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THE CURRENCY FUNCTION OF THE FEDERAL RESERVE BANKS

Three fundamental facts must be kept in mind in order to understand the functions of the Federal Reserve banks in relation to the country's supply of currency. These facts are: (1) The Federal Reserve banks are semi-public institutions with Government representation on the Boards of Directors; they operate under the general supervision and in some vital matters under the control of the Board of Governors of the Federal Reserve System, a Governmental body, appointed by the President. (2) The Federal Reserve banks are not operated for the purpose of making profits, but for the purpose of serving the public interest in ways prescribed by the law. Earnings of the Federal Reserve banks above expenses and dividends go into a surplus account which in case of liquidation belongs to the Government. (3) The amount of money in circulation is determined by the needs of the public and not by the Federal Reserve banks. This is what is meant by an elastic currency.

1. Federal Reserve banks are semi-public institutions

Each of the twelve Federal Reserve banks has nine directors, of whom three, including the chairman, are appointed by the Board of Governors in Washington. The appointments by the directors of the presidents and first vice presidents and all salaries fixed for officers and employees of the Reserve banks are subject to approval by the Board of Governors. The Board of Governors also has control over discount rates, that is, the rates that the Reserve banks charge for their loans to member banks, and constitutes a majority of the Federal Open Market Committee, which determines the amount of Government securities the Federal Reserve banks shall buy or sell. The Federal Reserve banks are privately owned institutions in the sense that their capital stock is owned by the member banks, but under the provisions of the law the stockholders elect only six of the nine directors, and the actions of the directors in all matters of national importance are subject to review by the Board of Governors in Washington.

Under the law the Board of Governors through its local representative, the Federal Reserve agent, has authority "to grant in whole or in part, or to reject entirely, the application of any Federal Reserve bank for Federal Reserve notes." The frequently made assertion that the Government has turned over the power to issue money to a private agency which uses such power for its own profit is, therefore, contrary to the facts both as a matter of law and as a matter of practical operation.

2. Federal Reserve banks are not operated for profit

The Federal Reserve banks were created for purposes stated as follows in the preamble to the Federal Reserve Act: "To furnish an elastic currency, to afford means of rediscounting commercial paper, and to establish more effective supervision of banking in the United States." They were not created for the purpose of making profits for private interests. The principal functions of the Federal Reserve System are to exert an influence on changes in the supply and cost of credit with the view to accommodating commerce and business, to hold the reserves of member banks and to make advances to them when they are in need of additional funds, to supply an elastic currency, to facilitate the collection of checks and interregional transfers of credit, to act as fiscal agents and depositaries of the United States Treasury and other Governmental agencies.

Earnings of the Federal Reserve banks are derived from interest obtained on their loans and investments, the volume of which reflects principally credit policies adopted in the public interest and not for the purpose of obtaining profits. Of the total earnings since their establishment in 1914, the Federal Reserve banks have spent nearly one-half in meeting expenses, a large part of which represents the cost of collecting checks drawn on deposit balances in member and nonmember banks and in the maintenance and distribution of an adequate supply of currency.

After the Federal Reserve banks' expenses have been met, they are required to pay out of their earnings a 6 percent cumulative dividend to stockholding member banks. Of the amount earned by the Reserve Banks above expenses from the time of their establishment to the end of 1935, about one-fourth has been paid as dividends to member banks, which in addition to their contribution to the capital funds of the Reserve banks are required to hold much larger reserve balances with the Reserve banks on which they receive no interest, one-fourth has been paid as a franchise tax to the United States Government, under a provision repealed in 1933, one-fourth was appropriated by Congress in 1933 as a contribution to the capital of the Federal Deposit Insurance Corporation, on which the Federal Reserve banks are not entitled by law to any return, and the remaining fourth has been paid into the Reserve banks' surplus account. The surplus increases the ability of the banks to serve the public and, when earnings are insufficient to pay expenses and dividends, it may be drawn upon to make up the deficiency. In case a Federal Reserve bank is liquidated, its surplus, after meeting all obligations, becomes the property of the United States Government.

It is apparent, therefore, that three-fourths of the net earnings of the Reserve banks since their establishment have been devoted to public purposes.

3. The Federal Reserve banks provide an elastic currency

The amount of money in circulation at a given time represents what the public collectively wants, since currency always moves out of the Federal Reserve banks when the demand for it increases and returns to them when the demand subsides. This is what is meant by an elastic currency. When currency is needed, the public obtains it from its local banks, and the latter obtain it from the Federal Reserve banks. When it is not needed, the public deposits it in the local banks, and the local banks in turn redeposit it in the Federal Reserve banks. The Federal Reserve banks may be regarded as reservoirs from which additional currency is drawn when the public requires it and to which currency not required by the public is returned. The Federal Reserve banks have no direct way of keeping in circulation a larger amount of currency than the public requires, or reducing the amount of currency that the public needs to finance its current operations.

The demand for currency is determined by various conditions. A certain minimum is required to day-to-day cash expenditures of individuals; a certain minimum is required for payrolls. There are times when personal expenditures rise, as during holidays, and there are times when payrolls rise, as during harvest. Certain individuals, businesses, and communities have their own periods when they need more or need less cash than ordinarily. The net effect of all of these factors is a normal and regularly repeated cycle of demand for currency year after year — slack after the first of January, when retail trade falls off following the holidays, larger during the succeeding spring months, when payrolls increase and outdoor industries become active, slack again in mid-summer, and steadily increasing during autumn and early winter to the regular peak in December.

In addition to this regular annual cycle, the amount of currency also responds to increases and decreases in the volume of retail trade and of payrolls as the amount of business done by the country increases or decreases. There have been times also when the demand for currency was greatly increased as in the period preceding the banking holiday in 1933. In the course of a few weeks at that critical time the Federal Reserve banks furnished the public with as much as $2,000,000,000 of additional currency.

For more than twenty years the Federal Reserve banks have fully met the normal demands of the country for currency; they have also fully met peak demands both in times of prosperity and in times of depression, and they have made it possible for the volume of money to decline automatically when the public demand for it declined. The elasticity of our currency is complete.

Machinery of note issue

Before a Federal Reserve bank can obtain Federal Reserve notes it must deposit as security with the local representative of the Government, known as the Federal Reserve agent, collateral at least equal in amount to the notes to be issued. This collateral, as provided by law, may consist only of the following assets: (1) promissory notes, drafts, bills of exchange, or acceptances, usually referred to as "eligible paper"; (2) gold certificates on hand or due from the United States Treasury; and (3), until March 3, 1937, United States Government securities bought in the open market. In addition to being secured by the pledge of specific collateral, Federal Reserve notes are a first lien on all the assets of the issuing Federal Reserve bank, and a 40 percent reserve in gold certificates must be maintained against them.

In all cases Federal Reserve notes are issued only for an adequate consideration. The currency an individual receives from his local bank is charged against the amount he already has to his credit on the bank's books, and the currency the local bank receives from the Federal Reserve bank is charged against the amount it already has to its credit on the latter's books. Issuing currency for purposes of circulation is at all points, therefore, an exchange of cash for something of equal value.

As of September 2, 1936, the Federal Reserve banks had obtained $4,300,000,000 of Federal Reserve notes, of which $4,000,000,000 were in circulation and $300,000,000 were held in the vaults of the Federal Reserve banks. The collateral held against these notes was as follows:

Gold certificates on hand and due from U. S. Treasury	$4,301,000,000
United States Government securities	73,000,000
Eligible paper	5,000,000
Total	$4,379,000,000

Gold certificates are receipts which are issued to the Federal Reserve banks by the United States Treasury for gold deposited with it in compliance with the Gold Reserve Act of 1934, which required all monetary gold in the United States to be delivered to the Treasury. The Federal Reserve banks have no right to pay out these gold certificates. As indicated, the Federal Reserve banks have pledged $4,300,000,000 of these certificates against $4,000,000,000 of their own notes in circulation. Federal Reserve notes, therefore, at present are virtually substitutes for gold held in the United States Treasury. They constitute about two-thirds of the total of $6,200,000,000 of money in circulation.

The Emergency Banking Act of March 9, 1933, authorized the Federal Reserve banks during the period of the emergency to issue Federal Reserve bank notes, which are to be distinguished from Federal Reserve notes. These notes, when issued, must be secured by at least an equal amount of collateral, which may consist either of direct obligations of the United States or of promissory notes, drafts, bills of exchange, or bankers' acceptances acquired by the Federal Reserve banks under the provisions of the Federal Reserve Act. There are about $50,000,000 of these notes in circulation, but the Federal Reserve banks have deposited a sufficient amount of lawful money with the Treasury to provide for their redemption. No such notes are now being issued.

National bank notes also are no longer being issued. The privilege of issue which national banks formerly had has been discontinued, and the banks have deposited with the Treasury sufficient funds to redeem all their outstanding notes. All other kinds of money — United States notes, silver certificates, and coin — are issued exclusively by the United States Treasury.