in conformity with previous rulings of the Board and of the Comptroller of the Currency, that member banks may purchase and sell stocks for the account of their customers. They may not purchase and sell stocks for their own accounts.

There are several important provisions in the new Act with respect to affiliates and holding company affiliates. These modify considerably the original requirements. When the first legislation defining affiliates and requiring reports of them was adopted in the Banking Act of 1933, it was undoubtedly directed primarily at securities affiliates and affiliates formed for the purpose of engaging in activities in which member banks were not authorized to engage or for the purpose of supplementing the activities of member banks. The definitions, however, were made extremely comprehensive, and as a result a very large number of organizations were caught in a net that was never intended for them. It frequently happened that banks were surprised to discover that under the law they had "affiliates", when as a matter of fact no such idea was in their minds. A bank might find that it had as an affiliate a corporation which belonged to an estate of which it was trustee; or it might find that it had as an affiliate a corporation whose stock was accidentally owned by the bank's own stockholders. There might be no financial connection between the two and yet at every call date a report would have to be procured from the affiliate and published. The original purpose of the law had been accomplished so far as securities affiliates were concerned, for they all disappeared, but the number of other affiliates reported to the Board was increasing - not because banks were forming new affiliations, but because unknown and unintended affiliations, quite accidental in fact, were constantly coming to light. The effect of the new provisions of the law will be to exclude a large number of such organizations from the requirement imposed originally. The Board and the Comptroller of the Currency are now authorized to waive reports which are not necessary to disclose fully the relations between a member bank and its affiliate, and the effect thereof upon the affairs of the bank, and the conditions of waiver have been announced. Roughly speaking, organizations which are affiliates under the terms of the law need not submit reports unless they are indebted to the affiliated member bank or unless the member bank owns their stock or other obligations. Reports of affiliations which have arisen as a result of ownership or control of an organization's stock by a member bank in a fiduciary capacity are also waived. This, it is believed, will be welcome news to many banks.

In addition, organizations which own or control the stock of a bank, but are found by the Board of Governors of the Federal Reserve System not to be engaged as a business in holding bank stock, are exempted by the new law from the requirements imposed on holding company affiliates except as to indebtedness of affiliates to member banks. This provision makes possible a distinction between holding companies organized for the purpose of holding bank stock, and companies which happen to own control of a bank, though their real business lies in a different field.

The Banking Act of 1935 ended double liability on National bank stock issued after June 16, 1933. Under the new Act National banks are permitted to terminate the double liability on stock issued prior to that date. After July 1, 1937, therefore, it is possible that all shareholders of active National banks may be relieved of personal liability on their shares. At the same time National banks are required to accumulate a surplus equal to the amount of their common capital. This change should be better both for bank shareholders and for the public. Personal liability for bank shares has never been a satisfactory protection to depositors, and it has placed a burden on shareholders of banks not borne by shareholders of other corporations.

There are several provisions which are of importance in connection with deposits and the interest payable thereon. In the first place, the rate of interest paid by the Postal Savings system is not to exceed that paid on savings deposits by member banks in the same place; and postal savings depositories may deposit funds on time with member banks subject to the provisions of the Federal Reserve Act and regulations of the Board of Governors of the Federal Reserve System regarding payment of interest on time deposits. In addition, the Federal Deposit Insurance Corporation is required to forbid the payment of interest on demand deposits by insured non-member banks, and to regulate the rate of interest paid on time and savings deposits by insured non-members. This provision explicitly gives the Federal Deposit Insurance Corporation authority similar to that which the Board of Governors of the Federal Reserve System has. In the same general connection, the definitions of deposits in the old Act are stricken out and the Board of Governors is authorized to define various types of deposits, and to determine what is to be deemed a payment of interest. For purposes of computing the reserves member banks are required to carry, amounts due from other banks (except Federal Reserve banks and foreign banks) and certain cash items in process of collection may be deducted from gross demand deposits. Formerly amounts due from other banks could be deducted only from amounts due to other banks. This will place country banks which have no balances of other banks, on a basis of equality in this respect with city banks that carry a large volume of bank balances.

I think it is not necessary to go further into details of the new banking legislation. I have described the major changes effected in the organization of the Federal Reserve System and I have mentioned certain provisions which affect you most directly as bankers.

You will realize from this partial account that a large number of changes have had to be made in the Board's regulations. This work has been pushed as rapidly as possible, but it will be some weeks before the Board will be able to complete the publication of all regulations in revised form.

Personally I feel that the new Act places us on a better footing than we have ever been on before. To be sure, it involves many points of compromise, as is inevitable in a democracy, and no two people will agree that it is perfect. Moreover, it is to be expected that unforeseen problems will arise, and that our resources and ingenuity will be taxed to meet them. But perhaps the greatest virtue of the Banking Act of 1935 is that it confers more definite responsibilities and more flexible powers. We are better prepared than in the past to meet the unexpected.

In particular I trust that membership in the System will be more valuable to you bankers under the new Act and more highly esteemed by you than ever before. I trust that you will find yourselves better able to meet the credit needs of your communities, and better able to maintain profitable operations. The new Act, as I have described it, should make that easier to do. The Federal Reserve Bank has broader powers than ever before to discount your paper and to lend to you. In the case of industrial loans for working capital purposes authorized by Section 13b it has the very unusual power to grant you commitments under which you may be assured of the perfect liquidity of your loan and have it virtually guaranteed up to 80 percent. I suggest that, considering the idle funds you have, you fully acquaint yourselves with what the Federal Reserve Bank is able and glad to do in cooperation with you, and that you canvass your territories for loans which you might formerly have felt were outside your field, but which you may now make with safety and profit. I thank you for this opportunity to discuss with you measures and matters of such moment to us all.

Speech delivered before
Mortgage Bankers Association
French Lick, Indiana
October 4, 1935

Mr. President, Ladies and Gentlemen: You were expecting to hear Governor Eccles, who is Chairman of the Board of Governors of the Federal Reserve System. Governor Eccles was expecting to have the privilege and honor of addressing you this morning. He planned to be here and it wasn't until last Saturday that he found himself unable, because of his other duties, to come here today to address you.

At that moment I was in New York. I received word to come to French Lick, Indiana, to take the place of the Governor.

My talk will be factual; it will be purely objective. With your kind permission, therefore, I shall say a few words about that law which was recently passed by the United States Congress, namely, the Banking Act of 1935, and in the Banking Act of 1935 that particular title, Title II, on which there was a great deal of discussion in recent months, perhaps more discussion than on any other banking legislation in recent years.

When in New York, about two months ago, speaking upon the subject of the Banking Act, I learned from the bankers that a great many of them were reading the Federal Reserve Act, so, therefore, if the Banking Act of 1935 did no more than just perhaps persuade a great many bankers and business men to read the Federal Reserve Act, then at least that much good has been accomplished by the Banking Act of 1935.

There are so few people who really understand the Federal Reserve System. As you know, there are twelve Federal Reserve Banks and some twenty-five branches and two agencies. In addition to these twelve Federal Reserve Banks, there is a Board in Washington, which, until recently, was known as the Federal Reserve Board, consisting of six members appointed by the President of the United States, with the advice and consent of the United States Senate, and two ex-officio members, the Secretary of the Treasury and the Comptroller of the Currency.

With the coming of the Banking Act of 1935, this board is reorganized. On February 1, 1936, the Board will consist of seven appointed members, in place of six, and the two ex-officio members, the Secretary of the Treasury and the Comptroller of the Currency, will cease to be members of that Board, so that on February 1, 1936, the Board of Governors of the Federal Reserve System will be seven.

There is to be continued the Federal Advisory Council which consists of twelve men from the twelve different Federal Reserve Districts of the country. They are elected by the directors of the Federal Reserve Banks. At the present time all of them are active bankers.

This Federal Advisory Council meets in Washington at least four times a year and, going over the economic and financial conditions of the country, proposes certain suggestions to the Federal Reserve Board in Washington. The organizations I have mentioned, together with the Federal Open Market Committee and the member banks, constitute the Federal Reserve System.

On February 1, 1936, the seven appointive members will be appointed for fourteen years. The first appointment, of course, won't be for fourteen years, because it is so provided that every two years one member will leave the Board, but thereafter each and every member will be appointed for fourteen years and cannot be reappointed after he has served a full term of fourteen years.

The important part of the Banking Act of 1935 is the new Federal Open Market Committee. The Open Market Committee, as you know, is that body which has to do with the buying and selling of securities in the open market. Through the purchase of these securities, credit becomes loose in the country; through the sale of these securities credit becomes tight. Therefore, the Open Market Committee is an essential part of the credit control in the United States.

Heretofore, the Open Market Committee consisted of twelve men selected by the twelve Federal Reserve Banks. These men adopted certain open market policies and referred them to the Board in Washington. The Board would approve or disapprove and then the policies were referred to each of the twelve banks to be approved or disapproved. Each Federal Reserve Bank could refuse to participate in a certain open market operation adopted by the Open Market Committee as a policy.

In accordance with the Banking Act of 1935, on March 1, 1936, the Board of Governors of the Federal Reserve System, on which will be seven men, together with five men selected by the twelve Federal Reserve Banks regionally from the various sections of the country will constitute the Open Market Committee. In other words, the Board of Governors and five representatives of the Federal Reserve Banks, altogether twelve men, will constitute the Open Market Committee.

In addition to that, the Banking Act of 1935 provides that all the policies adopted by the Open Market Committee must be published. The vote thereon and the reasons for the vote must be published in the annual report of the Board of Governors of the Federal Reserve System, so the public will know how each member of the Committee has voted, and why. This is very important because the public will know constantly of the operations of the Open Market Committee and reasons therefor.

In addition to that, the Banking Act of 1935 provides a very liberal loaning policy. Heretofore only certain paper, known as eligible paper, short term paper, was eligible for discount at a Federal Reserve bank. In accordance with the provisions of the Banking Act of 1935 any sound asset of a member bank in accordance with the regulations of the Board of Governors of the Federal Reserve System may be offered by such bank as security for an advance by a Federal Reserve Bank. Thus the loaning policy will be very liberal so that we shall not have to declare an emergency, as was the case heretofore, for other paper in that particular member bank to be discounted at the Federal Reserve Bank when the need arises for a liberal loaning policy.

Further, the Banking Act of 1935 provides that there be a liberalization of the loaning policy in the provision which increases with the national banks the percentage of the value of real estate that a loan may cover, from fifty to sixty per cent, and the term of the loan from five to ten years provided the loan is on an amortized basis requiring that at least forty per cent of the loan be repaid in the course of ten years.

Real estate loans may be made by a national bank in a total amount up to one hundred per cent of the unimpaired capital and surplus of the bank, or sixty per cent of its time and savings deposits, whichever is greater, as compared with previous limitations of twenty-five per cent of the capital and surplus or fifty per cent of time and savings deposits. The Banking Act of 1935 also provides for the elimination of the requirement in a previous law that loans may be made by a national bank only on real estate situated within its regional district or within one hundred miles of its location.

These changes should help greatly in the financing of building activity, the resumption of which is an essential factor in recovery. It is also a recognition of the fact that it is as proper for a member bank having a large volume of time and savings deposits to make mortgage loans as to purchase long-time bonds. The danger for banks is not in making real estate loans as such, but in making poor loans of any kind.

The Banking Act of 1935 liberalizes loaning policy and makes for a better administration of the Federal Reserve Act. This should be helpful in its own way to business conditions of the country.

There are many other provisions in the Banking Act, some under Title II and the rest under Titles I and III, which are of a more or less technical nature, and I shall, therefore, refrain from discussing them at this time. If, however, you are interested in obtaining further information on Titles I, II, and III of the Banking Act of 1935, I suggest that you write the Federal Reserve Bank of your district or the Board of Governors in Washington, and such information will be furnished you without delay.

And now as to business conditions in the country. Let me say that it is very difficult for us, to say the least, to appreciate the true nature of business conditions. It seems human to appreciate the present only after it becomes the past. This is true for two reasons: First, it requires some time for the data and the facts to be compiled throughout the country to give a complete picture of business conditions; and second, once we have made up our minds that conditions are bad, we keep thinking of them as bad, just as once we have made up our minds that conditions are good, we keep thinking of them as good. We do not seem to realize that in order to make conditions good or better, we must begin to appreciate fully the fact that conditions are improving; and that fact in itself makes for a betterment of conditions, for nothing succeeds like success.

An indication of a certain improvement in business conditions is the fact that business is critical. The patient who is dangerously sick does not criticise the doctor or the nurse; it is when the patient becomes improved that he begins to criticise those who started him on the way to recovery.

Now let us study some facts: The Federal Reserve index of industrial production, which reflects the output of our factories and mines, is compiled on the basis of years 1923 and 1925 as 100. That index struck a low point of 58 in July, 1932, and this low point represented a drop from 125 three years earlier. Our basic production had been more than cut in two in the course of three years. Since that time we have had four attempts at recovery.

The first one, in the autumn months of 1932, did not carry us very far and did not last very long; and by March, 1933, we were down close to the low point. Next we had a very rapid spurt which carried the production index up to a level equal to the base of 100. But that was a false start, reflecting uncertainties, fear of inflation, and attempts to beat the gun before the industrial codes and the processing taxes went into effect. By the end of 1933, much, but not all, of this gain was lost, for the low point of this decline was fully fifteen points higher than the previous low level.

The third attempt at recovery was in the year of 1934, when we had a rapid rise which was not sustained, but again the low point reached was above the low point of the depression. Finally, a rise began in the latter months of last year and has been much better sustained than any of the three other attempts. During 1935 the level attained at the beginning of the year has been maintained with only slight fluctuations. The index is now at 86 compared with the low of 58.

This affords an interesting reflection on the extent to which progress has been made. However, it represents only work in factories and in mines; it does not include the vast number of men employed outside of our factories and mines. Materials produced for construction are in the figures, but actual building activity is not. As you and I know, the high prosperity of the middle 20's was achieved by and rested primarily on two lines of activity: First, construction; and, second, the automobile.

The automobile industry has recovered to a surprising extent, and in many of the months of this year the output of the automobiles has been as large as in any other year, except the banner year of 1929. While it has been low in recent weeks, that fact is explained by the preparation for the introduction of new models. Therefore, the automobile industry has been the first to show a real sustained recovery from the depression.

In the building industry, from the beginning of this year, there has been a steady rise in residential construction, which is not directly influenced by public expenditures, but represents the increased ability of many people to acquire homes of their own or to improve the homes they already own. Cheaper money and better conditions in the mortgage market have contributed to this recovery in the construction industry, which, however, is very far from complete. But with a good start now made, with no lack of funds for mortgage financing, and with increased employment and returning confidence on the part of our people, there should be a steady and rapid growth in residential building. Construction creates a demand in nearly every kind of goods, and, therefore, stimulates an infinite variety of enterprise.

The figures show that there has also been an advance in employment particularly in industries producing durable goods where employment had declined the most during the depression. Steel plant operations, which for several months in 1932 were at only about fifteen per cent of capacity, are now at fifty per cent. Lumber production has also shown a marked increase. While employment has been obtained for several millions, unemployment is still a problem. But needs, new conditions, new inventions gradually assert themselves. There may be discomforts we have suffered so long that we do not question their legitimacy; and yet some one will come along and find a way to overcome them and we will all flock to him to get the benefits of his invention.

There is a great industry which is rapidly developing for the regulation of the heat and temperatures of our homes and business structures - air conditioning, we call it. That bids fair to develop on a very large scale indeed. Also we are still far from having bathtubs in all houses, to say nothing of having an electric or gas ice box and all the other electrical devices. Improved methods of manufacture and lower costs of production make it possible for more people to enjoy the products of industry. These, therefore, offer possibilities of increased employment.

At different times there has been a great deal of discussion about the price level, with the belief that our prosperity depends on restoring prices to the level of some previous year. During the depression there was a decline in the general level of wholesale commodity prices amounting to perhaps thirty-five per cent. The decline in the wholesale prices of farm products amounted to sixty per cent, with the consequence that there was a terrible gap between what the farmers received for their products and what they had to pay for the things they required in order to live. Since that time there has been a general rise in prices, but the advance has been much greater for agricultural commodities than for other commodities so that at the present time they are in close relationship when measured on the basis of 1926 as 100. The reestablishment of a better adjustment of prices is one of the elements in our economic situation which is encouraging.

Great improvement has been shown in the field of banking. With the establishment of the Federal Deposit Insurance Corporation and the work of bank rehabilitation conducted by the Federal Reserve Board and the office of the Comptroller of the Currency, as well as the Federal Deposit Insurance Corporation, our banks have been placed in a position to contribute their full share to the upswing of business.

While there has been only a relatively small increase in the loan activities of the banks, this has been due in part to the fact that people have been paying off debts incurred during the boom period and that the liquidation of these debts has been equal to the new loans extended by the banks. It should be remembered, however, that this liquidation improves the position of the borrowers and makes them more ready to embrace future opportunities.

Demand deposits at the present time are higher than at any time in history, while time deposits are still below their high levels. With this volume of deposits available to the people and with a large volume of unused reserves at the disposal of the banks, the banking system is prepared to finance a much larger volume of business than is now being done. Deposits, however, are still turning over in a much more sluggish way than they did in normal times. As business increases the deposits will be used more vigorously and the circulation of money in the form of checks will be resumed at a rate sufficient to carry on the country's business.

This depression has demonstrated beyond any doubt that the creation of money does not at all times insure its use. It takes ability and willingness to borrow as well as to lend to create a loan, and it takes ability and willingness to buy as well as to sell to bring about a transaction.

Bond prices have risen. This brought about a resumption of capital flotations - largely of a purely refunding nature, but to some extent for the raising of new capital. The refunding, as well as the low level at which new borrowing can be made, has reduced the cost of debt that had become excessively burdensome. The debt burden has also been reduced through the refinancing of a vast number of mortgages at low rates, both in agricultural and urban communities.

These, then, are the facts. I have purposely refrained from expressing any opinions; I have purposely refrained from expressing any preferences. You, as men of experience and ability, prefer only the facts. From these you will draw your own conclusions. This much is certain, however, we are all aware of a definite and sincere realization that we must understand the facts in order to cooperate in the direction of an improved condition for the general good of our country and the specific good of each and every one of its citizens.

Speech delivered before
Cleveland Chapter, American Institute of Banking
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November 7, 1935

THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935

I am glad of this opportunity to be with you this evening, for most of you I understand are students of banking, and that is what I am myself. No matter what our positions in the banking world, we are still students of banking if we are sincere. For banking is not a simple thing, and its principles cannot be understood without experience and patient study.

Speaking personally, I have always found that in the process of studying any institution, or function, or problem, it is important to keep referring back to fundamentals. Otherwise it is easy to go wandering off into details without knowing what they are all about. For that reason, I should like to review a few basic things in spite of the fact that we are all familiar with them. I should like to brush away the great mass of details for a little while and discuss some of the elementary facts about the Federal Reserve System and the functions it performs for the country. I believe it is particularly worth while to do this before considering the new and important legislation in the Banking Act of 1935.

The Federal Reserve Act, which in 1913 established the Federal Reserve System, is one of the most important pieces of financial legislation ever passed in this country. It represented the decision reached after many years of dissatisfaction with our banking and currency facilities, brought to a head by the panic of 1907; after a thorough study of banking here and abroad by a National Monetary Commission established by Congress in 1908; and after long and earnest public discussions of banking reform over a period of twenty years or more.

Since 1913, on the basis of actual experience and in response to new developments, numerous amendments have been made to the original Federal Reserve Act. During the depression changes were made by the Glass-Steagall Act of 1932, the Emergency Banking Act, the Banking Act of 1933, the Gold Reserve Act of 1934, and other acts. The most recent as well as the most important of these is the Act approved August 23, 1935.

## Federal Reserve banks

The work of the System may be considered first from the point of view of the Federal Reserve banks in their relations with the banking institutions of the country, and then from the point of view of the broader responsibilities for credit policy which come under the central organization in Washington, now known, under the Banking Act of 1935, as the Board of Governors of the Federal Reserve System.

The location of the Federal Reserve banks was not determined by Congress, but by the Secretary of the Treasury, the Secretary of Agriculture, and the Comptroller of the Currency acting as the Reserve Bank Organization Committee. To this Committee Congress delegated the authority to designate not less than eight nor more than twelve reserve cities and to divide the continental United States into a correspondeng number of reserve districts. These district, according to the law, were to be apportioned with due regard to the convenience and customary course of business. They may be readjusted by the Board of Governors of the Federal Reserve System. In addition to the twelve reserve banks there are now in all twenty-five branches and two agencies. The Federal Reserve Bank of Cleveland has a branch in Cincinnati and one in Pittsburgh.

All National banks were required to become members of the System, subscribing to the capital stock of the Reserve banks, and depositing their reserves therein. State banks were permitted to become members on similar terms, provided they fulfilled certain requirements as to capital structure and as to the general nature of their business. This division of the banks of the country into National and State banks, with different laws, powers, and supervisory authorities, was a basic condition upon which the Federal Reserve System was superimposed, and it is a basic condition to which its operations have always had to be adjusted.

About forty percent of the banks in the country now belong to the Federal Reserve System and these banks account for about seventy percent of the country's banking resources. The member banks include 5,425 national banks and 985 State banks and trust companies. The State banking institutions which are still outside the System are for the most part small. There are about 9,000 non-members; about 1,400 of them have deposits of less than $100,000, and about 2,600 have deposits of less than $250,000.

Under provisions of the Banking Act of 1935 State non-member banks, with certain exceptions, having average deposits of $1,000,000 or over, must become members of the System after July 1, 1942 or lose the right of having their deposits insured with the Federal Deposit Insurance Corporation.

The Federal Reserve banks differ from ordinary commercial banks in both their organization and their functions. Generally speaking, as you know, they do not deal directly with the public. Their customers are the member banks who make deposits with them and secure credit or currency just as the public does with the local banks. The capital stock of the Federal Reserve bank is owned by the member banks, which are required by law to subscribe to capital stock equal to six percent of their capital and surplus. One-half of such subscription is paid in cash and the other half is subject to call. The management of the reserve bank is in the hands of a board of directors which represents not only the member banks but other business interests of the community. Of the nine directors of each Federal Reserve bank, three known as Class C directors are selected by the Board of Governors of the Federal Reserve System and six are selected by the member banks, three known as Class A directors representing the stock holding member banks, and three known as Class B directors representing commerce, agriculture, or industry in the district. The chief executive officer of the bank, designated as president under the new banking act, is appointed by the board of directors of the bank subject to the approval by the Board of Governors of the System. The legal requirements for ownership and management of the Reserve banks, therefore, recognize that their functions must be performed in the public interest and that their management must take account of both the banking and the general business interests of the region.

Holding member bank reserves

One of the purposes of the Federal Reserve Act was to provide institutions which would hold the reserves of the nation's banking system. It is necessary for all banks to keep a certain proportion of their deposits available to meet the current demands of their customers. Before the establishment of the Federal Reserve System, National banks were required to keep part of their reserves in their own vaults and part on deposit in other banks, usually metropolitan banks. Banks in the central reserve cities, however, of which there were then three, New York, Chicago and St. Louis, had to hold all their reserves in cash. When there was a general and heavy demand for funds, especially at crop moving times, for example, and country banks everywhere drew down their balances with their city correspondents, a situation was developed in which a currency and credit crisis of greater or less magnitude might readily occur. Country banks then had difficulty in getting money from the city banks, and the public in turn had difficulty in getting money from the country banks and from the city banks as well.

Now all member banks are required by law to keep their reserves on deposit in the Federal Reserve bank of their district and it is the business of the Reserve banks to supply member banks with credit or cash in such emergencies.

The required reserves vary with the type of deposit and the class of bank. Banks in central reserve cities, which now are only New York and Chicago, are required by law to maintain reserves equal to thirteen percent of demand deposits, that is, deposits which can be withdrawn without advance notice. For example, if a customer of a Chicago bank borrows $1,000, his deposit balance is credited with $1,000 and the bank in turn must provide for $130 of reserve deposit at the Federal Reserve Bank of Chicago, unless prior to the loan it already had excess reserves of that amount or more. Banks in so-called reserve cities, of which there are about sixty, are required to maintain reserves of ten percent against demand deposits, and all other banks are required to maintain reserves of seven percent. Reserves of three percent against time deposits are required to be maintained by all banks. Member bank reserve balances on deposit with the twelve Reserve banks amount today to over $5,600,000,000. Because of unusual conditions, the total of these balances is about twice as much as the banks are required to have.

The Reserve banks serve as the credit reservoirs of our banking system. Local banks no longer need have any fear that they will be unable to draw on their reserves when needed, as used to be the case before the Reserve System was establshed. Accordingly, one important risk has been eliminated from commercial banking.

Loans to member banks

Equally important with their function of holding member bank reserves is the power of the Reserve banks to make loans to member banks. Through these loans the member banks are able to increase their deposit balances and thus provide the reserves necessary for the expansion of credit. The reserve banks may supply funds to member banks by rediscounting paper or by making advances to member banks, as provided by law and Board regulations, or by purchasing bills and securities, and entering corresponding credits to the account of the member banks, thus increasing their reserve balances. Member banks in turn can increase their loans to the public in the aggregate by an amount several times the amount of the additional reserves.

The Federal Reserve Act, however, places limitations on the character of paper on which loans may be obtained from the Reserve banks. For many years Reserve banks have had the power to discount only short-term self-liquidating commercial paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial, industrial and agricultural transactions, and to make advances to member banks on their promissory notes backed by paper eligible for discount or purchase or by United States Government obligations. They were not authorized to make advances on a wide range of other assets which made up an important part of the total earning assets of banks. These included real estate loans, securities other than those of the United States Government, and loans to business men which did not meet the requirements of the narrowly-defined eligible commercial paper.

As a result of many developments in our financial organization, paper which qualified for borrowing from the Reserve banks has constituted a constantly decreasing proportion of the total assets of member banks ever since the System was established. In 1929 it was only about twelve percent of total loans and investments of such banks, and in 1934 it was but eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks with assets which were good but technically ineligible for borrowing at Reserve banks, were obliged either to dump them on a falling market, suffer severe loss and contribute to the deflation in values or to close their doors.

The new banking act corrects this situation. It authorizes the Reserve banks to make advances to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank, at a rate of interest at least one-half of one percent above the highest discount rate in effect at the particular Reserve bank. This amendment modifies and makes permanent the emergency legislation which it was necessary to pass in 1932.

In addition to the foregoing general powers of discount and purchase the Federal Reserve banks have special powers with respect to loans to commerce and industry for working capital purposes. These powers are granted by Section 13b of the Act. Under this section the Reserve banks are authorized to discount loans made by member banks and other financing institutions to established industrial and commercial businesses for the purpose of supplying working capital. Such loans are to have maturities of not to exceed five years. The Reserve banks are authorized to discount these loans without recourse for as much as 80 percent of any loss thereon. The Reserve banks also have authority to grant commitments to discount such loans. This makes it possible for a member bank to hold in its portfolio loans which the Reserve bank is under obligation to take over upon request, and upon which the Reserve bank assumes 80 percent of any loss. In other words the member bank has an earning asset which is insured 100 percent as to liquidity and 80 percent as to loss. This arrangement is not restricted to member banks; it is open to non-members as well.

Under the same section the Reserve banks are authorized in exceptional cases, and when credit is not available from the usual sources, to make such loans for working capital purposes direct to the borrower.

As of October 23, the Federal Reserve Bank of Cleveland had received 553 applications for working capital loans aggregating $17,000,000. Of these, 141, aggregating $6,300,000, had been approved. The Reserve bank's outstanding advances on that date were $1,800,000 and at the same time it had commitments outstanding for another $1,800,000.

These loans have been made to all kinds of enterprises, industrial and commercial. In many cases they have been loans which bankers have not been accustomed to making, and which would not be made were it not for the fact that the Reserve bank stands behind the bank which makes them. But as it is, they constitute secure and liquid assets, yielding a good rate of interest.

Currency issued by Reserve banks

Another activity of the Reserve banks is the issuance of Federal Reserve notes. These constitute the paper money authorized by the Reserve Act for the purpose of supplying the country an elastic currency--that is, a currency whose volume can be readily increased or decreased according to the public demand for it.

Federal Reserve notes are obligations of the United States and are secured by specific collateral pledged by the Reserve bank. The bank is required to keep reserves in gold certificates at least equal to forty percent of the notes in actual circulation. The Federal Reserve banks, of course, do not supply the entire currency of the country. The Government issues silver dollars, minor coin and some paper money and, until July of this year, the National banks continued to have the privilege of issuing National bank notes. The larger part of money in circulation, however, consists of Federal Reserve notes.

A member bank that has satisfactory assets can always secure all the currency that it needs. If it has a demand for more cash than it has in its vault, it can readily obtain Federal Reserve notes at its Reserve bank. It can borrow and take the proceeds in notes or it can draw against its account and, if necessary, restore the account to the required level by borrowing. If it receives on deposit from its customers more currency than it needs to keep on hand for current requirements, it can send the ex excess to the Reserve bank to be added to its reserve balance.

The function of supplying elastic currency is important, but it is less important than the lending power, because, as you know, currency does not play a major role in present-day business transactions. About ninety percent of our business is conducted by the use of checks. Currency is used, for example, for purchases at retail stores and filling stations, for car fare, and for payrolls, but such uses account for only about ten percent of the total monetary transactions in the country. Such fluctuations in the demand for currency as appear regularly on pay days, during the period of Christmas shopping, and near holidays, are met completely by the machinery provided by the Federal Reserve Act.

Other activities of Reserve banks

Beside their work in holding the banking reserves of the country, in making loans to member banks, and in supplying currency when needed, the Reserve banks have other important functions which facilitate the smoother working of our financial machinery.

The Reserve banks have greatly simplified the procedure whereby banks collect checks drawn on other banks. This has been very useful to business in general because it has permitted more prompt and cheaper settlement of monetary transactions. The Reserve banks in effect act as a nationwide clearing house, not only for checks, but for other credit items such as notes, drafts, bonds and coupons.

In order to effect the prompt transfer of funds from one part of the country to another without actual movement of currency, the System maintains an inter-district Gold Settlement Fund in Washington. The fund was established by deposits of the twelve Federal Reserve banks, and transfers from one district to another are made daily by debits and credits to the respective accounts of the Reserve banks.

The Federal Reserve System has centralized the work of the fiscal agencies of the United States Government. The Reserve banks act as fiscal agents in connection with the issue and retirement of Government debt and as depositaries of Government funds in administering deposit accounts of the Government in the Reserve banks.

Central control of credit policy

I wish to turn now from this discussion of the functions which the Federal Reserve banks perform for the local banks and consider how these activities tie in with the general responsibility of the System, through its Board of Governors, for the nation's credit policy.

When the Federal Reserve System was established it was realized that for certain activities, particularly those related to local banking conditions, a regional organization was necessary. Only in this way could the System meet local bank needs in a country as large as the United States, with economic conditions varying so much from one section to another. Each regional bank would have intimate knowledge of developments in agriculture, commerce and industry in its district and of the district's special credit needs and problems. The principle was also established by the original Federal Reserve Act that under the authority of the Act and of regulations of the Board in Washington the Reserve banks should have final responsibility in their dealings with member banks.

At the same time, it was also realized that the credit policy of the different Federal Reserve banks must be coordinated so that policies adopted in one district would not be harmful to another. More than that, there should be a credit policy for the country as a whole which would take account of general business and credit conditions. The direction of this policy is the duty of the Board of Governors of the Federal Reserve System, which is the central organization located in Washington. The Board is aided by other organizations which work closely with it, the Federal Advisory Council and the Federal Open Market Committee.

Board of Governors of the Federal Reserve System

Experience has indicated that this power of the Board to affect the expansion and contraction of the general supply of credit is of vital importance to the country, since the volume of credit is a factor in determining the course of business, and proper changes in the cost and volume of credit may tend to moderate excessive expansion or contraction of business, or, in other words may reduce the danger of inflation and defaltion.

The Board's ability to influence the volume of credit rests on three important powers: the power to determine discount rates, the power to change reserve requirements, and the power, exercisable through its majority of members on the Federal Open Market Committee, to determine open-market policies.

Discount rates

Discount rates are the rates charged by the Federal Reserve banks on loans to member banks. These rates determine the cost of borrowing by member banks and consequently have a bearing on the cost at which the public can borrow from these banks. Indirectly they affect other rates in the money market. Under the Federal Reserve Act changes in discount rates are made by the various Federal Reserve banks but are subject to review and determination by the Board of Governors. This gives the Board final responsibility over the discount rates, and enables it to keep the cost of borrowing in the different sections of the country consistent with general credit conditions for the country as a whole.

The new banking act strengthens the Board's power to control these rates by making the further provision that discount rates must be submitted to the Board of Governors every fourteen days. This insures frequent review of the rates.

Reserve requirements

The Board of Governors also has the power to change the reserve requirements of member banks. The volume of credit which any member bank may extend is limited by the amount of reserves which are required by law to be maintained against its deposit liabilities. An increase in the reserve requirements reduces and a decrease increases the potential volume of member bank credit. Consequently the power to change reserve requirements gives the Board an important means of controlling the general volume of credit. Formerly this power could be exercised only in the event of an emergency arising out of credit expansion and then only with the approval of the President of the United States. Under the new act these conditions are omitted. The power is to be exercised in order to prevent injurious credit expansion or contraction, provided that reserve requirements may not be reduced below the present requirements specified in the law nor increased to more than twice the amount of these legal requirements.

Open-market operations

The third important means of control over the supply of credit are the so-called open-market operations, responsibility for which under the new banking act will be vested in a new Federal Open Market Committee. This committee will consist of the seven members of the Board of Governors and five representatives of the Reserve banks selected by the Reserve banks in different regions.

Open-market operations consist of the purchase and sale by Reserve banks of certain classes of securities, chiefly Government obligations. These operations have the effect of increasing or decreasing the supply of credit available in the market. By selling securities the Reserve banks withdraw funds from the market and there is a decrease in the supply of credit. Through a purchase of securities a Reserve bank puts funds into the market, thus tending to ease credit conditions.

Purchases and sales of securities by the Reserve banks were unimportant in the early days of the System. It was not until 1922 that they were large enough to affect the money market. At that time it became necessary to take steps to coordinate purchases and sales so that credit conditions for the country as a whole would not be adversely affected. Gradually these purchases and sales have become one of the most important means whereby the System can take the initiative in influencing credit conditions.

The responsibility for determining what security transactions should be undertaken and the authority for enforcing a program were not clearly defined by law until the new banking act. At the time this act was passed an Open Market Committee consisting of representatives of the twelve Reserve banks was authorized to propose purchases and sales. Its proposals were then submitted to the Federal Reserve Board, which had the authority to approve or disapprove but not to initiate a policy. Even after purchases or sales by the Reserve banks had been agreed upon by the committee and the Board, the boards of directors of the twelve Federal Reserve banks throughout the country could frustrate the policy by refusing to participate in its execution.

The new act clearly places responsibility for determining open-market transactions on the new Open Market Committee and directs the Reserve banks to carry out the transactions determined by this committee. This is one of the most important changes in the Federal Reserve System which the new act introduces.

Other work of the Board

The Board of Governors has a variety of other duties which tie in with its general responsibility for supervision of the System. These include the examination of Reserve banks, passing on applications of State banks and trust companies for membership in the System, obtaining condition reports from State member banks, administration of those provisions of the Clayton Anti-trust Act which relate to interlocking bank directorates, regulation of the maximum rate of interest to be paid by member banks on time and savings deposits, regulations under the Security and Exchange Act governing the margin requirements for loans on securities listed on the stock exchanges, and maintenance and operation of the inter-district Gold Settlement Fund.

In carrying out its responsibilities it is essential that the Board keep in touch with banking developments in different parts of the country. In the organization of the System provision was made for regular contacts between the Board and the various Federal Reserve districts. One of the class C directors at each Reserve bank, designated by law as the Federal Reserve agent, represents the Board at the bank and maintains an office of the Board at the bank. The Federal Advisory Council, also provided by law, is made up of representatives of each Federal Reserve district and meets at least four times a year in Washington to confer with the Board and to make recommendations. The Board also has meetings in Washington with the chief executive officers of the Federal Reserve banks and with the Federal Reserve agents.

Information bearing on credit policy

It has always been a part of the System's work to watch credit trends and to develop a better general understanding of the facts bearing upon credit policy. Information bearing on banking conditions throughout the country and on production, employment, trade and prices, has been regularly collected. In its monthly publication, the Federal Reserve Bulletin, and in its Annual Reports, the Board has undertaken from the beginning to give the public a comprehensive view of current banking and financial developments at home and abroad and also to furnish detailed information on conditions of banks throughout the country and on the business situation. Each of the Federal Reserve banks also publishes a monthly review of the business and banking conditions in its district.

There is no central bank in the world which makes available such exhaustive information on domestic banking and business developments and on the formulation of its credit policy as that which is published by the Federal Reserve System.

The new act still further increases the publicity given to the System's operations. It provides that records shall be kept of the actions of the Federal Open Market Committee and of the Board on all questions of policy. This information, together with the underlying reasons, is to be published in the Annual Reports of the Board so that the public may be able to study the reasons for the Board's decisions. This should create better understanding and facilitate general cooperation in support of credit policies.

In the foregoing description of the System and its functions I have had occasion to mention most of the important changes effected by the Banking Act of 1935, but I think it is desirable to summarize them for the sake of completeness. I omit reference to Title I of the Act, for it deals exclusively with deposit insurance. I also omit reference to Title III, for the changes it effects are mainly technical and by way of clearing up previously existing provisions. The following changes are summarized from Title II:

1. On March 1 next the chief executive officer of each Federal Reserve Bank will be designated president instead of governor, and the deputy governors will be designated as vice presidents.

2. The Board is given authority to waive in whole or in part the statutory requirements relating to the admission of State members to the Federal Reserve System, if such waiver is necessary to facilitate the admission of any State bank which is required to become a member in 1942 in order to be an insured bank or to continue to have its deposits insured.

3. The old designation of the Board as the Federal Reserve Board is changed to Board of Governors of the Federal Reserve System. At the same time an important change in the composition of the Board is brought about, to become effective February 1, next year. The Secretary of the Treasury and the Comptroller of the Currency then cease to be members of the Board, and the number of members is changed from eight to seven. Thereafter the regular term of a member will be fourteen years, and no member having served a complete term of fourteen years can be reappointed. On February 1, the terms of all present members of the Board cease under the Act, so that the President must by that time make appointments of all members of the newly constituted Board. The title of the chief executive officer of the Board is changed from Governor to Chairman.

4. The Board is required to keep a complete record of the action taken by the Board and by the Open Market Committee upon all questions of policy and of the reasons underlying such action and shall include a copy of the records in its annual report.

5. The Federal Reserve banks may make advances to member banks with maturities of not to exceed four months, secured to the satisfaction of the Reserve bank, and at a rate of interest not less than 1/2 percent higher than the Reserve bank's discount rate. This is the authorization I have already discussed which enables member banks to borrow from the Reserve bank not merely on so-called eligible paper, but on any good assets.

6. The Open Market Committee is made to consist of the members of the Board and of five representatives of the Reserve banks, and is given definite authority over the open market operations of all the Reserve banks.

7. The express stipulation is made that direct obligations of the United States and obligations which are fully guaranteed by the United States may be bought and sold by Reserve banks without regard to maturities, but only in the open market. This is to prevent direct purchases of issues of government securities from the Treasury.

8. Federal Reserve bank discount rates are required to be established every fourteen days, or oftener if deemed necessary by the Board.

9. The Board of Governors, on the affirmative vote of four of its members may by regulation change the requirements as to reserves to be maintained against time and demand deposits by member banks; but the change shall not make the required reserves less than now established by law nor more than twice that now required. Formerly the existence of an emergency and the approval of the President were necessary conditions of such action by the Board.

10. National banks may make real estate loans up to 50 percent of the appraised value of the mortgaged property for periods not exceeding five years; except that if the loan is on an amortization basis it may be

made up to 60 percent of appraised value and for a term of not longer than ten years. Real estate loans must not exceed the capital and surplus of the bank, or 60 percent of the bank's time and savings deposits, whichever is greater.

There are two important changes effected under the new banking legislation, and I should like in conclusion to emphasize them.

First there are the provisions that fix responsibility more definitely for the determination and direction of national credit policy through control of open market operations, of discount rates, and of reserve requirements.

Second there are the provisions that broaden the classes of member bank assets eligible as security for loans from Reserve banks, and encourage local banks to meet a wider range of credit needs in their communities.

It must be recognized, however, that if the System is to achieve as much as we all hope, it will need more than these new provisions. It will need the cooperation of business men, bankers, and the general public. For that reason I appreciate the opportunity I have had this evening of discussing with you the System's powers and purposes.

Speech delivered before
Pacific Northwest Conference on Banking
under the auspices of the State College of Washington
Pullman, Washington
April 9, 1936

## THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935

The four states which are represented in this meeting - Washington, Oregon, Idaho and Montana - are remarkable for their highly diversified resources. Among a host of other things, they produce beef, butter, copper, fish, fruit, gold, grain, lumber, mutton, petroleum, and wool. These products moreover are all important - they are not merely incidental. The geography of your region is full of variety. You span the great Divide, and of your two great river systems, one carries you to the Pacific and one toward the Atlantic. You have in Puget Sound and in the mouth of the Columbia two of the greatest of American harbors. You have some of the most strikingly beautiful mountains in the world, and some of the loveliest lakes. Furthermore, the fixed plant that has been built up in your four states in the course of two generations is remarkable. You have great irrigation systems, hydro-electric systems, mines, docks, railways, and steamship lines. You have in abundance the things that should maintain your people in comfort and make their lives interesting.

I am not telling you these things to flatter you. I am speaking of them because they are the background to the banking of the region. Banking takes its character from the economic life in which it is carried on. It adapts itself to what the people do, and their interests become the banker's interests.

In one sense, banks are engaged in individual extensions of credit. It is a question of one risk after another - who can be safely financed and to what extent and on what security, and who can not. But that is not all. In another and larger sense banks are constantly engaged in moving the products of their regions out to the markets and consumers of the world and in moving in to their own population the things it buys in exchange. Here in the Palouse country where we are meeting, the bankers every year move the great wheat crop out to the ports and the mills. Over in Wenatchee they move the great crops of apples. Down in the Snake River valley in Idaho they move the crops of potatoes. Back in Billings they move the wool-clip. The value of the products shipped from your four states to the markets of the United States and of the world is great, and it is through bankers that these products are exchanged for what the people of your region buy from the outside. During a long season of the year you are financing your farmers, your stock men, your orchardists. They are drawing on your reserves to meet the cost of equipment, of feed, of labor, and of supplies. Then as their crops are marketed and funds are placed to your credit in Chicago, in New York, in San Francisco, and other cities, your reserves again accumulate, and your customers are ready for the new season.

It is unfortunate that people generally fail to realize this fundamental function of the banks. They think of the banks as merely local affairs, which they have a hard time borrowing from at one season of the year and a hard time repaying at another. They do not see that because of the banks, credit is enabled to flow into the region to pay them for their products, and is enabled to flow out again in payment for the products they buy elsewhere. They see very plainly that steamers and railways carry away their wheat, their fruit, and their wool, and in exchange bring in to them from other regions the clothing and the machinery they need, but it is not so easy to see that without the system of credit the system of transportation would be of little use.

The importance of bank credit in the form of deposits is indicated by the fact that people almost invariably prefer it for payments in large amounts. A farmer who is selling his year's crop usually expects a check and would be surprised and inconvenienced if he were paid in currency or coin. The check represents bank credit; and when the farmer takes or sends it to the bank, the credit goes on the bank's books under his name. The arrangement is safe and convenient.

But there is far more to be said for bank credit in the form of deposits than that its use is convenient and safe. In our economy it has become indispensable. Without it how would it be possible for the people all over the United States and all over the world who use the products of your region, to pay for the timber, the metals, the wool-clip, and the salmon-pack, which you furnish them? Should currency be shipped in to pay for it all; and then shipped out again to pay for the carpets, the tractors, and the securities that your people buy?

The system of bank credit ties together things that are far apart in space and time. It enables the cattle and sheep raiser to build up his herds and flocks over a period of years to the point of their greatest value. It enables the farmer to be paid for his wheat even when it is eaten on the other side of the earth. It enables funds which are idle in New York to be put to use in Spokane within a few moments. It enables the people of your region to enjoy the various products of regions different from theirs.

These things are possible because the system of bank credit covers the whole country like a net-work of power lines, and supplies means of payment wherever needed. Wherever and whenever local bank reserves run low, as must regularly be the case in a region which is predominantly agricultural, the temporary deficiency can be made up. Whenever things produced in one place are paid for and consumed by people in another place the system of bank credit makes it possible to effect the payment readily. There is, however, one essential - the credit must be everywhere liquid and based on sound values; otherwise the system becomes clogged and stops working. The loss in that event is more than a loss to local stockholders and depositors. The loss is to the community whose processes of production and consumption have been to some extent disrupted.

Before 1914 this country had quite inadequate means of mobilizing its bank credit. Every bank in the country constituted a separate pool of credit - a pool that was not always adequate for local purposes, and yet that had no close connection by which it could always be replenished swiftly and easily. The banking system bore the same relation to what we have now, as a scattered number of independent power plants with potential connections would bear to an articulated power net-work. The banks in regions such as yours were comparatively well off under such an arrangement because, as I said in the first place, your economic activities are highly diversified. But in the south and back in the middle west, where whole regions are dominated by a few great cash crops, and where everyone is being paid at one period of the year and is paying out the rest of the time, the difficulties of mobilizing bank credit were extreme.

It was such difficulties as these that led to the establishment of the Federal Reserve System. They were difficulties that arose from the fact that the nation-wide exchange of commodities and services - especially the inter-regional exchange - had to be accomplished with banks whose interests and facilities were primarily local. In order that banks might meet the requirements of their communities more adequately, they needed closer interconnections with other communities, and a system through which means of payment for their regional products might be always and unfailingly available. The Federal Reserve banks were established to meet that need. They bind the 6,400 member banks of the country into a system which can make credit available for production and trade wherever and whenever it is required and in any amount. Practically all the functions which the Federal Reserve banks perform were previously performed in one way or another by different agencies, but it is believed that they are now performed more systematically and smoothly than before.

II.

In the course of twenty-two years much experience and knowledge have been derived from the operations of the Federal Reserve System. Some problems which the System was devised to remedy have now been settled and others have taken their place. At the same time the conception of central banking functions has changed in many respects. The net result is that the System presents in certain ways a different aspect from what it did formerly.

Twenty-two years ago the ideas prevailed that the important functions of the Federal Reserve banks were to furnish an elastic currency, to lend to member banks which were short of money some of the reserve funds accumulated by other member banks, and to curb the speculative use of credit by rediscounting only paper representing self-liquidating commercial transactions. These ideas now appear quite inaccurate or at least inadequate. Furnishing currency is seen to be less important than it was thought to be, because currency cuts a very small figure in the total of payments that are made by people in their dealings with one another. What they use for the most part, as I have already indicated, is bank credit in the form of deposits. The control of bank credit as a whole is, therefore, of greater importance than the control merely of the currency supply; it is also incomparably more difficult.

In the second place, the reserve banks do not depend on the deposits which member banks maintain with them for the ability to make loans and buy securities. They have the same kind of power you bankers have, to acquire additional assets by entering deposit credits on your books in favor of the person who discounts a note with you or sells you a bond or a mortgage. Consequently, if a member bank's reserves are deficient, it can turn over some of its assets to the reserve bank and receive a credit to its reserve account. The reserve bank in such a transaction is not lending to one bank what it owes to another; it is exercising the familiar banking power of paying for assets by the entry of deposit credit.

In the third place, it is recognized that there is no necessary connection between the form in which credit is procured from a bank and the form in which it is used. Money may be borrowed on acceptances and yet be used in the stock market. It may be borrowed on a real estate mortgage and yet be used to buy merchandise. It may be borrowed on the security of speculative stocks and yet be used to finance the production and shipment of commodities. Consequently, any discrimination for or against a certain type of paper offered for discount does not mean that speculation is being controlled or that credit is being supplied for the needs of commerce. The task of controlling the use of credit is far more difficult than such a supposition would imply.

The instrumentality that is now considered the most important for the control of credit is one that in the original reserve act was given only rudimentary attention. I refer to open market operations. These operations are important because they make it possible for the central banking organization - in this case the Federal Reserve banks directed by the Federal Open Market Committee - to exercise control over the volume of bank deposits and reserves. This means control over the volume of "money", or means of payment, required by the people in their economic life.

The principle of open market operations is of course simple. If securities are sold in the market by the Federal Reserve banks, they must of necessity be paid for with bank funds, for they will be bought either by the banks themselves or by bank customers. Consequently, in the process of paying for them there will necessarily be debits to be entered against the reserve accounts maintained with the reserve bank by the member banks. Upon completion of these entries, the reserve bank, reversing the process by which it acquires certain assets and simultaneously increases the amount of credit outstanding on its books, will have disposed of certain assets and simultaneously decreased the credit outstanding. The Reserve bank does not know in advance of its transactions what particular member bank accounts will be affected nor by how much, but it knows that if it sells a million dollars worth of securities, approximately a million dollars worth of available bank credit will be extinguished.

If, as a consequence, reserves are reduced to a minimum, the member banks are immediately impelled to restrict their extensions of credit, for they cannot continue making loans and increasing the deposit credit outstanding on their books without incurring a deficiency in their reserves. The result of the Reserve bank's action in selling securities, therefore, is to curtail the lending power of member banks and to tighten the money market.

On the other hand, if securities are bought by the Reserve bank, the result will be that in the process of paying for them the Reserve bank will have to credit the reserve accounts of member banks. Again it does not know to what extent particular member banks will be affected, but it does know that reserves in general will be increased. By the same token the lending power of the member banks will be increased and general credit conditions will be eased. In the first stages of a buying program, the effect will be to enable banks to pay off any obligations they may owe, but if a buying program is continued long enough it may result it an accumulation of excess reserves.

In addition to the effect upon the reserves of member banks, there is also an effect upon bank deposits in general - even non-member bank deposits; because, if an investor or an institution buys some of the securities sold by the Reserve bank, payment will ordinarily be made out of a checking account and deposits will be decreased by so much. If, on the other hand, the Reserve bank is buying securities, and institutions and individuals are selling to it, the payments made by the Reserve bank will increase the deposit credit outstanding on the books of banks. Accordingly, banks which are not members of the Federal Reserve System and banks which themselves have not purchased or sold securities as a result of the Reserve bank's action, will nevertheless be affected by it, either in their reserves or in their deposits, or in both. The money market as a whole will be influenced.

The effect of open market operations may be expressed in various ways, according to what one considers the most important aspect. It may be said when purchases are being made that funds are thereby being placed at the disposal of member banks which can be used to pay off indebtedness at the Reserve banks or as a basis of additional credit expansion. Contrariwise, it may be said, when sales are being made, that funds are being withdrawn from the member banks and that the latter are being compelled either to increase their indebtedness at the Reserve banks or to contract their loans and investments. It may be said, therefore, that open-market purchases tend to encourage an expansion of credit and open-market sales tend to encourage a contraction of it.

Turning to the other side of the balance sheet, it may be said that open-market operations have the effect of expanding or contracting bank deposits and thereby of increasing or decreasing the volume of money, or means of payment, required by the people for the transaction of their business. It may be said, without confining the statement to member banks, that open-market operations increase or decrease the supply of funds in the money market, and if they are timely, that they moderate any tendencies either to tightness or excessive ease. All of these descriptions are fair; all merely emphasize various aspects of what open-market operations tend to accomplish.

So much for principle. In practice, of course, all kinds of factors may conflict with a given program; just as all kinds of things may conflict with a man's attempt to drive his car straight through town without stopping. The proper exercise of open market powers is an art. It requires constant study of means and ends, and appraisal of the conditions under which a given program of action can be expected to accomplish its purpose.

The Federal Reserve banks at first attempted to carry on their open market operations independently of one another, but it soon became clear that their actions must be coordinated. Otherwise they might find themselves competing with one another, and in conflict as between their own transactions and those transactions which as fiscal agents of the Government they were conducting for the United States Treasury. Accordingly, in 1922 a committee of Reserve bank officers was appointed for the purpose of coordinating the operations. About the same time the purpose of the operations was clarified. The principle laid down was: "That the time, manner, character, and volume of open-market investments purchased by Federal Reserve banks be governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation."

For some time prior to this there had been a tendency to allow purchases and sales of securities to be influenced by profit as an objective. The statement of principle which I have just quoted meant a definite abandonment of that objective. This was in line with the general policy of central banks in conducting open market operations; they do so definitely with the idea of correcting market tendencies and not for the purpose of making earnings.

The Banking Act of 1933 gave open market operations more specific recognition than they had had in the original Act. It gave statutory standing to the Federal Open Market Committee, which by then comprised one representative from each Federal Reserve bank. No Reserve bank could engage in open market operations except in accordance with regulations of the Board. At the same time the Act adopted substantially the same statement of purpose which had already governed open market operations.

The Banking Act of 1935 gave still further attention to the machinery of open market operations and to recognition of their importance. The Federal Open Market Committee was reconstructed to comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen regionally by the twelve Federal Reserve banks. This made the members of the Board constitute a majority of the Committee, and marked considerable development away from the original informal arrangements by which the Federal Reserve banks first conducted open market operations on their own initiative and then under the direction of a Committee on which the Board was not specifically represented. Furthermore, under the terms of the Banking Act of 1935, the Federal Reserve banks may neither engage nor decline to engage in such operations except in accordance with the directions and regulations of the Committee.

Another requirement of the Act is that a complete record be kept of the action taken on all questions of policy relating to open market operations, including a record of votes taken in connection with the determination of open market policies and a statement of the reasons underlying the action taken, and that this record be included in the Board's annual report. The publication of this record will give the public an opportunity to study the decisions as to open market policy and credit policy in general, and should help clarify public discussions of national credit policy. It will also accentuate the individual sense of responsibility, for members of the Committee will be called on not only to decide on credit policy, but to give publicly the reasons for their decisions.

It is clear, I think, that as a result of experience and statutory amendments, open market operations have taken a far more important place in general credit policy than they formerly had. It is also clear, I think, that open market operations have become a more important or at least a more positive device of credit control than discount rates. When the Federal Reserve Act was adopted the prevailing idea probably was that discount rates were not only the most definite means of credit control, but the most important. The thought was that as banks felt more and more demand from borrowers and went to the Reserve banks to procure the funds to meet it, they would encounter a rising discount rate, which would have the effect of tempering the demand and preventing an excessive use of credit. Conversely, as conditions improved, business activity would be encouraged by the fact that banks could procure funds to lend at a progressively lower rate. The most obvious difficulty with this theory, however, is that banks have not shown a disposition to borrow from the Reserve banks in order to relend. Banks don't like to borrow, and as a general thing they won't borrow unless they have to, no matter how low the discount rate is. Consequently, the effectiveness of the Federal Reserve discount rate is, by itself, rather limited. It is significant as an index of the cost of credit, but it does not come into action otherwise until a member bank finds it necessary to replenish its reserves. As I have already indicated, however, a member bank may be forced into such a position as the result of sales of securities by the Reserve bank, and the discount rate then becomes effective.

In other words, an important difference between discount rates and open market operations in practical effect is that open market operations give the central banking organization the initiative in the control of credit, whereas the discount rate by itself offers the controlling authority no handles to seize; it must bide its time passively until the situation is so bad that demand for funds is voluntarily made. This delay may seriously impair the power of the Federal Reserve bank to help the situation.

The Banking Act of 1935 made only one change in respect to discount rates. This was to require that they be established every fourteen days or oftener. It is not necessary that the rates be changed every time, but they must at least be reviewed and reestablished.

With respect to the reserves which member banks are required to maintain, the Banking Act of 1935 makes a very important change, by simplifying the conditions under which the Board of Governors of the Federal Reserve System may alter the amount of reserves which is prescribed in the law. Prior to 1933, there was no authority to change reserve requirements administratively, but an act of May 12 of that year empowered the Board, with the approval of the President, to declare than an emergency existed and during the emergency to increase or decrease the reserve balances to be required. The Banking Act of 1935 allows reserve requirements to be changed by the Board without declaration that an emergency exists and without approval of the President. It does not permit, however, requirements to be reduced below the percentages stated in the statute nor to be more than doubled. The purpose of any change made in the requirements must be, in the words of the law, "to prevent injurious credit expansion or contraction."

With this power to alter reserve requirements and with the change by which the members of the Board constitute a majority of the Federal Open Market Committee, the Banking Act of 1935 definitely strengthened and centralized the control of credit. Another movement in the same direction was taken by the Securities Exchange Act of 1934, which authorized the Board to regulate the amount of security to be required on margin accounts by stock brokers and dealers and to regulate the making of loans by banks and others for the purpose of purchasing and carrying listed securities. These changes give the Governors of the Federal Reserve System more effective powers for the control of credit than ever before.

On the other hand, the regional autonomy of the Federal Reserve banks in their relations with member banks is preserved. Generally speaking, the Reserve banks are responsible for member bank relations and act as the agencies of system activities, while the Board in Washington, with the help of representatives of the Reserve banks, is responsible for central credit and monetary policy.

The Banking Act of 1935 also made important changes in the constitution of the governing body of the Federal Reserve System, which is no longer known as the Federal Reserve Board, but as the Board of Governors of the Federal Reserve System. The Secretary of the Treasury and the Comptroller of the Currency ceased to be ex officio members of the Board February 1, and provision was made for the Board to consist thereafter of seven members appointed by the President. The members now in office have terms ranging from 2 to 14 years and upon the expiration of the present terms all succeeding members will be appointed for terms of 14 years instead of 12 years as under the previous law. As formerly, not more than one member may be appointed from any one Federal Reserve district, and the President, in selecting the members, is to "have due regard to a fair representation of the financial, agricultural, industrial and commercial interests and geographical divisions of the country".

Since March 1, under the provisions of the Act, the chief executive officer of each Federal Reserve bank has the title "president", instead of "governor", and the title "vice-president" replaces that of "deputy governor". Both the president and the first vice-president are appointed by the Board of Directors for a five-year term with the approval of the Board in Washington. Formerly, as you know, the offices of governor and deputy governor were not specifically recognized by statute.

The responsibilities of the Federal Reserve banks as fiscal agents of the United States were not changed by the Banking Act of 1935, except for a provision which permits the Reserve banks to buy government obligations only in the open market; direct purchases from the Treasury are not authorized.

## III.

I think I have covered sufficiently the more prominent changes which the Banking Act of 1935 made with respect to Federal Reserve functions, and I wish to speak now of those features of the Act which more directly affect the operations of member banks.

The first of these has to do with lending powers.

Indirectly, the Act tends to broaden member bank lending powers by giving the Reserve banks authority to make advances to member banks on any satisfactory security. The former provisions still stand as to paper that is known under the original terms of the Federal Reserve Act as "eligible" for discount - paper, that is, which originates in connection with industrial, commercial or agricultural transactions - and they also still stand as to advances to member banks on notes secured by eligible paper or by Government obligations. The new provisions are added to these old ones without altering them. Advances authorized by the new provisions are simply required to be secured to the satisfaction of the Reserve bank, to bear a rate of interest at least one-half percent above the Reserve bank's discount rate, and to have maturities of not more than four months. At present, when the banks have large excess reserves, this new provision in the law may not seem very important. But times may change. If and when they do, the new provisions mean that, assuming a bank's assets are good, the Federal Reserve bank will be able to advance money on them, no matter what the type of paper, or the nature of the transactions in which they originated. In other words, borrowing from the Federal Reserve bank has now been made possible on other than technical conditions of eligibility alone. This is very important. Many banks in recent years would have had much less trouble if they could have taken to the Reserve bank some of their assets which were good, but not legally eligible under the old terms of the law, instead of having to sacrifice them on a demoralized market. Provision for such advances was first adopted as a temporary, emergency measure in 1932, but the Banking Act of 1935 made it permanent.

The original provisions of the law with respect to eligible paper were based on the principle that since the liabilities of banks were payable on demand they should be offset by short-term self-liquidating paper based on specific transactions involving the exchange of goods. The amendments added by the Banking Act of 1935 are based on the principle that in fact American banks do not specialize in one type of credit as against another. They deal in credit of all sorts. They combine long term and short term credit functions. There is not enough short-term commercial paper to fill more than a small part of their portfolios. They accept the savings and time deposits of their communities and they also hold long term obligations of their communities. The new provisions for eligibility make the Federal Reserve Act cognizant of these realities and adapt the powers of the Reserve banks to them.

In a more direct way, the Banking Act of 1935 broadened lending powers by liberalizing the conditions under which National banks may make real estate loans. The old stipulation that the real estate upon which such loans are made must be situated in the bank's Federal Reserve district or within a hundred miles of the bank, has been removed; and loans which are amortized are now permitted in amounts up to 60 percent of the appraised value of the property and with maturities of as much as ten years, provided installment payments are sufficient to repay at least 40 percent of the principal in that time.

The permissible aggregate of real estate loans which a national bank may hold has been changed by the Act from 25 percent of its capital and or 50 percent of its savings deposits, whichever is greater, to 100 per cent of its capital and surplus or 60 percent of its time and savings deposits, whichever is greater.

In connection with this subject of enlarged lending powers I want also to mention the provision of the Federal Reserve Act authorizing loans for working capital purposes. The provision is a year older than the Banking Act of 1935, but belongs logically with these more recent ones I have just been discussing.

Under this provision loans with maturities not exceeding five years which have been made by member banks or other financing institutions to established industrial and commercial businesses in need of working capital may be discounted by the Federal Reserve bank. Nor is that all. If the member bank wishes to hold the loan, but wishes also to be assured that it can be disposed of at any time if need be, a commitment may be procured binding the Federal Reserve bank to take over the loan when and if requested to do so. It may also be arranged that the loan be taken over without recourse for as much as 80 percent. Under such circumstances, the member bank has a loan which is insured 100 percent as to liquidity and 80 percent as to loss. This arrangement, however, is not restricted to member banks; it is open to non-members as well.

These loans have been made to all kinds of enterprises, industrial and commercial. In many cases they have been loans which bankers have not been accustomed to making, and which would not have been made were it not for the fact that the Reserve bank stands behind them.

I think I have now covered the changes of most general interest that were brought about by the Banking Act of 1935, but there are numerous other provisions that it may be worth while to mention without attempting to discuss them.

First there is the matter of deposit insurance, which has been made permanent on a basis similar to that originally adopted as temporary. As you know, insured banks are now subject to an annual assessment at a fixed rate - one-twelfth of 1 percent of deposits - instead of being under unlimited liability as would have been the case under the old permanent plan. Insurance covers deposits up to $5,000 for any one depositor, instead of $10,000 or more as the first permanent plan contemplated.

After July 1, 1942, no state bank with average deposits of $1,000,000 or more may be an insured bank without becoming a member of the Federal Reserve System. This provision had the effect of postponing required membership for several years. At the same time, the Board was given the power to waive in whole or in part the statutory requirements with respect to admission of State banks to membership.

The former prohibition against a member bank's purchasing and holding more than 10 percent of a particular issue of investment securities has been eliminated, but the total of the obligations of one obligor which may be purchased and held by a member bank is reduced from 15 percent of the bank's capital and 25 percent of its surplus to 10 percent of its capital and surplus. Banks are not required to dispose of securities lawfully held at the time the law was enacted. It has also been made clear, in conformity with previous rulings of the Board and of the Comptroller of the Currency, that member banks may purchase and sell stocks for the account of their customers. They may not purchase and sell stocks for their own accounts, however.

Several important changes were made by the Banking Act of 1935 with respect to affiliates and holding company affiliates of member banks. These changes modify considerably the original requirements. When the first legislation defining affiliates and requiring reports of them was adopted in the Banking Act of 1933, it was undoubtedly directed primarily at securities affiliates and affiliates formed for the purpose of engaging in activities in which member banks were either not authorized to engage or in which it was not felt expedient for them to engage. The definitions, however, were made extremely comprehensive, and as a result a very large number of organizations were caught in a net that was never intended for them. It frequently happened that banks were surprised to discover that under the law they had "affiliates", when as a matter of fact no such idea was in their minds. A bank might find that it had as an affiliate a corporation which belonged to an estate of which it was trustee; or it might find that it had as an affiliate a corporation whose stock happened to be owned by persons who owned the bank's stock. There might be no financial connection between the two and yet at every call date a report would have to be procured from the affiliate and published. The original purpose of the law had been accomplished so far as affiliates dealing in securities were concerned, for they all disappeared, but the number of other affiliates reported to the Board was increasing - not because banks were forming new affiliations, but because unknown and unintended affiliations, quite accidental in fact, were constantly coming to light.

Under amendments made by the Banking Act of 1935 the Board and the Comptroller of the Currency are now authorized to waive reports which are not necessary to disclose fully the relations between a member bank and its affiliate and the effect thereof upon the affairs of the bank. The result of the new provisions will be to relieve a large number of banks from the requirement originally imposed without exception. Roughly speaking, under the conditions of waiver that have been announced, organizations which are affiliates under the terms of the law need not submit reports unless they are indebted to the affiliated member bank or unless shares of their stock or other obligations are owned by the member bank in excess of certain minimum amounts. Reports of affiliations which are based solely on ownership or control of an organization's stock by a member bank in a fiduciary capacity are also waived. This, it is believed, has been welcome news to many banks.

In addition, organizations which own or control the stock of a bank, but are found by the Board of Governors of the Federal Reserve System not to be engaged as a business in holding bank stocks, have been exempted by the law from the requirements imposed on holding company affiliates, except in the matter of indebtedness to their affiliated member banks. This provision has made possible a distinction between holding companies organized for the purpose of holding bank stock, and companies which incidentally own control of a bank, while their principal business lies in a different field.

Double liability on National bank stock issued after June 16, 1933, was ended by the Banking Act of 1933, and under the Banking Act of 1935 National banks may terminate on July 1, 1937, or thereafter, the double liability on stock issued prior to June 16, 1933. It is possible, therefore, that all shareholders of active National banks will soon be relieved of personal liability on their shares. At the same time National banks are required to accumulate a surplus equal to the amount of their common capital. This change should be better both for bank shareholders and for the public. Personal liability for bank shares has never been a satisfactory protection to depositors, and it has placed a burden on shareholders of banks not borne by shareholders of other corporations.

There are several provisions which are of importance in connection with deposits and the interest payable thereon. In the first place, the rate of interest paid at offices of the Postal Savings system is not to exceed the maximum that Federal Reserve regulations allow to be paid on savings deposits by member banks in the same place; and postal savings depositories may deposit funds on time with member banks subject to the provisions of the Federal Reserve Act and to regulations of the Board of Governors of the Federal Reserve System regarding payment of interest on time deposits. In addition, the Federal Deposit Insurance Corporation was required to forbid the payment of interest on demand deposits by insured non-member banks, and to regulate the rate of interest paid by them on time and savings deposits. This provision explicitly gave the Federal Deposit Insurance Corporation authority with respect to non-member insured banks similar to that which the Board of Governors of the Federal Reserve System has with respect to member banks. The Act also repealed the former statutory definitions of demand and time deposits; the Board of Governors is authorized to formulate new definitions in their place, and to determine what is to be deemed a payment of interest.

For the purpose of computing the reserves which member banks are required to carry, amounts due from other banks (except Federal Reserve banks and foreign banks) and certain cash items in process of collection may now, as you know, be deducted from gross demand deposits. As a result of this change, country banks, which hold no balances due to other banks, may now make their deductions on the same basis as city banks, which hold balances due to other banks in large volume.

I think it is not necessary to go further into details of the 1935 Act. They are numerous, but most of them that I have not mentioned are technical and minute. I have discussed the essential points of Title II of the Act, and a few of the more important points of Title I, which deals with deposit insurance, and Title III, which mainly clarifies or modifies technical provisions already in force.

You will realize that the changes effected by the law have necessitated a great deal of work upon the regulations which the Board has to issue. Regulations on new subjects have had to be prepared and old regulations have had to be altered.

IV.

The general results of the changes I have spoken of which have been largely but not wholly effected by the Banking Act of 1935, may be summarized as follows:

In the first place, the 6,400 member banks have broader lending powers, and the facilities of the Federal Reserve banks have been made available to them on less technical and restrictive terms.

Second, the Federal Reserve banks remain essentially unchanged in organization and function, though the importance of their central banking activities has been more clearly recognized.

Third, the Federal Open Market Committee has been given a more effective position in the System and more definite authority.

Fourth, the Board of Governors has been given larger powers and more direct responsibilities, and the principles upon which the System is to be administered have been more clearly developed.

I do not mean to imply that with these changes brought about by recent legislation the task of credit control has been made easy. Far from it. It is hard to imagine that the control of credit ever will be a simple matter. There are too many conditions affecting it. To mention only one thing that has an important bearing on credit control, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. It does not now. The majority of banks in the United States are outside the System. Although, it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country, still from the point of view of the communities they serve and of relations with other banks, the importance of the thousands of small banks which are outside the System is not negligible. But I feel that in spite of difficulties--indeed because of them, perhaps--there is a growing sense of the importance of the System as an instrumentality of public service. The function of central banking, which looks definitely to the public good as a whole, is one that legislation is more and more emphasizing.

What we are now seeking to do in the field of bank credit may well be compared with what past generations attempted to do in establishing coinages of uniform and honest value, in simplifying currency, and in preventing wholesale issues of counterfeit and spurious notes. In the past, repeated efforts had to be made almost universally in order to standardize and protect the legal-tender--efforts that were the more important because people more generally depended on paper currency and coin for means of payment then than they do now. Today, with the increasing use of deposit credit in our interdependent economic system, the nature of the monetary problem has changed again. Bank credit must be kept always available in adequate amounts for the monetary needs of the country. Whether our problem is harder than those that previous generations had, I will not pretend to say. In some respects it is the same, but in the swift pressure of our economic life it is always presenting new aspects even while we study it, and requiring the adaptation of the old instrumentalities to newly developed needs.

Speech delivered before
Baltimore Chapter, American Institute of Banking
Baltimore, Maryland
April 17, 1936

THE BANKING ACT OF 1935 - TITLE II

The Banking Act of 1935 is divided in three parts. The first part, Title I, deals exclusively with Federal Deposit Insurance. The third part, Title III, comprises almost exclusively amendments intended to clarify and correct previously existing provisions of the law, and is chiefly of technical importance. The second part, Title II, makes changes in the organization of the governing board of the Federal Reserve System and in its authority to control credit. I shall limit myself to discussion of the provisions of Title II.

In general terms, I think the most important accomplishment of the Banking Act of 1935 so far as the Federal Reserve System is concerned is that it strengthened and clarified the lines of credit control. A few changes affecting the organization and functions of the Federal Reserve banks were made, but they were not changes in essentials. The most conspicuous of these changes was that the title of President was given to the principal executive officer. Formerly his title was Governor. The title of Vice President now replaces the former title of Deputy Governor. As you know, the former titles, Governor and Deputy Governor, were not mentioned in the Federal Reserve Act. The office of Governor was originally created under the general authority which the Federal Reserve Act gave the directors of the Federal Reserve banks to arrange for such officers as were necessary for the administrative work of the banks. Originally, the only office specifically mentioned by the Act, other than that of director, was that of Federal Reserve Agent and Chairman, with assistant agents and deputy chairmen. The Banking Act of 1935 in designating the President of the Federal Reserve bank as its chief executive officer merely recognized an arrangement that had developed under general authority and that had proved itself desirable from the point of view of Federal Reserve Bank administration.

The organization of the governing board of the System was changed considerably by the Banking Act of 1935. In the first place, the old name "Federal Reserve Board" was changed to "Board of Governors of the Federal Reserve System". At the same time, the chief executive officer of the Board was designated as Chairman. Furthermore, the number of members of the Board was changed from eight to seven and all of these members were made appointive. Formerly, as you know, the Secretary of the Treasury and the Comptroller of the Currency were ex officio members of the Board.

The term of office of the members of the Board was formerly 12 years. Under the new law, the terms of members now in office range from 2 to 14 years and their successors in office will have terms of 14 years so arranged that the term of one member will expire every 2 years. Since a member who has served a full term of 14 years is not eligible for reappointment, there will be a regularly recurring change in membership; one member leaving the Board and a new one being appointed every 2 years, unless more frequent changes occur from deaths or resignations.

The more important changes effected by the 1935 Act, however, have not to do with these matters of organization so much as with the function and authority of the governing Board in the field of credit.

The instrumentality that is now considered the most important for the control of credit is one that in the original reserve act was given only rudimentary attention. I refer to open market operations, with respect to which very significant changes were made by the Banking Act of 1935.

The principle of open market operations is of course simple. If securities are sold in the market by the Federal Reserve banks, they must of necessity be paid for with bank funds, for they will be bought either by the banks themselves or by bank customers. Consequently, in the process of paying for them there will necessarily be debits to be entered against the reserve accounts maintained with the reserve bank by the member banks. Upon completion of these entries, the reserve bank will have disposed of certain assets and simultaneously will have decreased the total amount outstanding to the credit of member banks in their reserve accounts. The Reserve bank does not know in advance of its transactions what particular member bank accounts will be affected nor by how much, but it knows that if it sells securities available member bank credit will be diminished.

If, as a consequence, reserves are reduced to a minimum, the member banks are immediately impelled to restrict their extensions of credit, for they cannot continue making loans and increasing the deposit credit outstanding on their books without incurring a deficiency in their reserves. The result of the Reserve bank's action in selling securities, therefore, is to curtail the lending power of member banks and to tighten the money market.

On the other hand, if securities are bought by the Reserve bank, the result will be that in the process of paying for them the Reserve bank will have to credit the reserve accounts of member banks. Again it does not know to what extent particular member banks will be affected, but it does know that reserves in general will be increased. By the same token the lending power of the member banks will be increased and general credit conditions will be eased. In the first stages of a buying program, the effect will be to enable banks to pay off any obligations they may owe, but if a buying program is continued long enough it may result in an accumulation of excess reserves.

In addition to the effect upon the reserves of member banks, there is also an effect upon bank deposits in general - even non-member bank deposits; because, if an investor or an institution buys some of the securities sold by the Reserve bank, payment will ordinarily be made out of a checking account and deposits will be decreased by so much. If, on the other hand, the Reserve bank is buying securities, and institutions and individuals are selling to it, the payments made by the Reserve bank will increase the deposit credit outstanding on the books of banks. Accordingly, banks which are not members of the Federal Reserve System and banks which themselves have not purchased or sold securities as a result of the Reserve bank's action, will nevertheless be affected by it, either in their reserves or in their deposits, or in both. The money market as a whole will be influenced.

In the early days of the System the Federal Reserve banks at first attempted to carry on their open market operations independently of one another, but it soon became clear that their actions must be coordinated. Otherwise they might find themselves competing with one another, and in conflict as between their own transactions and those transactions which as fiscal agents of the Government they were conducting for the United States Treasury. Accordingly, in 1922 a committee of Reserve bank officers was appointed for the purpose of coordinating the operations. About the same time the purpose of the operations was clarified. The principle laid down was: "That the time, manner, character, and volume of open-market investments purchased by Federal Reserve banks be governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation."

For some time prior to this there had been a tendency to allow purchases and sales of securities to be influenced by profit as an objective. The statement of principle which I have just quoted meant a definite abandonment of that objective. This was in line with the general policy of central banks in conducting open market operations; they do so definitely with the idea of correcting market tendencies and not for the purpose of making earnings.

The Banking Act of 1933 gave open market operations more specific recognition than they had had in the original Act. It gave statutory standing to the Federal Open Market Committee, which by then comprised one representative from each Federal Reserve bank. No Reserve bank could engage in open market operations except in accordance with regulations of the Board. At the same time the Act adopted substantially the same statement of purpose which had already governed open market operations.

The Banking Act of 1935 gave still further attention to the machinery of open market operations and to recognition of their importance. The Federal Open Market Committee was reconstructed to comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen regionally by the twelve Federal Reserve banks. This made the members of the Board constitute a majority of the Committee, and marked considerable development away from the original informal arrangements by which the Federal Reserve banks first conducted open market operations on their own initiative and then under the direction of a Committee on which the Board was not specifically represented. Furthermore, under the terms of the Banking Act of 1935, the Federal Reserve banks may neither engage nor decline to engage in such operations except in accordance with the directions and regulations of the Committee.

Another requirement of the Act is that a complete record be kept of the action taken on all questions of policy relating to open market operations, including a record of votes taken in connection with the determination of open market policies and a statement of the reasons underlying the action taken, and that this record be included in the Board's annual report. The publication of this record will give the public an opportunity to study the decisions as to open market policy and credit policy in general, and should help clarify public discussions of national credit policy. It will also accentuate the individual sense of responsibility, for members of the Committee will be called on not only to decide on credit policy, but to give publicly the reasons for their decisions.

It is clear, I think, that as a result of experience and statutory amendments, open market operations have taken a far more important place in general credit policy than they formerly had. It is also clear, I think, that open market operations have become a more important or at least a more positive device of credit control than discount rates. When the Federal Reserve Act was adopted the prevailing idea probably was that discount rates were not only the most definite means of credit control, but the most important. The thought was that as banks felt more and more demand from borrowers and went to the Reserve banks to procure the funds to meet it, they would encounter a rising discount rate, which would have the effect of tempering the demand and preventing an excessive use of credit. Conversely, as conditions improved, business activity would be encouraged by the fact that banks could procure funds to lend at a progressively lower rate. The most obvious difficulty with this theory, however, is that banks have not shown a disposition to borrow from the Reserve banks in order to relend. Banks don't like to borrow, and as a general thing they won't borrow unless they have to, no matter how low the discount rate is. Consequently, the effectiveness of the Federal Reserve discount rate is, by itself, rather limited. It is significant as an index of the cost of credit, but it does not come into action otherwise until a member bank finds it necessary to replenish its reserves. As I have already indicated, however, a member bank may be forced into such a position as the result of sales of securities by the Reserve bank, and the discount rate then becomes effective.

In other words, an important difference between discount rates and open market operations in practical effect is that open market operations give the central banking organization the initiative in the control of credit, whereas the discount rate by itself offers the controlling authority no handles to seize; it must bide its time passively until the situation is so bad that demand for funds is voluntarily made. This delay may seriously impair the power of the Federal Reserve bank to help the situation.

With respect to discount rates the Banking Act of 1935 made only one change. This was to require that they be established every fourteen days or oftener. It is not necessary that the rates be changed every time, but they must at least be reviewed and reestablished.

With respect to the reserves which member banks are required to maintain, the Banking Act of 1935 simplified the conditions under which the Board of Governors of the Federal Reserve System may alter the amount of reserves which is prescribed in the law. Prior to 1933, there was no authority to change reserve requirements administratively, but an act of May 12 of that year empowered the Board, with the approval of the President, to declare that an emergency existed and during the emergency to increase or decrease the reserve balances to be required. The Banking Act of 1935 allows reserve requirements to be changed by the Board without declaration that an emergency exists and without approval of the President. It does not permit, however, requirements to be reduced below the percentages stated in the statute nor to be more than doubled. The purpose of any change made in the requirements must be, in the words of the law, "to prevent injurious credit expansion or contraction."

I mentioned the requirement of the Banking Act of 1935 that a record be kept and published of the action taken with respect to open market operations. The Act also makes a similar requirement with respect to all questions of policy determined by the Board. A record of action taken, of votes upon policy, and of reasons underlying decisions is to be included in the annual report of the Board.

The responsibilities of the Federal Reserve banks as fiscal agents of the United States were not changed by the Banking Act of 1935, except for a provision which permits the Reserve banks to buy Government obligations only in the open market; direct purchases from the Treasury are not authorized.

I think that the foregoing covers sufficiently the more prominent changes which the Banking Act of 1935 made with respect to Federal Reserve functions. There are also two provisions of Title II which bear on member bank lending powers.

Indirectly, the Act tends to broaden these powers by giving the Reserve banks authority to make advances to member banks on any satisfactory security. The former provisions still stand as to paper that is known under the original terms of the Federal Reserve Act as "eligible" for discount - paper, that is, which originates in connection with industrial, commercial or agricultural transactions - and they also still stand as to advances to member banks on notes secured by eligible paper or by Government obligations. The new provisions are added to these old ones without altering them. Advances authorized by the new provisions are simply required to be secured to the satisfaction of the Reserve bank, to bear a rate of interest at least one-half percent above the Reserve bank's discount rate, and to have maturities of not more than four months. At present, when the banks have large excess reserves, this new provision in the law may not seem very important. But times may change. If and when they do, the new provisions mean that, assuming a bank's assets are good, the Federal Reserve bank will be able to advance money on them, no matter what the type of paper, or the nature of the transactions in which they originated. In other words, borrowing from the Federal Reserve bank has now been made possible on other than technical conditions of eligibility alone. This is very important. Many banks in recent years would have had much less trouble if they could have taken to the Reserve bank some of their assets which were good, but not legally eligible under the old terms of the law, instead of having to sacrifice them on a demoralized market. Provision for such advances was first adopted as a temporary, emergency measure in 1932, but the Banking Act of 1935 made it permanent.

The original provisions of the law with respect to eligible paper were based on the principle that since the liabilities of banks were payable on demand they should be offset by short-term self-liquidating paper based on specific transactions involving the exchange of goods. The amendments added by the Banking Act of 1935 are based on the principle that in fact American banks do not specialize in one type of credit as against another. They deal in credit of all sorts. They combine long term and short term credit functions. There is not enough short-term commercial paper to fill more than a small part of their portfolios. They accept the savings and time deposits of their communities and they also hold long term obligations of their communities. The new provisions for eligibility make the Federal Reserve Act cognizant of these realities and adapt the powers of the Reserve banks to them.

In a more direct way, the Banking Act of 1935 broadened lending powers by liberalizing the conditions under which National banks may make real estate loans. The old stipulation that the real estate upon which such loans are made must be situated in the bank's Federal Reserve district or within a hundred miles of the bank, has been removed; and loans which are amortized are now permitted in amounts up to 60 percent of the appraised value of the property and with maturities of as much as ten years, provided installment payments are sufficient to repay at least 40 percent of the principal in that time. The Act also increased the permissible aggregate of real estate loans which a national bank may hold.

I think the principal effects of the Banking Act of 1935 may be summarized as follows:

In the first place, while the Federal Reserve banks remain essentially unchanged in organization and function, the importance of their central banking activities has been more clearly recognized.

Second, the Federal Open Market Committee has been given a more effective position in the System and more definite authority.

Third, the Board of Governors has been given larger powers and more direct responsibilities, and the principles upon which the System is to be administered have been more clearly developed.

Fourth, the 6,400 member banks have been given broader lending powers, and the facilities of the Federal Reserve banks have been made available to them on less technical and restrictive terms.

Speech delivered before
Annual Convention of Maryland Bankers Association
Atlantic City, New Jersey
May 22, 1936

THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935

As I was on my way here from Washington yesterday afternoon and was turning over in my mind what I should be saying to you today, it occurred to me that I should by all means say something about the richness and diversity of the State of Maryland, which I was crossing. Cutting across the state in a northeasterly direction through Baltimore toward Philadelphia, I had on my right hand a part of the state that I understand is devoted largely to the production of tobacco and of tomatoes for canning. That part of the state also includes Chesapeake Bay with its shipping and its production of sea food. It includes the Eastern Shore with its fertile vegetable farms. It includes also the city of Baltimore, with its important shipping, manufacturing, and distributing activities.

To the left and running far out toward the west is another fertile region largely devoted to the cultivation of vegetables and other farm crops; and in the farther most counties, where the mountains rise, there is coal, buckwheat flour, and maple syrup.

It is the production of commodities such as these that furnishes the basis of the wealth of Maryland and of the business of its banks. Your customers live largely by producing these commodities and exchanging them for commodities produced outside the state. In facilitating this exchange, which is indispensable to the economic life of the state, you bankers perform an essential function. You make it possible for the tobacco, the sea food, and the vegetables produced in Maryland to be shipped outside to other markets, and to be paid for in the simplest and surest way. If it were not for your instrumentality, and if all these exchanges of goods had to be effected by the actual handling of currency, the whole economic process would be disrupted. But, through the utilization of bank credit, the process is facilitated.

This monetary function that you bankers perform involves your cooperation with one another. The banks not only of your state but of the country as a whole and even of the world constitute a net work of credit connections by means of which the trade between different regions is carried on. One of the most important steps ever taken in this country in the way of making this net work more effective was the establishment of the Federal Reserve Banks. These institutions knit the banking business of different communities and regions closely together so that inter-regional and inter-community payments and exchanges can be smoothly effected. They help to bridge with credit the distances that separate consumers from producers, and the intervals of time that elapse between production and consumption - between seed time and harvest - between the fabrication of goods and their delivery.

Instead of going into special phases of federal reserve policy, I want to survey briefly but comprehensively the structure and functions of the Federal Reserve System as a whole. This means I must mention many things already quite familiar to you; I trust you will understand that I do so not because I underestimate your knowledge of the System, but because I want to fill in the whole picture.

The Federal Reserve Act, which in 1913 established the Federal Reserve Banks, is one of the most important pieces of financial legislation ever passed in this country. It represented the decision reached after many years of dissatisfaction with our banking and currency facilities, brought to a head by the panic of 1907; after a thorough study of banking here and abroad by a National Monetary Commission established by Congress in 1908; and after long and earnest public discussions of banking reform over a period of twenty years or more. Since 1913, on the basis of actual experience and in response to new developments, numerous amendments have been made to the original Federal Reserve Act. During the depression changes were made by the Glass-Steagall Act of 1932, the Emergency Banking Act, the Banking Act of 1933, the Gold Reserve Act of 1934, and other acts. The most recent as well as the most important of these is the Act approved August 23, 1935.

Federal Reserve banks

The work of the System may be considered first from the point of view of the Federal Reserve banks in their relations with the banking institutions of the country, and then from the point of view of the broader responsibilities for credit policy which come under the central organization in Washington, now known, under the Banking Act of 1935, as the Board of Governors of the Federal Reserve System.

The location of the Federal Reserve banks was not determined by Congress, but by the Secretary of the Treasury, the Secretary of Agriculture, and the Comptroller of the Currency acting as the Reserve Bank Organization Committee. To this Committee Congress delegated the authority to designate not less than eight nor more than twelve reserve cities and to divide the continental United States into a corresponding number of reserve districts. These districts, according to the law, were to be apportioned with due regard to the convenience and customary course of business. They may be readjusted by the Board of Governors of the Federal Reserve System. In addition to the twelve reserve banks there are now in all twenty-five branches and two agencies. The Federal Reserve Bank of Richmond has branches in Baltimore and Charlotte.

All National banks were required to become members of the System, subscribing to the capital stock of the Reserve banks, and depositing their reserves therein. State banks were permitted to become members on similar terms, provided they fulfilled certain requirements as to capital structure and as to the general nature of their business. This division of the banks of the country into National and State banks, with different laws, powers, and supervisory authorities, was a basic condition upon which the Federal Reserve System was superimposed, and it is a basic condition to which its operations have always had to be adjusted.

About forty percent of the banks in the country now belong to the Federal Reserve System and these banks account for about seventy percent of the country's banking resources. About 35 percent of the banks in Maryland are members of the Federal Reserve System, and they hold about 50 percent of the banking business in the state. In the United States as a whole the member banks include 5,386 national banks and 1,001 State banks and trust companies. The State banking institutions which are still outside the System are for the most part small. There are about 9,000 non-members; about 1,400 of them have deposits of less than $100,000, and about 2,600 have deposits of less than $250,000.

Under provisions of the Banking Act of 1935 State non-member banks, with certain exceptions, having average deposits of $1,000,000 or over, must become members of the System after July 1, 1942 or lose the right of having their deposits insured with the Federal Deposit Insurance Corporation.

The Federal Reserve banks differ from ordinary commercial banks in both their organization and their functions. Their customers are the member banks who make deposits with them and secure credit or currency just as the public does with the local banks. Of the nine directors of each Federal Reserve bank, three known as Class C directors are selected by the Board of Governors of the Federal Reserve System and six are selected by the member banks, three known as Class A directors representing the stock holding member banks, and three known as Class B directors representing commerce, agriculture, or industry in the district. The chief executive officer of the bank, designated as president under the new banking act, is appointed by the board of directors of the bank subject to the approval of the Board of Governors of the System. The legal requirements for ownership and management of the Reserve banks, therefore, recognize that their functions must be performed in the public interest and that their management must take account of both the banking and the general business interests of the region.

<u>Holding member bank reserves</u>

One of the purposes of the Federal Reserve Act was to provide institutions which would hold the reserves of the nation's banking system. Before the establishment of the Federal Reserve System, National banks were required to keep part of their reserves in their own vaults and part on deposit in other banks, usually metropolitan banks. Banks in the central reserve cities, however, of which there were then three, New York, Chicago and St. Louis, had to hold all their reserves in cash. When there was a general and heavy demand for funds, especially at crop moving times, for example, and country banks everywhere drew down their balances with their city correspondents, a situation was developed in which a currency and credit crisis of greater or less magnitude might readily occur. Country banks then had difficulty in getting money from the city banks, and the public in turn had difficulty in getting money from the country banks and from the city banks as well.

Now all member banks are required by law to keep their reserves on deposit in the Federal Reserve bank of their district and it is the business of the Reserve banks to supply member banks with credit or cash in such emergencies.

The required reserves vary with the type of deposit and the class of of bank. Banks in <u>central reserve</u> cities, which now are only New York and Chicago, are required by law to maintain reserves equal to thirteen percent of demand deposits, that is, deposits which can be withdrawn without advance notice. For exmple, if a customer of a New York bank borrows $1,000, his deposit balance is credited with $1,000 and the bank in turn must provide for $130 of reserve deposit at the Federal Reserve Bank of New York, unless prior to the loan it already had excess reserves of that amount or more. Banks in so-called reserve cities, of which there are about sixty, are required to maintain reserves of ten percent against demand deposits, and all other banks are required to maintain reserves of seven percent. Reserves of three percent against time deposits are required to be maintained by all banks. Member bank reserve balances on deposit with the twelve Reserve banks amount now to over $5,000,000,000. Because of unusual conditions, the total of these balances is about twice as much as the banks are required to have.

Loans to member banks

The Reserve banks also supply funds to member banks either by rediscounting paper or by making advances to member banks, as provided by law and Board regulations, or by purchasing bills and securities, and entering corresponding credits to the account of the member banks, thus increasing their reserve balances. Member banks in turn can increase their loans to the public in the aggregate by an amount several times the amount of the additional reserves.

The Federal Reserve Act, however, makes distinctions as to the character of paper on which loans may be obtained from the Reserve banks. For many years Reserve banks have had the power to discount only short-term self-liquidating commercial paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial, industrial and agricultural transactions, and to make advances to member banks on their promissory notes backed by paper eligible for discount or purchase or by United States Government obligations. They were not authorized to make advances on a wide range of other assets which made up an important part of the total earnig assets of banks. These included real estate loans, securities other than those of the United States Government, and loans to business men which did not meet the requirements of the narrowly-defined eligible commercial paper.

As a result of many developments in our financial organization, paper which qualified for borrowing from the Reserve banks has constituted a constantly decreasing proportion of the total assets of member banks ever since the System was established. In 1929 it was only about twelve percent of total loans and investments of such banks, and in 1934 it was but eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks with assets which were good but technically ineligible for borrowing at Reserve banks, were obliged either to dump them on a falling market, suffer severe loss and contribute to the deflation in values or to close their doors.

The new banking act corrects this situation. It authorizes the Reserve banks to make advances to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank, at a rate of interest at least one-half of one percent above the highest discount rate in effect at the particular Reserve bank. This amendment modifies and makes permanent the emergency legislation which it was necessary to pass in 1932.

In addition to the foregoing general powers of discount and purchase the Federal Reserve banks have special powers with respect to loans to commerce and industry for working capital purposes. These powers are granted by Section 13b of the Act. Under this section the Reserve banks are authorized to discount loans made by member banks and other financing institutions to established industrial and commercial businesses for the purpose of supplying working capital. Such loans are to have maturities of not to exceed five years. The Reserve banks are authorized to discount these loans without recourse for as much as 80 percent of any loss thereon. The Reserve banks also have authority to grant commitments to discount such loans. This makes it possible for a member bank to hold in its portfolio loans which the Reserve bank is under obligation to take over upon request, and upon which the Reserve bank assumes 80 percent of any loss. In other words the member bank has an earning asset which is insured 100 percent as to liquidity and 80 percent as to loss. This arrangement is not restricted to member banks; it is open to non-members as well.

Under the same section the Reserve banks are authorized in exceptional cases, and when credit is not available from the usual sources, to make such loans for working capital purposes direct to the borrower.

As of May 13, the Federal Reserve Bank of Richmond had received 594 applications for working capital loans aggregating $24,000,000. Of these, 199, aggregating $11,000,000, had been approved. The Reserve bank's outstanding advances on that date were $4,200,000 and at the same time it had commitments outstanding for another $2,400,000.

These loans have been made to all kinds of enterprises, industrial and commercial. In many cases they have been loans which bankers have not been accustomed to making, and which would not be made were it not for the fact that the Reserve bank stands behind the bank which makes them. But as it is, they constitute secure and liquid assets, yielding a good rate of interest.

<u>Currency issued by Reserve banks</u>

Another activity of the Reserve banks is the issuance of Federal Reserve notes. These constitute the paper money authorized by the Reserve Act for the purpose of supplying the country an elastic currency - that is, a currency whose volume can be readily increased or decreased according to the public demand for it.

Federal Reserve notes are obligations of the United States and are secured by specific collateral pledged by the Reserve bank. The bank is required to keep reserves in gold certificates at least equal to forty percent of the notes in actual circulation. The Federal Reserve banks, of course, do not supply the entire currency of the country. The Government issues other paper money, silver dollars and minor coin, and National bank notes are still in circulation. The larger part of money in circulation, however, consists of Federal Reserve notes.

A member bank that has satisfactory assets can always secure all the currency that it needs. If it has a demand for more cash than it has in its vault, it can readily obtain Federal Reserve notes at its Reserve bank. It can borrow and take the proceeds in notes or it can draw against its account and, if necessary, restore the account to the required level by borrowing. If it receives on deposit from its customers more currency than it needs to keep on hand for current requirements, it can send the excess to the Reserve bank to be added to its reserve balance.

The function of supplying elastic currency is important, but it is less important than the lending power, because currency does not play a major role in present-day business transactions. About ninety percent of our business is conducted by the use of checks. Currency is used, for example, for purchases at retail stores and filling stations, for car fare, and for payrolls, but such uses account for only about ten percent of the total monetary transactions in the country. Such fluctuations in the demand for currency as appear regularly on pay days, during the period of Christmas shopping, and near holidays, are met completely by the machinery provided by the Federal Reserve Act.

## Other activities of Reserve banks

Beside their work in holding the banking reserves of the country, in making loans to member banks, and in supplying currency when needed, the Reserve banks have other important functions which facilitate the smoother working of our financial machinery.

The Reserve banks have greatly simplified the procedure whereby banks collect checks drawn on other banks. This has been very useful to business in general because it has permitted more prompt and cheaper settlement of monetary transactions. The Reserve banks in effect act as a nation-wide clearing house, not only for checks, but for other credit items such as notes, drafts, bonds and coupons.

In order to effect the prompt transfer of funds from one part of the country to another without actual movement of currency, the System maintains an inter-district Gold Settlement Fund in Washington. The fund was established by deposits of the twelve Federal Reserve banks, and transfers from one district to another are made daily by debits and credits to the respective accounts of the Reserve banks.

The Federal Reserve System has centralized the work of the fiscal agencies of the United States Government. The Reserve banks act as fiscal agents in connection with the issue and retirement of Government debt and as depositaries of Government funds in administering deposit accounts of the Government in the Reserve banks.

## Central control of credit policy

I wish to turn now from this discussion of the functions which the Federal Reserve banks perform for the local banks and consider how these activities tie in with the general responsibility of the System, through its Board of Governors, for the nation's credit policy.

When the Federal Reserve System was established it was realized that for certain activities, particularly those related to local banking conditions, a regional organization was necessary. Only in this way could the System meet local bank needs in a country as large as the United

States, with economic conditions varying so much from one section to another. Each regional bank would have intimate knowledge of developments in agriculture, commerce and industry in its district and of the district's special credit needs and problems. The principle was also established by the original Federal Reserve Act that under the authority of the Act and of regulations of the Board in Washington the Reserve banks should have final responsibility in their dealings with member banks.

At the same time, it was also realized that the credit policy of the different Federal Reserve banks must be coordinated so that policies adopted in one district would not be harmful to another. More than that, there should be a credit policy for the country as a whole which would take account of general business and credit conditions. The direction of this policy is the duty of the Board of Governors of the Federal Reserve System, which is the central organization located in Washington. The Board is aided by other organizations which work closely with it, the Federal Advisory Council and the Federal Open Market Committee.

## Board of Governors of the Federal Reserve System

Experience has indicated that this power of the Board to affect the expansion and contraction of the general supply of credit is of vital importance to the country, since the volume of credit is a factor in determining the course of business, and proper changes in the cost and volume of credit may tend to moderate excessive expansion or contraction of business, or, in other words may reduce the danger of inflation and deflation.

The Board's ability to influence the volume of credit rests on three important powers: the power to determine discount rates, the power to change reserve requirements, and the power, exercisable through its majority of members on the Federal Open Market Committee, to determine open-market policies.

## Discount rates

Discount rates are the rates charged by the Federal Reserve banks on loans to member banks. These rates determine the cost of borrowing by member banks and consequently have a bearing on the cost at which the public can borrow from these banks. Indirectly they affect other rates in the money market. Under the Federal Reserve Act changes in discount rates are made by the various Federal Reserve banks but are subject to review and determination by the Board of Governors. This gives the Board final responsibility over the discount rates, and enables it to keep the cost of borrowing in the different sections of the country consistent with general credit conditions for the country as a whole.

The new banking act strengthens the Board's power to control these rates by making the further provision that discount rates must be submitted to the Board of Governors every fourteen days. This insures frequent review of the rates.

## Reserve requirements

The Board of Governors also has the power to change the reserve requirements of member banks. The volume of credit which any member bank may extend is limited by the amount of reserves which are required by law to be maintained against its deposit liabilities. An increase in the reserve requirements reduces and a decrease increases the potential volume of member bank credit. Consequently the power to change reserve requirements gives the Board an important means of controlling the general volume of credit. Formerly this power could be exercised only in the event of an emergency arising out of credit expansion and then only with the approval of the President of the United States. Under the new act these conditions are omitted. The power is to be exercised in order to prevent injurious credit expansion or contraction, provided that reserve requirements may not be reduced below the present requirements specified in the law nor increased to more than twice the amount of these legal requirements.

## Open-market operations

The third important means of control over the supply of credit are the so-called open-market operations, responsibility for which under the new banking act will be vested in a new Federal Open Market Committee. This committee will consist of the seven members of the Board of Governors and five representatives of the Reserve banks selected by the Reserve banks in different regions.

Open-market operations consist of the purchase and sale by Reserve banks of certain classes of securities, chiefly Government obligations. These operations have the effect of increasing or decreasing the supply of credit available in the market. By selling securities the Reserve banks withdraw funds from the market and there is a decrease in the supply of credit. Through a purchase of securities a Reserve bank puts funds into the market, thus tending to ease credit conditions.

Purchases and sales of securities by the Reserve banks were unimportant in the early days of the System. It was not until 1922 that they were large enough to affect the money market. At that time it became necessary to take steps to coordinate purchases and sales so that credit conditions for the country as a whole would not be adversely affected. Gradually these purchases and sales have become one of the most important means whereby the System can take the initiative in influencing credit conditions.

The responsibility for determining what security transactions should be undertaken and the authority for enforcing a program were not clearly defined by law until the new banking act. At the time this act was passed an Open Market Committee consisting of representatives of the twelve Reserve banks was authorized to propose purchases and sales. Its proposals were then submitted to the Federal Reserve Board, which had the authority to approve or disapprove but not to initiate a policy.

The new act clearly places responsibility for determining open-market transactions on the new Open Market Committee and directs the Reserve banks to carry out the transactions determined by this committee. This is one of the most important changes in the Federal Reserve System which the new act introduces.

## Other work of the Board

The Board of Governors has a variety of other duties which tie in with its general responsibility for supervision of the System. These include the examination of Reserve banks, passing on applications of State banks and trust companies for membership in the System, obtaining condition reports from State member banks, administration of those provisions of the Clayton Anti-trust Act which relate to interlocking bank directorates, regulation of the maximum rate of interest to be paid by member banks on time and savings deposits, regulations under the Security and Exchange Act governing the margin requirements for loans on securities listed on the stock exchanges, and maintenance and operation of the inter-district Gold Settlement Fund.

Information bearing on credit policy

It has always been a part of the System's work to watch credit trends and to develop a better general understanding of the facts bearing upon credit policy. Information bearing on banking conditions throughout the country and on production, employment, trade and prices, has been regularly collected. In its monthly publication, the Federal Reserve Bulletin, and in its Annual Reports, the Board has undertaken from the beginning to give the public a comprehensive view of current banking and financial developments at home and abroad and also to furnish detailed information on conditions of banks throughout the country and on the business situation. Each of the Federal Reserve banks also publishes a monthly review of the business and banking conditions in its district.

There is no central bank in the world which makes available such exhaustive information on domestic banking and business developments and on the formulation of its credit policy as that which is published by the Federal Reserve System.

In the foregoing description of the System and its functions I have had occasion to mention most of the important changes effected by the Banking Act of 1935, but I think it is desirable to summarize them for the sake of completeness. I omit reference to Title I of the Act, for it deals exclusively with deposit insurance. I also omit reference to Title III, for the changes it effects are mainly technical and by way of clearing up previously existing provisions. The following changes are summarized from Title II:

1. Since March 1 the chief executive officer of each Federal Reserve bank is designated president instead of governor, and the deputy governors are designated as vice presidents.

2. The Board is given authority to waive in whole or in part the statutory requirements relating to the admission of State members to the Federal Reserve System, if such waiver is necessary to facilitate the admission of any State bank which is required to become a member in 1942 in order to be an insured bank or to continue to have its deposits insured.

3. The old designation of the Board as the Federal Reserve Board is changed to Board of Governors of the Federal Reserve System. An important change in the composition of the Board became effective February 1 when the Secretary of the Treasury and the Comptroller of the Currency ceased to be members, and the number of members was changed from eight to seven. The regular term is now fourteen years, and no member having

served a complete term of fourteen years can be reappointed. The title of the chief executive officer of the Board has been changed from Governor to Chairman.

4. The Board is required to keep a complete record of the action taken by the Board and by the Open Market Committee upon all questions of policy and of the reasons underlying such action and to include a copy of the records in its annual report.

5. The Federal Reserve banks may make advances to member banks with maturities of not to exceed four months, secured to the satisfaction of the Reserve bank, and at a rate of interest not less than 1/2 percent higher than the Reserve bank's discount rate. This is the authorization I have already discussed which enables member banks to borrow from the Reserve bank not merely on so-called eligible paper, but on any good assets.

6. The Open Market Committee is made to consist of the members of the Board and of five representatives of the Reserve banks, and is given definite authority over the open market operations of all the Reserve banks.

7. The express stipulation is made that direct obligations of the United States and obligations which are fully guaranteed by the United States may be bought and sold by Reserve banks without regard to maturities, but only in the open market. This is to prevent direct purchases of issues of government securities from the Treasury.

8. Federal Reserve bank discount rates are required to be established every fourteen days, or oftener if deemed necessary by the Board.

9. The Board of Governors, on the affirmative vote of four of its members may by regulation change the requirements as to reserves to be maintained against time and demand deposits by member banks; but the change shall not make the required reserves less than now established by law nor more than twice that now required. Formerly the existence of an emergency and the approval of the President were necessary conditions of such action by the Board.

10. National banks may make real estate loans up to 50 percent of the appraised value of the mortgaged property for periods not exceeding five years; except that if the loan is on an amortization basis it may be made up to 60 percent of appraised value and for a term of not longer than ten years. Real estate loans must not exceed the capital and surplus of the bank, or 60 percent of the bank's time and savings deposits, whichever is greater.

There are two important changes effected under the new banking legislation and I should like in conclusion to emphasize them.

First there are the provisions that fix responsibility more definitely for the the determination and direction of national credit policy through control of open market operations, of discount rates, and of reserve requirements.

Second there are the provisions that broaden the classes of member bank assets eligible as security for loans from Reserve banks, and encourage local banks to meet a wider range of credit needs in their communities.

It must be recognized, however, that if the System is to achieve as much as we all hope, it will need more than these new provisions. It will need the cooperation of business men, bankers, and the general public. For that reason I appreciate the opportunity I have had of discussing with you the System's powers and purposes.

Speech delivered before
Seattle Convention, American Institute of Banking
Seattle, Washington
June 9, 1936

# THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935

In speaking before the American Institute of Banking it is appropriate to stick to facts and fundamentals.

I want to describe the Federal Reserve System from the point of view first of the Federal Reserve Banks and then from the point of view of the Board of Governors in Washington, and in passing to indicate such changes as were effected by the Banking Act of 1935.

## Federal Reserve Banks

The Federal Reserve Banks have direct relations with about 6,400 banks which are members of the Federal Reserve System. This is less than half the banks in the country. However the banks which belong to the System do about 70 per cent of the banking business of the country; and the proportion of the total banking business handled by them has shown in recent years a strong tendency to increase.

## Holding Member Bank Reserves

The fundamental purpose of the Federal Reserve Banks is to hold reserves of member banks. Before the establishment of the System it was long recognized that one of the greatest weaknesses of our banking was the lack of a scientific system of reserves. The requirements for national banks thirty years ago, for example, just before the panic of 1907, - which had much to do with bringing about the establishment of the Federal Reserve Banks - was that each country bank should keep reserves of 15 per cent, of which at least 6 per cent was to be kept as cash on hand and the rest on deposit in correspondent banks in reserve or central reserve cities. National banks in reserve cities had to keep reserves of 25 per cent, at least 12½ per cent in cash and 12½ per cent on deposit with correspondent banks in central reserve cities. There were three central reserve cities: New York, Chicago, and St. Louis. The banks in these cities had to keep reserves of 25 per cent - all in vault cash.

The percentage of reserves which such banks are now required to keep on demand deposits is 7 per cent for country banks, 10 per cent for reserve city banks, and 13 per cent for central reserve city banks; and on time deposits all banks must keep 3 per cent.

The great difference, however, is that whereas at that time the banks partly kept their legal reserves in their own vaults and partly kept them with one another, and had no certain means of augmenting their reserves except when everything was easy, the banks now have to keep their legal reserves with the Reserve Banks and they have in the Reserve Banks a means of augmenting their reserves by the discount or sale of assets.

The Federal Reserve System substitutes a flexible arrangement for a rigid one; and a bank with sound assets can no longer find itself without the means of maintaining its reserves.

These conditions remain the same substantially as they were in the original act. With respect to the assets which a bank can discount at the Federal Reserve Bank, however, the law has made important changes.

Lending Powers

The original act sought to encourage banks to make commercial loans and it therefore definitely discriminated in favor of such loans by limiting the class of paper eligible for discount. This comprises, in the words of the act, "notes, drafts, and bills of exchange issued or drawn for agricultural, industrial or commercial purposes." Moreover, such paper, to be eligible, had to mature in three months or less from the time of discount, except that agricultural paper might mature in six months.

Whatever the intention, this limitation did not in fact result in a preponderance of such paper in the portfolios of banks. On the contrary eligible paper has showed for many years a tendency to occupy relatively a smaller and smaller place among bank assets. In 1929 it was only about 12 per cent of loans and investments of member banks, and in 1934 it was only 8 per cent. This change is due to a variety of factors. In the large it represents the fact that American banks, instead of specializing in any one type of credit, have tended to deal in all kinds of credit, long term as well as short, required by their communities. The effect of this was to limit the power which it was originally intended that the Reserve Banks should have of enabling banks with sound assets to maintain their reserves. Consequently, banks which still needed to convert assets into reserves after having discounted their eligible paper were often forced to dump other sound assets on the market and get what they could.

The Banking Act of 1935 sought to correct this condition by amending the Federal Reserve Act to authorize the Federal Reserve Banks to make advances to member banks for not to exceed four months on any security satisfactory to the Reserve Bank. Previous legislation had already enlarged the lending powers of the Reserve Banks, but this change went farthest by making it possible for a member bank to discount any sound asset at the Reserve Bank regardless of type.

Currency

At the time the Federal Reserve Act was adopted, probably its most important purpose in most people's minds was to furnish an elastic currency. The difficulties at which the System was aimed were thought of mainly as currency problems and not as credit problems. It is now generally recognized, however, that the supply of currency is principally a routine matter that presents no difficulties so long as credit and banking conditions are sound.

This brings me to the matter of general credit control and to the functions which pertain largely if not mainly to the Board of Governors of the Federal Reserve System.

## Discount Rates

The establishment of discount rates as authorized by the Federal Reserve Act is partly the responsibility of the Federal Reserve Banks and partly the responsibility of the Board of Governors. The Reserve Banks, in the words of the act, are to establish the rates "subject to review and determination of the Board". Since discount rates affect other rates in the money market and since the rate in one district should take into account the rates in other districts, the Board has to consider the question from the point of view of general credit conditions. It has, therefore, the final responsibility.

The Banking Act of 1935 strengthened the Board's power by requiring that rates be established every fourteen days or oftener. It is not necessary that the rates be changed every time, but they must at least be reviewed.

The great limitation upon discount rates as a means of general credit control is that they are not effective except as banks voluntarily seek to discount their paper. When the Federal Reserve Act was adopted the importance of this limitation was not fully realized, and discount rates were generally regarded as the most prominent means of credit control. At the same time a device that is now regarded as most important received at that time very little consideration. This is open market operations.

## Open Market Operations

Open market operations are now regarded of great importance because they are not subject to the limitation just referred to. They enable the central banking organization to take the initiative instead of having to wait on individual banks to take the initiative. Moreover, their effect is comprehensive rather than local.

Open market operations consist of purchases and sales of securities - mainly government securities - by the Federal Reserve Banks. By selling securities the Reserve Banks withdraw funds from the market and there is a decrease in the supply of credit, because as the securities are paid for the reserves of member banks are diminished. By purchasing securities the Reserve Banks put funds into the market, and tend to ease credit, because their payments increase the reserves of member banks.

It was not till 1922 that open market operations became large enough to affect the money market. As a result of war financing the Federal debt had increased from one to twenty-six billions with a correspondingly large volume of government securities. It then became necessary for the individual Reserve Banks to coordinate their purchases and sales. Accordingly a committee was formed for that purpose. At the same time it was definitely established that the purpose of the operations was not profit but control of credit. The principle was as follows:

> That the time, manner, character, and volume of open market investments purchased by Federal Reserve Banks be governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation.

The Banking Act of 1935 gave statutory recognition to the Federal Open Market Committee, and forbade any Reserve Bank to engage in open market operations except in accordance with regulations of the Board. At the same time the Act adopted substantially the same statement of purpose as had already governed the operations.

The Banking Act of 1935 went still further. It directed that the Federal Open Market Committee should consist of all the members of the Board of Governors and five representatives chosen by the Federal Reserve Banks regionally. This was a definite centralization of control.

Reserve Requirements

The Banking Act of 1935 increased the Board's power in another respect also by authorizing it to change the statutory reserve requirements, which have already been mentioned. The Board may increase them to as much as twice the present requirement, but may not lower them below the present. This is a very important power because the volume of credit which any member bank may extend is limited by the amount of reserves it is required to hold.

Formerly this power could be exercised only in emergency and with the approval of the President of the United States. The matter is now one simply of the Board's discretion.

Other Changes

The most important changes effected by the Banking Act of 1935 have been covered in the foregoing. A few others may be mentioned.

The title "president" was given to the chief executive officer of each Federal Reserve Bank instead of the former title "governor".

The old designation "Federal Reserve Board" was changed to "Board of Governors of the Federal Reserve System", and the title of the chief executive officer of the Board, which was formerly "governor", was changed to "chairman".

The ex officio membership of the Secretary of the Treasury and the Comptroller of the Currency was discontinued and appointment of seven appointive members was authorized.

Other Activities

The Federal Reserve Banks and the Board of Governors have a variety of duties which cannot be mentioned in brief space. Notable among these is the compilation and publication of information bearing on banking and credit conditions, here and abroad, and including data on production, employment, trade, and prices. In the Federal Reserve Bulletin, which is published monthly, and in the Annual Report of the Board, a comprehensive view is presented of the current banking and financial situation. Each of the Federal Reserve Banks also publishes a monthly review and an annual report.

No other central banking organization in the world makes available such comprehensive information on domestic banking and business developments, and on the considerations taken into account in formulating credit policy, as does the Federal Reserve System.

Speech delivered before
Michigan Bankers Association Convention
Mackinac Island, Michigan
June 27, 1936

Mr. Chairman and Ladies and Gentlemen: I did not know until just the day before yesterday that I would be here this morning. I got in touch with Mr. Brundage, and told him that inasmuch as a member of the Board was expected here, we felt it our duty to send someone. After I returned from the Coast, where I had spoken in Seattle, Spokane, Portland and other places, I was the one chosen, and it has given me much pleasure to come. I am glad to be with you this morning, but I am sorry I cannot stay with you throughout the day, tomorrow and the day following, but have to return immediately to the East.

It is important for members of the Board to attend conventions, especially a Jubilee Convention. It is important for members of the Board to meet with bankers, as well as businessmen and industrialists. It is important for us to get information directly, so that we might be able to prepare ourselves for the various tasks which confront us in Washington from day to day, principally on matters of regulation. It is difficult to adopt regulations of one kind or another in Washington after a law has been passed by Congress, unless one knows something of the actual conditions which face bankers, businessmen, industrialists and farmers throughout the country. That is the reason that we find it necessary, and also very pleasant, to come out and meet you, talk to you and get from you whatever information we can, and take it back to Washington.

There is not anything in what I shall say this morning that will make a front page story. I will express no opinions whatsoever. I shall be purely factual in what I have to say.

It is important likewise for us not only to discuss the different matters that confront us from time to time, but it is important for us also to meet you here, not only you individually, but to hear the other speakers on your program, because in that way we get something of existing ideas and conditions throughout the country, and we are able to adjust ourselves to them.

You know after being in Washington for a certain period of time, one is apt to think or feel that because the laws are made there, and because regulations are adopted there, perhaps we are a sort of a power in ourselves. We are not. Whatever we do must be based upon what you do. Therefore, it is important for us to know what you are doing. Very frequently, too, we hear frank discussions, which are very important for us to hear.

We are much in the position of the fellow who went back to his home town, down in Indiana, after he had served two or three years in Washington, in the Cabinet of the President of the United States, many years ago; and after arriving in his home town, he naturally looked for some of the people that he had known when he had lived there. He saw an old character coming down the street, and walked up to him and said, "Do you remember me?" The chap said, "Sure, I remember you; you are Mr. So-and-So." "You remember that I left here many years ago?" He said, "Yes, not so many, about three years ago you left here." "Well, do you know where I am now?" This fellow said, "Yes, you are in Washington." "Well, do the people out here know that I am in Washington?" "Yes, the people here know that you are in Washington." "Do they know that I am the Attorney-General, in the Cabinet of the President of the United States?" "Yes, they know that. They all know that." "Well, what do they say about it?" This man looked at him and said, "Oh, they just laugh, that is all."

That is about the size of it.

I have not had time to prepare a speech. I shall, therefore, discuss with you, not off the record, but extemporaneously, the provisions of the Banking Act of 1935.

I am sorry that Mr. Miller is not here to speak to you on "Money." He would have delivered a very fine address on that subject.

Now, if I repeat some of the things that you already know about the Banking Act of 1935, I shall have to ask you to pardon me. But if I mention some of the other things that perhaps you do not recall at the moment, then I do so for the purpose of keeping them in mind constantly.

In the preparation of our regulations, one must remember that we do no prepare them because we want to bind the bankers in their operations. We get out regulations simply because we have to. The laws are passed by Congress, and not by the Board. After they are passed by Congress, we naturally have to send out to the bankers, to member banks, something that is of a specific nature, and has to do with the administration of that particular law. Frequently, therefore, in order to cover nearly every imaginable case that might arise under that law, the regulations are rather lengthy and appear to be complicated, and it is not so pleasant for a banker to have a very lengthy and very complicated regulation. But the regulations cover many possible emergencies that might or might not arise under the law.

On the other hand, if you adopt a regulation that is short, simple, and broad, it, of itself, of course, brings into Washington a great many requests for interpretation. As each case arises, there is a request for interpretation of that particular part of the regulation. So rulings are sent out through the Federal Reserve banks to the member banks, and the shorter the regulation, the more numerous the rulings under the regulation; so that whether you begin with a long regulation in the first place, or whether you begin with a short regulation in the first place, you finally end up with about as many provisions either in the regulation, or in the form of rulings. In each section of the Act we have different conditions, and different practices, and in order to meet these different conditions and these different practices, different interpretations of the regulations are necessary.

Now, that is why it is so important for us to keep daily in touch, through the Federal Reserve banks, with the practices of the member banks, and the non-member banks, for that matter. That is why the Federal Reserve Bank of Chicago has present here in this room the president of that bank, Mr. Schaller, the Assistant Federal Reserve Agent, now vice president of the Federal Reserve Bank of Chicago, Mr. Young, and Mr. Dillard, also a vice-president of the Federal Reserve Bank of Chicago. I would just like in passing to introduce these gentlemen, Mr. Schaller, Mr. Dillard, Mr. Young; and over to the left of Mr. Dillard is Mr. Buss, the manager of the Detroit branch of the Federal Reserve Bank of Chicago. Also present here this morning is Mr. Geery, of the Federal Reserve Bank of Minneapolis. There are others of the Federal Reserve present, that I have not seen up to this moment. They are here for the purpose of hearing you, and talking to you about these different matters that arise from time to time, and getting from you directly whatever you may have in your minds, and giving to you directly whatever information they have available, so that our relations with you may be as effective as possible, and so that we may all work together for the common good.

In the Banking Act of 1935, there were two principal ideas. The first was to place responsibility more definitely upon a group of men, for the monetary control, or the credit control of the country. And so the Banking Act of 1935 made new provisions for open market operations, which were not specifically referred to in the original Federal Reserve Act. Originally the open market operations of the Federal Reserve System were engaged in by each Federal Reserve Bank independently of the other Federal Reserve Banks; and principally for the profit of each Federal Reserve Bank.

It was soon recognized that these operations had effects upon the credit condition of the country, because as the Federal Reserve Banks purchased large amounts of securities in the open market, they naturally supplied the country with a large amount of credit or funds, and as they sold large amounts of securities, they naturally received from the banks the funds with which the securities were purchased. The operation of buying tends to make money or credit more available; and the operation of selling tends to make money less available. The operation of buying tends to ease the money market as it were, and the operations of selling tends to harden the money market.

Open market operations soon became so important that in 1922 a committee was organized for the purpose of unifying the operations of the Federal Reserve Banks. After adopting the policy, this committee would refer it to the Board in Washington, and the Board would either approve or disapprove it. After this action, each Federal Reserve Bank could, if it wished, proceed with the operation, taking its share of securities, or selling its share of securities; or it had the choice of not participating.

In other words, there were three principal bodies in each and every open market operation. First, there were the twelve Governors of the Federal Reserve Banks. Second, there were the eight Board members in Washington. Third, there were the nine Directors of each Federal Reserve Bank.

Now, it was soon learned that when a certain operation was considered advisable, and a certain policy was adopted, it required a certain amount of time under this form of procedure to consummate the action, and when finally the thing was done, it might be found that the result intended was not obtained, because of the time that had elapsed.

The Banking Act of 1933 gave specific authorization for the Federal Open Market Committee and adopted the following statement of the purposes of open market operations:

> "The time, character, and volume of all purchases and sales of paper described in section 14 of this Act as eligible for open-market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made further reference to the Federal Open Market Committee and its powers. It provided that the seven members of the Board of Governors of the Federal Reserve System should be members of the committee and that there should also be five members representative of the 12 Federal Reserve Banks. One of these five representatives is elected by the Federal Reserve Banks of Boston and of New York. Another is elected by the Federal Reserve Banks of Chicago and of St. Louis. The third is elected by the Federal Reserve Banks of Cleveland and of Philadelphia. The fourth is elected by the Federal Reserve Banks of Atlanta, Richmond, and Dallas. The fifth is elected by the Federal Reserve Banks of Kansas City, Minneapolis, and San Francisco. In this connection I should mention the fact that the Banking Act of 1935 also changed the name "Federal Reserve Board" to "Board of Governors of the Federal Reserve System," and made the Board consist of 7 members in place of 8. The Board formerly had two ex officio members, the Secretary of the Treasury and the Comptroller of the Currency, but now all seven of its members are appointive. The 7 members of the Board in addition to the 5 representatives of the banks make 12 members of the Federal Open Market Committee in all.

The Federal Open Market Committee meets in Washington at least four times a year. Frequently, of course, it meets upon call, when there is a condition that must be met immediately.

There is an Executive Committee of five, which has power to do certain things in the absence of the members of the full Committee. They initiate the open market operations. Purchases and sales are principally of Government securities; the Reserve Banks now have about two billion four hundred million dollars of Government securities.

Having decided upon its policy, the Open Market Committee communicates its decision to the twelve Federal Reserve Banks. The Banking Act of 1935 now provides that no Federal Reserve Bank can engage in open market operations except in accordance with the regulations of the Open Market Committee. The Reserve Banks purchase or sell in accordance with the policy adopted. In other words, they do not have the choice they had previously, either to join with the other banks, or refuse to join with the other banks in following any particular policy.

The next thing of importance in the Banking Act of 1935 has to do with the discount rate. Discount rates are dependent upon one particular thing that open market operations are not dependent on; that is, they are dependent on the banks borrowing at the Federal Reserve Bank, whereas open market operations are not dependent upon anybody else initiating anything. They are dependent on the Board, or the Committee, to be initiated and carried through.

Discount rates presume that member banks are borrowing at the Federal Reserve Bank, and when they are borrowing, of course, discount rates have some meaning. The lower the rate, naturally the easier it is to borrow, and the more funds are supplied to the public, through the member banks, and through the non-member banks. The higher the rate, the more difficult it is to borrow, and, therefore, the less funds are made available through the banks to the public.

But banks are not apt to borrow unless they have to. Originally it was not thought that that would be the case when the Federal Reserve Act was passed; it was thought that the banks would borrow, as a regular thing, at the Federal Reserve Bank, and, therefore, discount rates had more meaning, and the rate was the thing that everybody watched for. Today the rate only means that that is the cost of money, and little more.

It has some further meaning only when banks borrow at the Federal Reserve Bank, and banks do not borrow at the Federal Reserve Bank unless they have to. When they have an excess reserve, they naturally will not borrow at a Federal Reserve Bank. When their reserves are just above, they will not borrow, but when they get down to the point where they are below the 13 percent or the 7 percent, or whatever it is, why, then they begin to watch the discount rate. So then your rate does have some effect upon the credit conditions of the country.

The Banking Act of 1935 now provides that the directors of each Federal Reserve Bank shall adopt a discount rate every fourteen days. That is a new requirement. This must be done every fourteen days, and the rates submitted to the Board in Washington for approval.

Now, the purpose of this is, I think, that they may be in constant touch with the rate in each Federal Reserve Bank, so that if conditions change, the rate will be changed as frequently as necessary. The rate will not be allowed to run for an indefinite period of time without reconsideration both by the Reserve Bank directors and by the Board of Governors in Washington.

In addition to that, there is another very important part of the Banking Act of 1935 that I should like to mention here this morning. It has to do with credit control. That is the power to establish an increas of the reserve requirements, and it is pretty important, principally today.

I have just returned from the Coast, where I spoke to the bankers of Washington, Idaho, and Oregon. Six or eight months ago when I was speaking to them, they were in favor of an increase in the reserve requirement. But, today, I understand, they are not so much in favor of it.

The Banking Act of 1935 gives the Board of Governors power to increase, when necessary, the reserve requirements, and thereby to check at any time an excessive use of credit. For example, the requirements may be doubled if necessary, the 13 percent becoming 26, or any point between, and the 10 percent becoming 20, if necessary, or any point between 10 and 20, for Reserve city banks, and the 7 percent becoming 14 percent, if necessary, for other banks, known as country banks, or any point between 7 and 14, and the 3 percent on time savings deposits becoming 6, or any point between 3 and 6. Reserve requirements may be increased for the purpose of taking action against the possible excessive use of credit, all over the country, if necessary.

Of course, the thing that worries the average banker, as I see it, is that power. Perhaps the average banker would not worry so much about the power if the law were very specific about it, stating very definitely that we must readjust our reserve requirements, and, therefore, in place of 13 percent on demand deposits in central Reserve cities, from now on it would be 26, or, let us say 10 more, making it 23, or any point within that figure of 13 and 26.

What worries the average banker is that perhaps if the Board should increase reserve requirements from 13 to, say, in the central Reserve cities, up to 20, or from 13 to 15, making it less than 20, then perhaps in a short while there would be another increase. That puts the average banker in a position of uncertainty.

We have at present about three billion dollars excess reserves -- when I left Washington it was about two billion six hundred million. In spite of the fact that we have the largest amount of excess reserves in the history of this country, certainly no one will say that there is an excessive use of credit. We might say, however, that there is a possibility of excessive use of credit should this money once begin to flow into agriculture, into commerce, into industry, and especially if it should begin to flow into speculative channels.

The Federal Reserve Act originally contemplated that paper eligible for discount would be paper that is called commercial paper, 30, 60 and 90-day paper, and the thought was that the money that originally was loaned on that paper would go back into the same channels when it was rediscounted, but we found that that was not the case. The money may go back into commerce, industry and agriculture, or it may go into speculative channels, nobody knows.

So, therefore, action for the purpose of making an adjustment that is more or less stable, might be considered. But whatever is done naturally must be based on the information we obtain from banks, from business, commerce, agriculture and industry, and from what we see is going on in the speculative market.

We are constantly in touch, through our Federal Reserve Banks, as you know, with the general credit conditions of the country. We have charts supplied us by the Federal Reserve Banks' statistical departments, and we have our own department in Washington, one of the best in the country, which presents the facts and the figures constantly, so that we know what is going on. We also obtain information directly wherever we can.

We have, as you know, one of the best publications of its kind, and that is the Federal Reserve Bulletin, which has all of these facts, all of these figures and trends from day to day, from week to week, and from month to month, and from year to year. We have these not only in respect to the United States, but in connection with foreign countries, because we have to reckon with conditions that are not purely domestic, as you know. We have to reckon with conditions that exist in Europe. We do not know from day to day what will happen in France, for example. We do know that certain amounts of gold have come into the United States from France and from England. We do know that certain amounts of gold are still flowing into the United States. There was a time when these amounts were very large, and they are not as large now. We do not know what will happen in Europe. We do not know what negotiations may be going on, as far as relations between foreign countries are concerned. We have no control over those conditions, as you know.

The monetary situation of the country is a factor in the credit condition of the country. The issuance of silver certificates by the Treasury is a factor in the credit condition of the country. Knowledge of the fact that the Treasury itself has a very large stabilization fund that it can use at almost any time to affect a certain credit condition that might exist, makes us the more careful, because whatever we mete out in that direction may be offset by action taken by the Treasury with its stabilization fund. All of these facts must, therefore, be taken into consideration, and it is very important that the members of the Board and the officers of the Federal Reserve Banks keep an open mind constantly on matters of that kind.

We have refrained, therefore, from expressing opinions on things that we do not know about, and we are quite frank to say that we do not always know what we shall do until the condition faces us at the particular moment. Then when we do it, we must do it because its effectiveness in operation is dependent upon the action that is taken. We depend upon the facts and figures that we have at the particular moment.

The next important thing in connection with monetary control, is the policy of warning banks not to conduct certain operations, or engage in certain credit practices, and asking them to limit the amount of money that they lend for certain purposes, particularly speculative purposes, to certain customers. If they continue to engage in practices about which they have been warned, there is power given to the Board to stop further extension of credit to the bank concerned. And if they still engage in those operations, even after that, there is power granted to effect the removal of the officers who are responsible.

Now, of course, that is something that no Federal Reserve Bank, and no Board of Governors wishes to do, but it is a very direct means of acting in the situation which might arise in a particular bank.

There is still another means of credit control that I must tell you about. It has to do with lending money on registered securities, by brokers, dealers, and by member and non-member banks.

When the Securities Exchange Act was passed, power was given the Board of Governors of the Federal Reserve System to regulate the amount of credit that would be extended on registered securities by brokers and dealers, and by banks, to their customers, as they come into the bank to borrow money. This is covered by Regulation U.

Now, the principal purpose of Regulation U is to limit the percent of the current market value of the securities that can be loaned by the bank to the customer. When the customer says that he is borrowing the money, in order to purchase the securities, and is pledging the securities that he is purchasing with the bank as collateral, the banker proceeds under present limitations to loan 45 percent of the current market value. That is for the purpose of purchasing. If a customer borrows for the purpose of carrying the securities, the same principle applies.

The question arises, if the customer does not submit the security that he purchases with this money, is the banker still compelled to loan him only 45 percent of the current market value of the security? The answer is, no. Of course, in practice, in ninety-nine cases out of a hundred, the banker will certainly request the security that the man purchases with the money that he borrows from the bank. There are very few cases where the banker will say, "Now, you can go ahead and purchase this security, and you do not need to bring in the collateral."

But suppose this man does not bring this collateral in, or, suppose he brings in a certain collateral, and when the banker looks at it, it is not the registered security in question, and he borrows the money not for the purpose of purchasing that particular security, but he borrows the money for the purpose of building a house. Now, does the banker need to loan him only 45 percent? Does he come under the regulation? The answer is, no. It is only for the purpose of purchasing or carrying registered securities, and only when those securities are the collateral put up behind that particular note.

Now, that, in general, is Regulation U, as it affects the banker. It has to do with a specific means of control and with a certain particular type of credit which does not affect commerce, industry or agriculture. It is a means by which the use of bank credit for speculation is checked. It necessitates our keeping in touch with the Securities Exchange Commission. It is a very important thing, especially at this time.

Well, that much for monetary control. The Banking Act of 1935, therefore, places that responsibility principally in the Board of Governors in Washington, including the Open Market Committee, which consists of the Board of Governors in Washington and five representatives of the twelve Federal Reserve Banks. That is one section of the Banking Act of 1935. The other section of the Banking Act of 1935, has to do with the liberalization of the credit basis upon which member banks may obtain money or funds from the Federal Reserve Bank. As you know, there is a provision in the Banking Act of 1935 that permits a member bank to borrow at the Federal Reserve Bank for a period not to exceed four months on any sound collateral, - not merely on eligible paper, but on any sound collateral. The question does not arise anymore as to the particular paper. It is just a question of soundness. Therefore, the loan may be made for a period of four months on any sound collateral, at a rate not less than one-half percent higher than the discount rate at that bank at the moment of signing the note. That is important only when banks are borrowing at the Federal Reserve Bank.

There is another important matter which has to do with the extension of credit; that is the power given National Banks to make mortgage loans up to fifty percent of the appraised value of the mortgaged property, or sixty percent of the appraised value, if the loan is for a period of ten years, and forty percent is to be amortized during the period of ten years

Those, in general, comprise the essence of the Banking Act of 1935. There are several other things of minor importance.

There is another matter that I forgot to tell you about. The Federal Reserve Banks are prohibited from purchasing Government securities directly from the Treasury. All purchases of Government securities by the Federal Reserve Banks must be in the open market, and never from the Treasury directly. That is very important.

I am very happy to have been with you this morning, and I wish that I could stay longer, but my 'plane is waiting to take me back. I think that our presence here indicates how much we are interested in what you are doing and saying. I personally do not come far from this particular point, as I hail from Chicago, and I am very much interested in Michigan, naturally, because I expect to be back here again some day. An understanding of the things that we are trying to do is the important thing, and not so much what I have tried to say to you here, because if you do understand them, itis so much easier; if you understand our problems, and we understand yours, it is so much easier to work together, because, after all, we are not trying to work against each other, but we are trying to work together, and the more we understand each other, the easier it is, because, as Kipling wrote,

"It ain't the individual, nor the army as a whole
But the everlasting teamwork of every blooming soul."

I thank you very much.

Speech delivered before
Trenton Chapter, American Institute of Banking
Trenton, New Jersey
November 18, 1936

THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935

It gives me the greatest pleasure to visit chapters of the American Institute of Banking and see the effort and interest devoted to improvement of the technique of banking. The activity of the institute's chapters is evidence of an initiative that makes for progress. Bankers as never before are studying the technique of their business and developing their knowledge of the conditions affecting it. Supervision of banking in the public interest is no deterrent to initiative, for the desire of the supervisory authorities is not to interfere with the banker's initiative but to cooperate with him in every possible way for the improvement of American banking. A real spirit of cooperation is characterized in the relations of your Institute, the American Bankers Association, and the Federal Reserve authorities. Out of the day to day contact of bankers with their customers in banking offices throughout the country, there arise certain broad questions of policy and practice, which, in the public interest need to be followed by especially constituted authorities. These are questions that can only be seen in the large and when one detaches himself sufficiently from the day to day routine. It is from this point of view that I wish to speak to you about the Federal Reserve Banks and the Board of Governors and the duties they exercise with respect to the interest of the public as a whole in the banking business.

The Federal Reserve System is not a commercial banking system, nor a savings bank system, nor an investment banking system. It deals with reserves. It is a system which does not work for individual banks, but for the banking system as a whole. It is not a system operated for profit; it deals with reserves which must be held back at certain times and utilized at others in order to correct extreme tendencies one way or other in credit conditions. It is operated in the public interest - as created by Congress - crossing all state lines and covering the nation as a whole.

Its organization is such that responsibility is partly centralized and partly decentralized. Certain general responsibilities are entrusted to the Board of Governors in Washington and to the Federal Open Market Committee; regional responsibilities are entrusted to the twelve Federal Reserve Banks.

The cooperation between the central Board of Governors and the twelve regional Banks is illustrated by the fact that five of the members of the Federal Open Market Committee are elected from the Reserve Banks and by the fact that discount rates originate in the districts, even though they are subject to review and determination by the Board in Washington. The System is represented in the Federal Advisory Council which now consists of 12 bankers elected by the boards of directors of twelve Federal Reserve Banks. It is represented also in the conferences of presidents of the Federal Reserve Banks which are held periodically in Washington. There are many other System conferences in the law department, examination department, economic department, operating department and in other fields.

The System consists of 6,400 member banks. These include 5,368 national banks and 1,032 member state banks. As you know all national banks are required to be members of the System. State banks may voluntarily make application for membership, and if they qualify, are accepted into the System. Although the number of member banks is less than half the banks in the country, they do about two-thirds of the banking business of the country.

As you also know the member banks hold stock in the Federal Reserve Bank of their district. Each subscribes to six percent of its capital and surplus - three percent of which is paid in at once and the other three percent may be called at any time.

There are twelve Federal Reserve Banks located in different sections of the country. There are also twenty-five branches of these twelve Federal Reserve Banks, and two agencies.

At each Federal Reserve Bank is a Board of Directors, consisting of nine men. Six of these men are elected by the member banks and three are appointed by the Board of Governors of the Federal Reserve System in Washington. One of these three men appointed by the Board of Governors in Washington, is designated as Chairman of the Board and Federal Reserve Agent.

The Federal Reserve Banks have the power of selecting their presidents and vice-presidents. The Board has no power to force an unacceptable candidate on the Federal Reserve banks, but those selected by the Federal Reserve Banks must have approval of the Board of Governors in Washington. This results in a more harmonious operation of the System, which naturally requires a meeting of minds between the directors of the bank and the Board in Washington in the selection of key officials.

The officers of the Federal Reserve Banks keep in close touch with their member banks in order to insure that the service of the Federal Reserve Banks is satisfactory and that their facilities are fully known. The officers of the Federal Reserve Banks as well as the members of the Board welcome criticism and constructive suggestions, for it is their desire to do everything within their authorized powers to make the services of the Federal Reserve Banks useful and valuable to their member banks. Visits are also made to nonmember banks, in order that no bank interested in becoming a member of the Federal Reserve System need feel doubtful as to what the conditions and advantages of membership are.

Prior to the establishment of the System it was felt that an outstanding weakness of our banking was the lack of a satisfactory system of reserves. As I said before the fundamental purpose of the Federal Reserve Banks is to hold reserves of member banks.

Just prior to the panic of 1907 - which played a large part in bringing about the establishment of the Federal Reserve Banks - each country national bank was required to keep reserves of 15 percent, six percent of which was to be kept as cash on hand. The rest was on deposit in correspondent banks in reserve cities or central reserve cities. National banks in reserve cities were required to keep reserves of 25 percent, at least 12 1/2 percent in cash and 12 1/2 percent on deposit with correspondent banks in central reserve cities. New York, Chicago, and St. Louis constituted the three central reserve cities, and the banks in these cities had to keep reserves of 25 percent - all in vault cash.

The percentage of reserves which such banks are now required to keep on demand deposits is 10 1/2 percent for country banks, 15 percent for reserve city banks, and 19 1/2 percent for central reserve city banks. All banks must keep 4 1/2 percent on time deposits.

The great difference, however, is that whereas at the time the banks partly kept their legal reserves in their own vaults and partly kept them with one another, they had no certain means of augmenting their reserves except when everything was easy. The banks now have to keep their legal reserves with the Reserve banks and they have in the Reserve banks a means of augmenting their reserves by the discount or sale of assets.

It was the purpose of the original Federal Reserve Act to encourage banks to make commercial loans. It definitely discriminated in favor of such loans by limiting the class of paper eligible for discount (in the words of the Act) to "notes, drafts, and bills of exchange issued or drawn for agricultural, industrial or commercial purposes." This paper, however, had to mature in three months or less from the time of discount, with the exception of agricultural paper, which might mature in six months.

This limitation did not in fact result in an abundance of such paper in the portfolios of banks - on the contrary such paper, for many years, showed a tendency to occupy a relatively smaller place among the bank assets. In 1929 it amounted to about 12 percent of loans and investments of member banks. In 1934 it was 8 percent. This shows that the American banks, instead of specializing in any one type of credit, have dealt in all kinds of credit - long term as well as short - according to the requirements of their communities. The effect of this was to limit the power which it was originally intended that the Reserve Banks should have of discounting for member banks which wished to replenish their reserves.

The Banking Act of 1935 sought to correct this condition by amendment, which would authorize the Federal Reserve Banks to make advances to member banks for not to exceed four months on any security satisfactory to the Reserve Bank. Previous legislation had enlarged the lending powers of the Reserve Banks, but this change made it possible for a member bank to discount any sound asset at the Reserve Bank regardless of type.

Now you might ask - how can reserves be augmented or, in other words, built up - how can the banking system <u>increase</u> the amount of reserves available to it at the Federal Reserve Bank? First, it can do so by depositing currency, but this is not a practicable means, because the amount of currency required by the public is a definite amount at a given time and the banks cannot very well change that amount. Second - it can do so by depositing gold. However, the availability of gold is not dependent on the action of the banks, but on the international flow of funds and the output of domestic mines. Substantially, therefore, increase of reserves can be brought about only by member banks borrowing at the Federal Reserve Banks, or by the Federal Reserve Banks buying securities or acceptances. When the amount of Federal Reserve credit increases, member bank reserves increase, and when member bank reserves increase, there is ordinarily a corresponding increase of several times that amount in the volume of member bank deposits as the result of loans or purchases of investments by the member banks. On the other hand, when the volume of reserve bank credit diminishes either through the repayment of discounts by a member bank or through a sale of securities by the Federal Reserve Bank, there is a loss of reserves which in the absence of currency or gold movements can be made up only through a decrease in the banks' loans and investments of several times the amount of the decrease in reserves. This is the leverage through which the Federal Reserve System can influence the volume and cost of money.

Another activity of the Reserve banks is the issuance of Federal Reserve notes. These constitute the paper money authorized by the Reserve Act for the purpose of supplying the country an elastic currency - that is, a currency whose volume can be readily increased or decreased according to the public demand for it.

Federal Reserve notes are obligations of the United States and are secured by specific collateral pledged by the Reserve bank. The bank is required to keep reserves in gold certificates at least equal to forty percent of the notes in actual circulation. The Federal Reserve banks, of course, do not supply the entire currency of the country. The Government issues silver dollars, minor coin and some paper money and, until July of last year, the National banks continued to have the privilege of issuing National bank notes. The larger part of money in circulation, however, consists of Federal Reserve notes.

A member bank that has satisfactory assets can always secure all the currency that it needs. If it has a demand for more cash than it has in its vault, it can readily obtain Federal Reserve notes at its Reserve bank. It can borrow and take the proceeds in notes or it can draw against its account and, if necessary, restore the account to the required level by borrowing. If it receives on deposit from its customers more currency than it needs to keep on hand for current requirements, it can send the excess to the Reserve bank to be added to its reserve balance.

The function of supplying elastic currency is important, but it is less important than the lending power, because, as you know, currency does not play a major role in present-day business transactions. About ninety percent of our business is conducted by the use of checks. Currency is used, for example, for purchases at retail stores and filling stations, for car fare, and for payrolls, but such uses account for only about ten percent of the total monetary transactions in the country. Such fluctuations in the demand for currency as appear regularly on pay days, during the period of Christmas shopping, and near holidays, are met completely by the machinery provided by the Federal Reserve Act.

Next I wish to mention a function of the Federal Reserve Banks whose existence and importance is frequently overlooked. I refer to what they do as fiscal agencies. As you know, the Federal Reserve Act provides that the Federal Reserve Banks "when required by the Secretary of the Treasury shall act as fiscal agents of the United States." The duties which the Federal Reserve Banks perform under this provision always have been extremely important to the government, and in recent years they have come to absorb a larger and larger part of the attention and time of the Federal Reserve Bank personnel. In addition to servicing the public debt, providing currency, and acting as depositary of the United States Treasury, the Federal Reserve Banks perform a large amount of work for various government agencies, such as the Reconstruction Finance Corporation, the Federal Home Owner's Loan Corporation, the Farm Credit Administration, the Public Works Administration, the War Department, Veterans Administration and an additional number of government agencies and bureaus. In the year 1935 the Federal Reserve Banks handled almost 69,000,000 Treasury checks and over 16,000,000 checks issued to work relief employees. This was an average of about 20,000 checks a day at each of the twelve Federal Reserve banks.

The transactions involved in servicing government securities are of great importance; they comprise receiving applications for new issues, delivery of securities to subscribers, exchanging securities of different denominations, meeting maturities, and paying interest. During the year 1935 the Federal Reserve Banks delivered to subscribers almost 1,600,000 bonds, notes, certificates, and bills sold by the Treasury, and redeemed over 4,000,000 different government obligations. They exchanged over a million obligations for the convenience of their holders and paid over 14,000,000 interest coupons. In the year 1936 they prepared and mailed over 24,000,000 bonus bonds to veterans.

Were it not for the Federal Reserve Banks, the government would have to provide other agencies for the purpose of handling these operations at a substantially increased cost.

In addition to holding the reserves of the United States banking system, making loans to member banks, furnishing an elastic currency which automatically increases or decreases according to the public demand, simplifying the procedure whereby banks collect checks drawn on other banks, acting as fiscal agents of the Government in connection with the issue and retirement of Government securities, etc., the Federal Reserve System has a certain national credit control through discounts, open market operations, direct action, reserve requirements, and margin requirements.

DISCOUNTS:

The Federal Reserve Act provides that each Federal Reserve Bank establish from time to time rates of discount, subject to review and determination by the Board of Governors of the Federal Reserve System. The Banking Act of 1935 added the requirement that such rates shall be established "every fourteen days, or oftener if deemed necessary by the

Board." This does not require that such rates must be changed every time, but they must be regularly and frequently reviewed.

The presumption behind discount rates is that member banks will borrow at the Federal Reserve Bank, and when they are borrowing, of course, discount rates have some force. The lower the rate, naturally, the easier it is to borrow, and the more funds are supplied to the public, through the member banks, and through the nonmember banks. The higher the rate, the more difficult it is to borrow, and, therefore, the less funds are made available through the banks to the public.

Originally at the time of the passage of the Federal Reserve Act, it was thought that the banks would borrow, as a regular thing, at the Federal Reserve Bank, and, therefore, the discount rates had more meaning. The rate was the thing that everybody watched for. Today the rate has significance of the cost of money, and little more.

As a matter of fact, banks do not borrow at the Federal Reserve Bank unless they have to. When they have an excess reserve, they naturally will not borrow at a Federal Reserve Bank. When their reserves are just above, they will not borrow, but when they get down to the point where they are below the required percent, they begin to watch the discount rate.

<u>OPEN MARKET OPERATIONS:</u>

The Banking Act of 1933 gave specific authorization for the Federal Open Market Committee and adopted the following statement for the purposes of open market operations:

> "The time, character, and volume of all purchases and sales of paper described in section 14 of this Act as eligible for open-market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Act further provided that the seven members of the Board of Governors of the Federal Reserve System should be members of the Committee and that there should also be five members representative of the 12 Federal Reserve Banks.

The Federal Open Market Committee meets in Washington at least four times a year. Of course, it also meets upon call when conditions exist that must be met.

Open Market Operations consist of the purchase and sale by the Reserve Banks of securities, mainly government obligations, for the purpose of increasing or decreasing the supply of credit available in the money market as a whole. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available. On the other hand, by purchasing securities the Reserve Banks place funds into the market and more credit becomes available.

When the Reserve Banks sell securities the reserves of member banks become diminished in the process of paying for the securities that are sold, whereas when they purchase securities, the funds which are released in payment flow directly or indirectly into the reserve accounts of the member banks and enlarge them.

The Banking Act of 1935 gave statutory recognition to the Federal Open Market Committee. It also prohibited any Reserve Bank to engage in open market operations except in accordance with regulations of the Board

The purpose of the open market operations is not to make profit for the Federal Reserve Banks.

DIRECT ACTION:

Another means of credit control is by direct action. By this I mean efforts to discourage credit policies of given member banks in given circumstances. This is a policy of warning banks not to conduct certain operations or engage in certain credit practices, and of directing them to limit the amount of money that they lend for certain purposes, particularly speculative purposes.

If a bank continues to engage in practices about which it has been warned, there is power given to the Board to stop further extension of credit to the bank concerned. And if the bank continues with the practice criticized, there is power granted to effect the removal of the officers responsible.

Direct action is aimed at the correction of specific conditions in particular banks; also for the purpose of enforcing general credit policy.

RESERVE REQUIREMENTS:

The Banking Act of 1935 gives the Board of Governors power to increase, when necessary, the reserve requirements, and thereby to check at any time an excessive use of credit, but the Board is not permitted to lower them below the original requirements of thirteen, ten, seven percent on demand deposits, and three percent on time deposits, nor increase them to more than twice that amount.

Naturally the result of raising the rates would be to decrease the lending power of member banks and the amount of available credit, whereas the lowering of rates enlarges the lending power and the amount of available credit.

This power formerly could be exercised only in emergencies and with the approval of the President of the United States. It is now one simply of the Board's discretion.

MARGIN REQUIREMENTS:

There is still another means of credit control - it has to do with the lending of money on registered securities, by brokers, dealers, and by member and non-member banks. Authority for the Board to issue regulations governing this form of credit control was granted by the Securities Exchange Act of 1934.

Under this authority the Board has issued Regulations "T" and "U".

Regulation "T" governs the extension and maintenance or credit by brokers and dealers in securities for the purpose of purchasing of carrying securities. Regulation "U" governs loans made by banks for the purpose of purchasing of carrying stocks registered on exchanges.

The power given the Board to impose and relax restraints upon the demand for credit for speculative purposes is aimed at a particular use of credit and at the specific channels through which demand for it becomes effective.

It extends the powers of the Board outside the Federal Reserve System to reach directly brokers and nonmember banks. It differs from the powers of discount, because while these powers may be exercised to discriminate against paper directly involved in speculative uses, they cannot prevent the speculative use of funds procured by the discount of paper not directly involved in speculation. It also differs from the power to conduct open market operations which influence the total amount of funds, but not the uses to which they can be put. The same thing is true of the power to alter reserve requirements. Direct action can be used to discriminate against the speculative use of credit, but only in individual cases. In margin accounts, however, the regulation is directed at an unmistakable objective and cannot miss affecting the speculative use of credit.

Although the means I have discussed by which credit control may be exercised might appear comprehensive and powerful, I do not wish to convey the thought that a perfect control of credit is affected through them. Their application cannot be mechanical nor governed by unvarying rules. Credit and economic relationships are extremely intricate and circumstances under which the need for action arises are always to some extent different and special.

For one thing, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. Although it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country, still from the point of view of the communities they serve and of relations with other banks, the importance of the thousands of small banks which are outside the System is not negligible.

For another thing, United States Treasury activities must be taken into account. These have to do in part with the operations of the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve large sums and intimately affect the banking and credit situation.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold to the United States from abroad - a movement that in the last two years has added over three billion dollars to the reserves of member banks and created a quite unprecedented credit situation.

These factors, among others, necessarily limit and modify the exercise of credit control.

Credit control is a very technical matter. It is essential, however, and if the important objectives of credit control are to be achieved, their general purpose must be understood.

While I have discussed the more important changes effected by the Banking Act of 1935, there are a few others that might be mentioned for the sake of completeness.

1) The chief executive officer of each Federal Reserve Bank is designated president instead of governor, and the deputy governors are designated vice-presidents.

2) The Board has authority to waive in whole or in part the statutory requirements relating to the admission of State banks to membership in the Federal Reserve System, if such waiver is necessary to facilitate the admission of any State bank which is required to become a member in 1942 in order to be an insured bank or to continue to have its deposits insured.

3) The old designation of the Board as the Federal Reserve Board is changed to Board of Governors of the Federal Reserve System. At the same time an important change in the composition of the Board was brought about. The Secretary of the Treasury and the Comptroller of the Currency are no longer members of the Board. The number of members is now seven, whose terms are for fourteen years. No member having served a complete term of fourteen years can be reappointed. The Act provides that such members shall be appointed by the President with the advice and consent of the Senate, and the President in making the selection shall have due regard to a fair representation of the financial, agricultural, industrial, and commercial interests, and geographical divisions of the country. The title of the chief executive officer of the Board is now Chairman, instead of Governor. Each of the seven Board members is a Governor.

4) The Board is required to keep a complete record of the action taken by it and by the Open Market Committee upon all questions of policy, and of the reasons underlying such action, and shall include a copy of the records in its annual report to Congress.

5) Provision is made for the purchase and sale by the Federal Reserve Banks of direct obligations of the United States and obligations which are fully guaranteed by the United States without regard to maturities, only in the open market. This prevents purchases of issues of government securities from the Treasury.

6) National banks may make real estate loans up to 50 percent of the appraised value of the mortgaged property for periods not exceeding five years; except that if the loan is on an amortization basis it may be made up to 60 percent of appraised value and for a term of not longer than ten years. Real estate loans must not exceed the capital and surplus of the bank, or 60 percent of the bank's time and savings deposits, whichever is greater.

As you know, the Board in Washington is constantly in touch, through our Federal Reserve Banks, with the general credit conditions of the country. We have data supplied us by the Federal Reserve Banks' statistical departments, and we have our own research and statistical department in Washington, which presents facts and figures constantly, so that we know what is going on. We compile and publish information bearing on banking and credit conditions, here and abroad, and include data on production, employment, trade, and prices.

We also publish the Federal Reserve Bulletin, a monthly publication, and the Annual Report of the Board, in which is presented information on the current banking and financial situation. Each of the Federal Reserve Banks also publishes a monthly review and an annual report.

No other central banking organization in the world makes available such comprehensive information on domestic banking and business developments.

This information is of vital importance, especially to bankers.

I wish to emphasize particularly the importance of it as related to the operations of the Federal Reserve System. In that connection I am glad to know that many chapters of the American Institute of Banking are giving courses on the Federal Reserve System; and at the Institute graduate school of banking at Rutger's a course on the System will be given beginning next summer by Dr. Burgess of the Federal Reserve Bank of New York.

It has been a genuine privilege to be with you this evening I hope my visit is evidence of the sincere desire of the Board of Governors and of the Federal Reserve Banks to cooperate with you as individual bankers, as members of the American Institute of Banking, and as members of the American Bankers Association in the development of an ever improving technique of banking in the interest of the public.

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