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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date September 23, 1937

To Chairman Eccles

Subject:

From Mr. Goldenweiser

The attached article on "The Nature of Federal Reserve Banks" was written for the purpose of giving a more complete list of differences between Federal Reserve banks and other banks than is now available. I have not given any thought to the question as to the desirability of its publication nor to the form such publication might take.

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THE NATURE OF FEDERAL RESERVE BANKS

by

E. A. Goldenweiser

Federal Reserve banks were established and are operated for the advancement of the public interest. They are not ordinary business undertakings like other banks, which are operated with a view to making the maximum amount of returns on the capital investment, consistent with the safety of the funds entrusted to them by their depositors.

Purpose of Federal Reserve banks

The public purposes for which Federal Reserve banks are operated have been variously defined at different times. In the preamble to the Federal Reserve Act it is stated that they were established for the purpose of providing an elastic currency, to offer opportunities to discount paper, and for better supervision of banking. In other sections of the law the guiding principle for Federal Reserve policy is stated as "the accommodation of commerce and business with due regard to general credit conditions." On the basis of experience the Federal Reserve System has gradually developed a broader conception of its purposes.1/ Briefly stated, these objectives are to use the powers of the System in such a way as to contribute to the continuous employment of the nation's productive resources and to diminish undesirable fluctuations in the volume of business activity.

1/ See: Objectives of Monetary Policy, issued by the Board of Governors. Federal Reserve Bulletin, September 1937.

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It is clear, therefore, that the purposes of the Reserve banks are radically different from those of other banks. In the following pages are outlined the structural and functional differences between the Reserve banks and other banks, with a view to indicating in what ways these differences are adapted to the furtherance of the public purposes which the Federal Reserve banks must serve.

Number and location of Federal Reserve banks

Perhaps the first difference is the fundamental one that a Reserve bank cannot be organized or dissolved, except by the action of Congress. Congress determined that there shall be no less than eight and not more than twelve Federal Reserve banks, and once twelve banks were established upon the decision of the Federal Reserve Board their number cannot be changed, except by Congress. The cities in which the Federal Reserve banks are located were also determined by a public body, an official committee appointed for that purpose. Branches of the Reserve banks can be established and discontinued, but this can be done -- not by private individuals or by directors of the Reserve banks -- but only by the Board of Governors of the Federal Reserve System, a public body appointed by the President with the advice and consent of the United States Senate. The Reserve banks, therefore, are the creation of Congress, and not of private enterprise, and their number and location are determined by a public body.

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Ownership of Federal Reserve banks

Ownership of the Federal Reserve banks is legally vested in its member banks. But the manner of their ownership is also very different from the usual arrangement followed in the case of a private enterprise. Participation in the ownership is not optional. No bank or other institution can purchase Federal Reserve bank stock simply because it believes that the stock is a good investment, or that a voice in the management of the Reserve banks would be desirable to obtain. Who shall be the owners of the stock of the Federal Reserve banks is stated in the law: all national banks, that is banks operating under charters granted by the Federal Government, must be members of the Federal Reserve System and purchase stock in the Federal Reserve banks. They can avoid it only by abandoning their national charters and obtaining State charters. National banks are the principal owners of the Federal Reserve banks,-- they constitute 5,293 out of a total membership of 6,357.

Banks chartered by States have an option about joining or not joining the Federal Reserve System. Out of a total of approximately 10,000 State banks only 1,064 are members of the System. They can join, however, only if they have the required amount of capital and if the nature of their business and the character of their management is such as to convince the Board of Governors that they are eligible. Their purchase of Federal Reserve bank stock, therefore, is not at all like any other kind of investment. Not only must they be granted permission by a public body to make the investment, but they can acquire the stock only in a determined amount and as a part of the process of becoming member banks subject to examinations, rules and regulations, reserve requirements, and general supervision by the Board of Governors.

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Amount of Federal Reserve bank stock

Every member of the Federal Reserve System, national and State, must subscribe to the stock of the Federal Reserve bank of its district an amount equal to 6 percent of its capital and surplus. It has no option in the matter. It cannot buy more if it thinks the investment is good or for the purpose of increasing its influence; it cannot buy less if it finds a more profitable use for its funds. The member bank's investment in the stock of the Federal Reserve bank changes only when changes occur in its own capital and surplus. It has to subscribe 6 percent of these capital funds: 3 percent have been paid in and the remainder is subject to call by the Board of Governors. In these circumstances stock in the Federal Reserve banks is not so much an investment from the point of view of a member bank as a compulsory participation in a public enterprise.

Returns on Federal Reserve bank stock

It is true that this participation has yielded a good return to the member banks -- it has yielded them 6 percent on their investment, no more, no less. The rate of return on the capital has not been left to the determination of the directors of the Reserve banks. It has been determined by Congress, and can at any time be changed by that body. In this, as in other respects, the arrangement under which the Federal Reserve banks function is entirely different from the arrangements customary for private undertakings.

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Distribution of Federal Reserve bank earnings

The question arises what becomes of the earnings of the Federal Reserve banks over and above the 6 percent dividend paid to the member banks. This also is prescribed by law. The dividends are paid out of earnings after expenses have been met. The amount earned by the Reserve banks and the volume of their expenses are determined by considerations different from those that would prevail in a private undertaking, and the disposition of such funds as the Reserve banks may have after meeting expenses and dividends is strictly prescribed by law. Until 1933 it was divided in fixed proportions between the Reserve banks' surplus and the franchise tax paid to the United States Government. At that time Congress appropriated $140,000,000 of the surplus to be contributed to the capital of the Federal Deposit Insurance Corporation, and at the same time abolished the franchise tax, presumably in order to enable the Reserve banks to rebuild their surplus. This surplus, so long as it belongs to the Reserve banks, enables them to absorb losses and to meet expenses when earnings are low. In case of liquidation the surplus belongs to the United States Government.

The volume of earnings of the Reserve banks is not the result of deliberate policy; it is in the main an incidental result of decisions with regard to discount rates and open-market operations. These decisions are made, not by the owners of the banks, but by public bodies, and for purposes having to do with influencing the volume and cost of the nation's supply of money, rather than with the returns on Federal Reserve bank stock. Expenses of the Reserve banks are also subject to regulation, supervision, and scrutiny by public

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authorities. To a large extent they arise out of the performance of services to the community in supplying it with cash and in clearing and collecting checks.

Since their establishment the Reserve banks have earned about $1,000,-000,000. Of this amount about one-half was disbursed in meeting expenses. Of the other half, one-fourth was paid as franchise tax to the Government, principally during 1920 and 1921, when the volume of discounts was large and the discount rates high; another fourth was paid out in dividends to member banks; one-fourth was contributed to the capital of the Federal Deposit Insurance Corporation; and one-fourth was added to surplus. In other words, while one-eighth of the Reserve banks' earnings has been paid out to its proprietors, the member banks, seven-eighths has been used directly or indirectly for a public purpose.

Sources of Federal Reserve banks' lending power

Another difference between the Reserve banks and other banks is in the source of their lending power. A commercial bank derives the funds for making loans and investments from three sources: its capital, its earnings above expenses, and its deposits. No bank can lend or invest more than it derives from these sources. An exception to this rule existed while national banks had authority to issue notes, but this power has now been abrogated. A Reserve bank, on the other hand, derives the funds available for its loans and investments from powers conferred upon it by Congress. The capital it has is prescribed by Congress and constitutes a small part of the funds at its disposal. The other source of funds of the Reserve banks is its power to issue notes and to accept and create deposits.

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The note issuing power makes it possible for the Reserve banks to create funds. It is limited only by the requirement that they must keep a reserve of 40 percent in gold certificates against their notes in circulation. The Reserve banks, therefore, can acquire gold, pay for it by Federal Reserve notes, exchange it at the Treasury for certificates, and then have authority to issue additional notes on the basis of reserves thus acquired. To illustrate in figures: A Reserve bank may issue $1,000,000 of Federal Reserve notes in exchange for that much gold purchased from a bank that has imported it from abroad. The gold can then be deposited in the Treasury in exchange for gold certificates or gold certificate credit on the Treasury's books. Forty percent or $400,000 of these certificates would be required as reserves against the Federal Reserve notes issued in payment for the gold, and $600,000 would be available as reserves against a further issue of notes. This issue could amount to $1,500,000, since $600,000 is 40 percent of that amount, and 40 percent is the required reserve.

The power to issue notes, therefore, conferred by Congress on the Federal Reserve banks is a power to create funds when they are needed by the public. In our financial system, however, Federal Reserve notes and other currency are used only to a limited extent, nine-tenths of all the payments being made by check. The Reserve banks can issue notes, but they can keep in circulation only enough to meet the requirements of the public, which in normal times vary with the volume of payrolls, retail trade, and retail prices. Currency above that amount finds its way back into the banks and is deposited by them with the Reserve banks. This is what is meant when we say that we have an

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elastic currency. Its volume is attuned to the nation's business. This very fact, however, places an important limitation on the Federal Reserve banks' note issuing power, in practice a more important limitation than the 40 percent reserve requirement.

The other source of the Federal Reserve banks' funds is in their power to accept and to create deposits. So far as deposits by member banks consist of gold imported from abroad, the deposits increase the funds at the disposal of the Reserve banks. A more important source of deposits, however, is their creation through loans or investments made by the Reserve banks. When a member bank borrows from a Reserve bank,this bank gives the member institution a deposit credit on its books. Such a deposit is not made by the member bank but is created by the transaction. It has not added to the Reserve bank's lending power, but, on the contrary, has arisen out of the use of that power and has used up a corresponding amount of it. For the Reserve banks are required to keep a 35 percent reserve in cash against their deposits, and that is the only limitation on the amount of deposits they can create.

Difference from member bank deposits

The creation of deposits by a Reserve bank is similar to the creation of deposits by other banks. These banks also create deposits by lending funds to their customers. There is a great difference, however, in that a commercial bank can only lend funds that it has, because the borrower is almost certain to withdraw a large part of the proceeds in cash or by drawing a check, and the bank has no way of telling whether the money will be redeposited with it or with another bank. It must be prepared to lose the funds before it can make

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a loan. A Reserve bank is under no such obligation, and that for two reasons: first, the member banks cannot withdraw their deposits permanently from a Reserve bank because the law requires them to keep a specified reserve on deposit with the Reserve banks. In fact, a member bank usually borrows from a Reserve bank only for the purpose of bringing its reserve deposit to the level required by law. In the second place, a member bank frequently keeps its deposits,even above the legal amount,with the Reserve bank when it has no other use for the funds.

Withdrawals from a Reserve bank are different from withdrawals from other banks:-- if they are in cash,they are met by the issuance of Federal Reserve notes, a mere substitution of one kind of liability of the Reserve bank for another; if they are made by check in favor of a bank in the same district,there is no withdrawal at all, but merely a transfer of funds from the account of one bank on the Reserve bank's books to that of another bank. Only when a member bank withdraws funds to send to another district does the Reserve bank lose funds. When that occurs,the funds go to another Reserve bank, but still remain in the System.

Summary of sources of funds

To sum up, the Reserve banks obtain funds with which to make loans and investments through: (1) capital contribution made by member banks in accordance with legal requirements; (2) issuance of Federal Reserve notes limited by a 40 percent reserve requirement and by the need of the public for currency; (3) authority to receive deposits from member banks; and (4) the power to create deposits, combined with the legal obligation of member banks to hold

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their reserves with the Reserve banks. In a word, the Reserve banks' power to make loans and investments arises entirely out of powers and privileges given these banks by the Government, and not out of voluntary deposit of funds by stockholders or depositors, as is the case with non-Reserve banks. This is an important distinction which should be particularly recognized in connection with discussions of the part that the Government, from which the Reserve banks derive all their power to create funds, has in the management of these banks and in the determination of their policies.

Management of Federal Reserve banks

In accordance with the differences in their purposes and the sources of their funds, the management of the Reserve banks is also very different from that of other banks. The Reserve banks are managed in the first instance by their directors, as are other banks. But the manner of electing these directors and the persons eligible to be directors are prescribed by law. Of the nine directors, six are elected by member banks and three are appointed by the Board of Governors. Of the six, three are bankers and three must not be bankers. Also of the six, two must represent small banks, two medium size banks, and two large banks. The chairman and deputy chairman are appointed by the Board of Governors in Washington. Finally, all of the directors are subject to removal for cause by that Board. This organization creates a pattern under which the Board in Washington, a governmental body, has a considerable voice in the management of a Reserve bank.

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Nor is this all of the participation of the Government in the management of a Reserve bank. Its two chief executive officers, the President and First Vice President, are appointed by the directors (for five-year terms) subject to the approval of the Board of Governors. In addition, all salaries and expenses of the Reserve banks are subject to review by the Board of Governors, and all its officers and employees are subject to removal for cause by that Board. It is clear, therefore, that the Government, which gives the Reserve banks all their powers, retains a close control over their management.

Determination of credit policies

This describes the differences between Federal Reserve banks and other banks in organization and management. In the determination of national policies public regulation goes even farther. Of the instruments of policy possessed by the Reserve banks, discount rates are subject to review and determination of the Board of Governors, which has been construed to mean that the Board not only must pass on rates proposed by the banks before they become effective, but has power also to establish rates on its own initiative. Reserve requirements of member banks are prescribed by law, subject to changes within certain limits that can be made by the Board of Governors. Foreign relations of the Reserve banks are made subject to special supervision of the Board of Governors. This Board has also authority over maximum rates of interest to be paid by member banks on time deposits and over the amount of loans member banks may make on a given volume of security. Finally, purchases and sales of the Federal Reserve banks in the open market are determined by a Federal Open Market Committee which consists of the seven members of the Board of Governors and

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five representatives of the Reserve banks, elected regionally by those banks. In this way all the policies that have an influence on monetary conditions throughout the country are determined by governmental authorities, and the independent activities of the twelve Federal Reserve banks are largely confined to current day-to-day relationships with their member banks.

Summary

To sum up, the difference between Federal Reserve banks and other banks is that the Reserve banks are operated in the public interest, and not for private profit, that they derive the funds for their operations from powers granted to them by Congress, that the disposition of their earnings is prescribed and can at any time be changed by law, that the Government has an important participation in their management, and that those of their operations that exercise an influence on national monetary conditions are determined by governmental agencies established for that purpose by Congress. Federal Reserve banks, therefore, though their stock is owned by member banks, are in effect public institutions operated in such a manner as to leave local matters to local management, under Government supervision, and to have national monetary policies determined by national public authorities.

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