THE FEDERAL RESERVE ACT AND THE PLACE IT IS TO OCCUPY IN AMERICAN FINANCE

An address before
The Baltimore Association of Credit Men
Baltimore, Md.
by Frederic A. Delano
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IN addressing you on the subject of "The Federal Reserve Act and the Place it is to Occupy in American Finance," I shall avoid as far as possible the use of technical banking phrases. My approach to the whole subject is that of the business man, or bank customer, rather than that of the banker, and I assume that in inviting me to address you, your object has been to hear the point of view of the business man rather than that of the banker.

THE title of the Federal Reserve Act, passed December 23, 1913, states its purpose as follows:

> "An act to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means for rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

However, in order to understand the place which the Federal Reserve Bank System is destined to occupy in the life of the nation, one must review, at least cursorily, the provisions of the system under which the National Banks have operated for fifty years and appreciate the fact that, in the new Act, Congress sought to correct and supplement an existing system with which nearly two generations of our people have become familiar, rather than to supplant it with an entirely new system, built upon a new foundation. Furthermore, it is important to bear in mind that two-thirds of the banking of the country is done by banks and trust companies chartered by the various states, under laws differing rather widely and in some cases under charters much less strict than the Federal law. This feature becomes of great importance when it is considered that the ultimate banking reserves of the country are the reserves of the National Banks.

Reserve Requirements.

It is an elementary, but important fact that the whole theory of banking is based upon the principle of averages derived from the results of experience. Banks represent, roughly, two classes of customers—depositors and borrowers. If a bank had to keep in its vaults cash subject to instant demand by all its depositors, no bank could live except by borrowing from its neighbor banks; and if the demand were simultaneous the entire banking system would break down, because there is not sufficient currency to meet the demand.

Banking, therefore, depends upon the hypothesis that a large proportion of the funds of depositors will not be called upon simultaneously; that somewhere between 10 per cent and 25 per cent must be kept on hand and on the premises, and that the remainder can be actively employed at interest—that is, earning something; otherwise a bank could not earn its rent, salaries, and cost of operation, to say nothing of a return on the capital invested by its promoters.* This 10 to 25 per cent which experience has found must be retained in hand is called a *Reserve,* but the term has been more or less misused and misunderstood. We might assume, for example, that 10 per cent were the minimum percentage of cash which had to be kept in vault and that 25 per cent were the amount which, including this irreducible minimum was required for emergencies. This is equivalent to saying that 10 per cent was the minimum requirement of normal conditions and that the 15 per cent additional was *reserves.* Under the Banking Law of 1864, reserves varying from 15 per cent to 25 per cent were stipulated, but unfortunately that law (which permitted Reserve Cities to deposit half their reserves in Central Reserve Cities, and country banks, three-fifths of their reserves in Reserve Cities), permitted a great duplication of reserves without any elasticity. A demand for currency attending a panic or loss of confidence on the part of the public invariably found the banks carrying the minimum reserves authorized under the law, and it would at once develop that these so-called reserves were not, in truth, reserves—they might more truly be called minimum requirements, not reserve funds, available to overcome a period of stress.

*It is proper to explain that while a bank begins doing business by lending its capital and a share of its deposits, each loan that is made goes to swell the deposits because the loan when made is not usually paid out in cash, but is put as a deposit credited to the borrower and subject, like any other deposit, to check by the borrower who has thereby become a depositor. The relationship of deposits to loans and to currency are well illustrated by the aggregate figures taken from the statement of the Comptroller of the Currency for June 30, 1914, as follows (the report includes all National Banks and 95 per cent or more of the State Banks and trust companies): Gross deposits of individuals and corporations in National Banks, State Banks and Trust Companies $18,517,732,879; gross loans and discounts by National Banks, State Banks and Trust Companies $15,288,357,284; total U. S. currency outstanding same date, $3,402,015,427.

An Elastic Currency.

This subject of reserves thus became one of paramount importance, and it was recognized by many that a correct solution was of immense importance to the country's development. For twenty years bankers, business men and economists have interested themselves in the problem of working out a remedy. The fact that other countries were able to adjust their banking and currency methods to the ebb and flow of business, or even to survive considerable recessions without complete stagnation or panic was constantly referred to. After much discussion it became apparent that this question of reserves was closely associated with that of a suitable currency; that one of the phenomena attending every panic or business disturbance was a demand for currency which, if not satisfied, invariably led to the hoarding of metallic money. It was pointed out that in this respect the currency system of the United States, under the National Banking Act of 1863, was peculiarly rigid and inelastic—far more so than it had been under earlier banking acts or under the central bank systems common in Europe.

The currency provision of the law of 1863 was based on the idea of compelling National Banks to purchase United States Government Bonds and using those bonds as collateral security for National Bank currency. As a plan to create a market for Government bonds of which there were some three billions outstanding at the close of the Civil War (three times as many as now) the Act was a great success. Under its provisions bonds which sold on a basis of more than 7 per cent reached a basis of less than 2 per cent. Nobody could complain that this form of currency was not *safe*. The complaint came only from the economists and students of the problem, that it was incapable of expansion and contraction with the demands of business. If the amount were increased to take care of maximum requirements, there was no ready means, in periods of slack business, of contracting the amount of currency in circulation except by the clumsy method of returning the currency, redeeming the deposited bonds and converting these into cash again, a manifest impossibility on any large scale, because United States bonds soon had acquired a market price by reason of their circulation privilege, far above their investment value. Our own experience in this country before the Civil War, as well as that of European nations, pointed out a remedy in basing the currency, not on long-time securities like Government bonds, but on short-time loans of merchants, manufacturers and agricultural producers, based upon and representing actual purchase and sale of raw material, produce or commodities, or of manufactured or partly manufactured products. The great advantage of such loans lay in the fact that they were self-liquidating, that they represented largely food or other products classed as necessities of life, that the paper was of short time maturity, that in the nature of the case, currency based on such loans would increase or decrease in volume directly with the enlargement or diminution of trade requirements, population, etc. In order to leave undisturbed the existing currency, with which every one was familiar, Congress provided that the present bond-secured currency should remain practically intact or subject only to gradual replacement through a period of twenty years with a new bond-secured currency of the Federal Reserve Banks. This means that the notes of twelve Federal Reserve Banks will gradually displace the notes of 7,600 National Banks. In addition to this currency, plus the gold and gold certificates; silver and silver certificates and greenbacks, already in existence and which I have enumerated in table A; there was created by the Federal Reserve Act a new form of currency, known as Federal Reserve Notes.

Table "A."

In circulation February 1, 1915.

Gold Coin (including bullion in treasury)	$ 623,050,364
Gold Certificates	958,448,039
Standard Silver Dollars..................	67,621,922
Silver Certificates	452,613,274
Subsidiary Silver	160,334,776
Treasury Notes of 1890....................	2,321,968
United States Notes	319,711,226
National Bank Notes......................	879,497,881
Total	$3,463,599,450

N. B. This table does not include any gold which is back of gold certificates, or silver back of silver certificates. In other words, there is no duplication in this statement.

These notes, issued in five denominations ($5, $10, $20, $50, $100) represent the elastic currency of the country. In other words, the previously issued currency already mentioned, amounting in total on February 1, 1915, to $3,463,599,450, will easily take care of average requirements, while the new currency provides an elastic, supplementary currency. The plan devised and finally adopted by Congress not only meets the requirements of an elastic currency, but meets most ingeniously the difficulty in respect to reserves to which I have already referred. Depending somewhat on the diversity of business or the dependence of a community upon a single crop, there is to some extent a seasonal ebb and flow in the demands of every community, exhibiting itself in an increased or diminished demand for currency and banking credit.

The Act provides for substantial reduction of reserves by country banks, Reserve City Banks and Central Reserve City Banks (as shown in table B), but at the same time allows no duplication in its determination; a circumstance which, in the past, has led to much unsettlement and lack of confidence as to the ultimate security of the banks.

Table "B."

	Percentage of deposits required as reserves under the old law.	Percentage of active or demand deposits required as reserves under new law at end of three years.	Percentage of time deposits or savings deposits under the new law.
Three Central Reserve Cities	25 per cent.	18 per cent.	5 per cent.
Forty-nine Reserve Cities	25 per cent, of which one-half could be kept in a Central Reserve City.	15 per cent.	5 per cent.
Country Banks	15 per cent, of which three-fifths could be kept in a Reserve City.	12 per cent	5 per cent.

The Act further provides that at the end of a period of three years, the percentages of total *demand* deposits required by the twelve Federal Reserve Banks from member banks in Central Reserve and Reserve Cities and in the country, respectively, shall be 7 per cent, 6 per cent and 5 per cent, and at the option of member banks these deposits may be increased to 12 per cent, 10 per cent and 8 per cent respectively. These reserves, instead of being held in vault as fixed cash reserves, subject to call on demand, are made the basis for issuance of the new Federal Reserve currency.

At first blush this might seem an indiscreet use to make of *reserves;* it might indeed strike one as a wild project of pyramiding on assets, but a study of the Act will satisfy the student that, if the Federal Reserve Board does its duty, these reserves can be used expansively as suggested, yet be absolutely safe. At this writing with only two installments of the capital stock paid in and with reserve deposits only in part paid in, the twelve District Reserve Banks have a total cash reserve in their hands aggregating $281,373,000. The law requires a cash reserve against deposits of member banks of 35 per cent; this requires, then, an aggregate cash reserve of $99,749,000. In respect to the issuance of currency, the law requires, first that each of these twelve reserve banks (except for supervision by the Federal Reserve Board) shall be autonomous, self-contained and independent; that it may issue currency against approved "commercial paper" or "acceptances" *when indorsed by member banks, dollar for dollar, provided it shall deposit as additional protection and reserve against such notes not less than 40 per cent of gold. From this it will be seen that, after deducting $99,749,000 from the aggregate cash resources of the Federal Reserve Banks as a reserve against member bank deposits, there remains $181,624,000 which would sustain a total reserve note currency of $454,060,000, and, obviously, this will increase very materially when all the reserves shall have been paid in; and still further increased if government deposits are made in the Federal Reserve Banks, or if, as is to be hoped, State Banks in large numbers enter the system.

Operations of the Reserve Banks in Ordinary Times.

It might be assumed from what has been said that these twelve Federal Reserve Banks exist solely to take care of unusual, spasmodic, or seasonal demands of business or else

***By "acceptances" are meant "drafts" or "bills of exchange" drawn upon a purchaser of goods to be delivered, growing out of export or import and *accepted* by the buyer or by a banker or accepting house, acting on behalf of the buyer.**

those excessive demands which periodically come upon us at greater intervals of time. That alone might well be called a worthy object to attain, but it would have to be admitted that a ponderous and costly machine had been created to serve an occasional demand; and it might be doubted whether a machine thus kept in comparative idleness through two-thirds of the year would operate smoothly and successfully when the steam was turned on. But the framers of the Act had no such idea. They meant that these district banks should be active undertakings and, among other requirements, imposed upon them the duty of earning for their stockholders (the member banks aggregating to begin with 7,600) not only operating expenses and all costs by the Government for engraving and printing of notes, the salaries and expenses of the Federal Reserve Board and its staff of employees but, in addition, 6 per cent on the investment by the banks. In order to enable the twelve reserve banks to employ their funds profitably in the dull seasons (the seasons of liquidation) and recognizing that in such seasons the member banks would not bring commercial paper to the reserve banks for rediscount and the issuance of currency, for the obvious reason that in those seasons the member banks themselves would have ample loanable funds, Congress provided for the purchase and sale of certain readily marketable investments, for example, Government bonds, tax warrants of states, municipalities, etc., acceptances, e. g., drafts or bills of exchange, the payment of which has been guaranteed or promised at maturity and other similar documents. Investments of this kind which must be made under restrictions of the Federal Reserve Board are, with the exception of Government bonds, all short-time paper, the idea being that they shall mature in advance of the active requirement of funds for crop moving, etc. It is impossible to foretell just what experience will develop, but it is probable that the rediscounting of commercial paper and the issue of Federal Reserve notes therefor will reach normally a minimum in the months of January to March, inclusive; that thereafter it will gradually rise to a maximum requirement in the autumn and from that maximum recede again to the low point after Christmas. However, it is to be expected that the demands in the various districts, with a diversity of harvesting seasons will develop a condition where there may be a scarcity of funds in one region and a surplus in another. With this possibility in view, the Act provides that the Reserve Bank of one district may rediscount for that of another district.

From the foregoing it may be seen that, while the Federal Reserve Act provides a valuable "shock absorber," it is far more than an inert piece of machinery which comes into action simply in an emergency. It might more truly be likened to an extra unit in a large power station, revolving at all times on, say half load, yet capable of taking on a full load at any time or, for short periods, even a considerable overload.

In much that has been said and written, however, it is evident that in some particulars the true functions of the Federal Reserve Banks have been misunderstood. These great District Banks, each representing a large and important territory, important though they be as the central banks of their districts, are not in any sense *wholesalers* of money to their member banks who, in turn, dispense or retail it at a profit to their customers. These central banks, with whom the public is not directly permitted to deal, are in a sense "banks of banks" as has been frequently said, but their gross assets really bear only a small ratio to that of the aggregate of the stockholding banks, and, while their powers and influence are very great, their actual currency issuing power will represent, after all the reserves have been paid in, only some 12 per cent to 15 per cent of total loanable funds of banks in the country, National and State. (See footnote.)

What the Reserve Banks Have Accomplished.

The benefits of the Reserve Act as thus far developed are evidenced more by the indirect benefits derived than by the actual transactions of the Reserve Banks themselves. For example, there was released on the 16th of November, when the banks were declared open by the Secretary of the Treasury,

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Stated in round figures, after deducting the reserves required against deposits, there remains $181,600,000 of gold on hand, which will sustain an issuance of four hundred and fifty-four millions of Federal Reserve Notes. As already shown, this will be increased in three years to, say 700 millions, which is 4½ per cent of the total loans and discounts of the State and National banks of the country on June 30, 1914. This will be increased, as already explained, as State banks enter the System and as Government deposits are added.

something like 450 millions of dollars (the exact amount has not been determined on account of the difficulty of computation by reason of the duplications in previous methods of calculation). This large fund was released to meet the demands of business; its immediate effect was a reduction in all interest rates in every district. The emergency currency issued to meet the panic conditions brought on by the European war was rapidly retired so that, from a maximum issue of $385,216,655, this emergency currency outstanding has been reduced (at the close of business on the 13th day of February) to $44,205,802, and this is in spite of the fact that a large area of our country has suffered from a most serious setback, due to the unexpected and sudden reduction in the demand for their chief staple product—cotton. As a precautionary measure, and on the advice of bankers quite generally, three years are provided in which to develop the Reserve Banks to their full power. Whether or not this was an unnecessary length of time is a debatable subject, but one thing is already evident and that is that the country is now demanding *results* as if three months instead of three years had been named.

Other Important Functions of the Bank.

Before closing this paper it is proper to discuss briefly some of the other functions of these Reserve Banks. These lie chiefly in two directions; first, as Government depositaries and fiscal agents; second, as clearing houses for checks drawn within their districts or, on such plan as the Reserve Board may approve, between districts.

The Act does not abolish the subtreasuries, but at the same time authorizes the Secretary of the Treasury to deposit and the Reserve Banks to receive, Government monies and to act as fiscal agents of the Government. It is for this reason chiefly that the Secretary of the Treasury is made ex-officio member of the Federal Reserve Board and its chairman, while the Comptroller of the Currency is also made an ex-officio member; thus giving the Government a minimum representation on the Board of two out of seven members. The framers of the Act argued the propriety of this representation, in spite of the fact that the capital investment was made solely by the subscribing banks, not in order to give the Federal

Reserve Board a political (i. e. partisan) complexion, but on the ground that as the Government was to be a large depositor, it should have an influential voice in the general supervision.

The argument in favor of the Government thus using the Federal Reserve Banks is strong; first, the general reason that the money of the people (the taxpayers) is retained where it will be most effective in promoting trade and commerce; second, that it is safe, because the integrity of the twelve reserve banks is assured by the guarantee, individual and collective, of all the member banks; lastly, that the function of fiscal or disbursing agent for all Government drafts or checks, aggregating in round figures more than a million dollars per day, can be performed effectively by these banks and doubtless at a saving to the Treasury (even after allowing for the interest paid by National banks on Government deposits) compared with the costly and necessarily cumbersome methods of remitting from the treasury or subtreasury to pay checks drawn on the Treasurer of the United States.

The second important function of the Reserve Bank outside of the chief functions for which it was created, is that of its place as a collecting agency or clearing house for checks of its respective district. All important cities of the country have had their clearing houses for checks of National and State banks in the community. These clearing houses, formed for mutual convenience by voluntary action of their component banks, have developed important functions quite outside of those originally contemplated. Among these may be mentioned a system of self-examination more rigid and thorough than that previously maintained by the Government; agreed rules for charges for collections on out-of-town checks, and, in times of panic, such as 1907 and 1914, the rediscount of paper and securities of its members, issuing against these, clearing house certificates, which have been used not only in transactions between banks but in some cases even in public transactions.

There is little doubt that this development of the clearing houses, adjusting themselves as they have, through many years of experience, to the demands of business, provided a valuable and effective suggestion to the framers of the Federal Reserve Law. So it is not to be wondered at that the Federal Reserve Act, in adopting the emergency function of the clearing houses in the rediscount of member banks' paper, saw the desirability of adopting, at the same time, the chief feature of these clearing houses; namely, the check clearing idea. And so, in fact, the Act did embody, not in the most lucid terms, but certainly by intent, a complete system of clearings within and finally between the districts, subject to the rules to be framed by the Reserve Board, and, at the same time, authorized the Reserve Board, in co-operation with the Comptroller of the Currency, to raise the standard of the examination system co-ordinate with the examination by the Federal Reserve Banks and by the Federal Reserve Board.

Conclusion.

And thus briefly I have endeavored to lay before you in simple phraseology the salient features of the Federal Reserve Act and the place it is likely to take in the financial structure of our country and of our business life.

The reason the Federal Bank System is great, is that it has been evolved by the patient study and adaptation of our own best banking experience, the experience of Europe, the clearing house certificate plan, all ingeniously engrafted upon an existing National Banking and Currency System with which the country was familiar. The result is a system, far better suited to American needs and American methods and prejudices than a *central bank* or a *branch bank* system.

We have created under this Act twelve central banks, each as nearly as possible autonomous, but each under central supervision of the Federal Reserve Board, on matters of joint and common interest. If the plan works out in practice as well as it should; if the Federal Reserve Board does its full duty; if petty or partisan politics are laid aside, we shall have reached one ideal of *scientific management*—"local self-government and centralized supervision;" we shall have accomplished the object of all good organization—local incentive and enthusiasm with only enough centralized supervision to compare results; to measure men, methods and costs; and to ensure the necessary co-operation on all matters where joint co-operation is necessary, either for the good of the country or of the banks themselves.

The President has drawn the apt parallel of the relations of the various Reserve Banks to the Central authority (the Federal Reserve Board) and the relation of the various states to the Federal Government.

As a servant of the public, one of those employed to administer the law, it is to be expected that I should be enthusiastic as to its possibilities. At the same time, not having been a banker, my views as to what this Act really does mean to the public may be questioned. I will, therefore, close my remarks by quoting from the recent paper of Vice-President Herbert R. Eldridge of the National City Bank of New York, so that you may know what a practical banker of large and varied experience has to say:

> "The Federal Reserve Act marks the greatest step forward this country has ever made in its financial advancement. While it leaves much to be desired, and will undoubtedly be subjected to several revisions, it remains the greatest constructive measure Congress has given us in many, many years."

The wonder is not that there are some imperfections in the Act, but that out of the great melting pot of conflicting opinions a problem so difficult and so technical should have been successfully worked out.