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THE FEDERAL RESERVE SYSTEM IS UNIQUE

Address of C. Canby Balderston, Member,

Board of Governors of the Federal Reserve System,

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Why is the Federal Reserve System unique? What difference does its proper functioning mean to businessmen and to citizens generally? What work does it do, how and through whom? These are questions whose answers should be understood by informed businessmen, especially bankers, so that they, in turn, can interpret our central banking system to others.

As to its basic aims, the System is not peculiar in the sense of being markedly different from the central banks of other countries. Its aims, however, are different from those of a commercial bank. This may explain why commercial bankers sometimes find its workings as difficult to comprehend as do non-bankers.

The importance of a central bank stems primarily from the influence that it can exert over the money supply. The importance of this function has been sensed ever since the establishment of the Federal Reserve System in 1913, although the particular problems and emphases have changed. When, prior to 1913, the National Monetary Commission studied the need of this country for a central bank, it was particularly concerned with averting the financial panics which had occurred every few years because of the inflexibility of the monetary system. It was also concerned with the development of a monetary system which would be more responsive to the needs of trade over shorter periods of time. Specifically, it wished to give the country an elastic currency, to facilitate the discounting of commercial paper, and to improve the supervision of banking.

Since then, basic economic and financial changes have taken place; old problems have been solved, and new ones have developed. With experience, understanding of the workings of the monetary mechanism has increased. Concern with the monetary supply has been maintained, however, even though there have been changes in emphasis. For example, more attention has come to be placed on influencing the volume of demand deposits than of currency. No longer is a close relationship supposed to exist between fluctuations in the volume of commercial paper and in the volume of money. Central banking has come to be recognized as more than an aid in averting panics; it has a positive contribution to make in bringing about healthy economic growth and a stable dollar. Related to these goals are such cherished aims as a rising standard of consumption, sustained high employment for the breadwinner, and stable values for widows who live on savings and for those who do the saving.

The problems of assisting to control the supply, availability and cost of credit are highly intricate. In dealing with them our central banking system has the tremendous responsibility of influencing money and credit conditions in such fashion as to assist in promoting economic stability and growth. You will note that by stability I do not connote a dead level of economic activity, but one that moves steadily into higher and higher ground. The supply of money, now of course consisting mainly of bank deposits, is a more potent factor in our economy than a century ago when households were more self-sufficient, and barter was a bigger factor in commerce. Today, money passes from person to person and from institution to institution in accordance with millions of decisions to buy or to sell. If the supply of money becomes excessive in relation to the goods and services available, prices tend to rise; if the converse is true, prices tend to fall. Therefore, if the value of money is to be stable and to assist the economy to move steadily upward, its supply must be harmonized with the flow of goods.

The impact of the general supply of money upon the economy and upon nearly all citizens is so great as to make it a matter of public interest. Thus, the supervision and control of the government is required. The apportionment of credit among individual borrowers, however, is not a matter for government, but for private lenders. To determine, on the basis of intimate knowledge, which businessmen and which firms are good risks is one of the important contributions of an independent private commercial banking system. It is the responsibility of the central bank to exert an influence over the total amount of money, but the selection of the particular customers to whom loans are to be made is and should be left to the discretion of commercial banks. The role of the Federal Reserve is potent and indispensable, but it operates indirectly through relatively free and uncontrolled markets so that there will be a minimum of interference with the essential freedoms of our enterprise system.

Let me emphasize here that the quality of loans is as important, and of as great concern, as is the quantity. The Federal Reserve influences the general availability of money, but the competitive forces of the market largely determine the extent and manner of its use. Although the initial responsibility for soundness rests with the makers of individual loans, it is of interest to the System also that the use of credit be sound and productive.

I turn now to the philosophy that pervades the Federal Reserve System and guides its methods. The point has been made by Chairman Martin that the philosophy of the System may be likened to the concept of trusteeship. Trusteeship involves obligations that extend beyond mere legality. It involves the highest ethical and moral standards in the carrying out of the mandate issued to the trustee. While that mandate is in force, it implies the courage to take actions, however unpopular they may be at the moment, that the trustee believes to be best for the country and its economy. Naturally, the "trust indenture" of which we are speaking, that is, the Federal Reserve Act, is not irrevocable because it may be changed at the will of the Congress.

In bringing about this trustee arrangement to deal with the highly complex problems faced by a central banking system, the Congress is to be credited with foresight in the degree of independence with which it has surrounded the System. The nuances of independence are not easily spelled out. They involve an opportunity, like that of the judiciary, to act objectively without favor and without fear, free of private pressures on the one side and partisan political pressures on the other. Such objective action requires full recognition of the real needs and interests of all concerned, along with recognition of their important roles in a properly functioning economy.

The Federal Reserve System as a central banking system has a combination of public and private elements in its organizational structure. Through long decades different countries have experimented with the relation that the central bank should have to government on the one hand and to private enterprise on the other. Once the Bank of England was owned privately. George Washington is said to have owned some of its shares. Now, its shares are all owned by the British Government. The Bank of France is also nationalized, as are all of the central banks of Russian-dominated Eastern Europe. In Belgium, the State owns one half of the National Bank. Indeed, Mr. Robert Auboin, Director General of the Bank of International Settlements, has observed recently that the number of state-owned banks in the world is greater than those not so owned. Whatever its form of ownership, a central bank must obviously be operated in the public interest. And to be so operated, it should be independent of both political and financial interests.

The Federal Reserve Act provided for a unique combination of public and private elements which is peculiarly adapted to the situation in this country.

It provided for a Board of Governors in Washington which has an independent status in the government structure and reports directly to Congress. In order to prevent the inflexibility and lack of local knowledge that usually goes with overly centralized authority, it also provided for a structure of district banks and branches which now consists of 12 banks, 24 branches, and some 250 directors. There is also a Federal Open Market Committee, which is composed of both Board members and Reserve Bank representatives.

This structure may seem cumbersome, but it provides a mechanism by which decentralization of functions can be combined with such coordination as is essential to unity of action in the matters that require it. Within it, functions that can best be carried out locally are performed by the Reserve Banks and their branches, while policy decisions on a national scale are made by the Board of Governors and by the Open Market Committee.

The Board of Governors is composed of 7 members appointed by the President and confirmed by the Senate. It has authority to establish the reserve requirements of member banks, within limits set by statute, and to establish margin requirements for purchasing and carrying stocks. It has the authority to review and determine changes in discount rates proposed by the Reserve Banks, to approve the appointment of their chief officers, and to appoint three members of each of their boards of directors.

The Federal Open Market Committee is composed of the 7 members of the Board of Governors, together with the presidents of 5 Reserve Banks. The 5 Reserve Bank positions are rotated among the Banks, except that the President of the New York Bank is always a member. This Committee makes all decisions concerning System open market operations, which influence the level of unborrowed bank reserves.

The district banks and their branches perform numerous operations that can be done best at the local level by personnel in close touch with local conditions. They administer the discount function, and their directors customarily initiate discount rate changes. The district banks and branches comprise an immense network of economic intelligence through which the System is kept informed as to the changing problems and conditions in business and within the commercial banks themselves.

The local directors, most of whom are businessmen and bankers who tend to abhor waste and inefficiency, provide an effective check upon the operating performance of the Reserve Banks. Six of the directors of each Reserve Bank are elected by member banks, which own all the stock in the Federal Reserve Banks. Such ownership is often viewed as a compulsory contribution by member banks to the capital funds of their Reserve Banks rather than as proprietorship in the strict sense. Nevertheless, member banks tend to keep in closer touch with their Federal Reserve Bank because of their stock ownership and their representation on its board of directors.

The banks in each district are divided into three size groups, each of which elects one banker and one representative of commerce, industry, or agriculture. The latter cannot be officers, directors, or employees of commercial banks. Three directors, including the chairman, are appointed by the Board of Governors. These directors also must be free from banking connections. The directors, both those elected by the commercial banks and those appointed by the Board of Governors, bring to Federal Reserve problems a variety of experience. It must be emphasized, however, that although they have different backgrounds, their function as Federal Reserve directors is not to represent special interests, but to serve the public.

President Woodrow Wilson, Senator Carter Glass, Paul M. Warburg, and the others responsible for the founding of the System were sensitive to the delicate balance needed between public control and domination that would destroy the rights of individuals under our free enterprise system. Accordingly, they contrived a system whose structure is distinctive in central banking. It is partly governmental, partly private.

The Federal Reserve System reflects in its design a touch of genius. Its founders recognized that the United States had a heterogeneous population, tremendous variety in its industry, commerce and agriculture, and a banking system that contained thousands of different units. Some of these were national banks, some not. Had the United States been as small as England, with just a few private banks whose heads could be brought quickly into conference around the same table, the solution contrived by the designers of the Federal Reserve would have been different. But just as problems of size and mass are reflected in the structural design of the short-legged hippopotamus and the long-legged giraffe, so are the problems of this country's banks and commerce reflected in the Reserve System. There is a legend in Africa that the giraffe was designed by a committee. So, in effect, was the Federal Reserve, except that the result has more symmetry.

Among the freedoms that American citizens enjoy is the freedom of enterprise. Like the former Chairman of our Board, Mr. Thomas B. McCabe, I look on the Federal Reserve System as one of the great bulwarks of such freedom. It is my view that bankers have a particular responsibility to see that the various aspects of that freedom are defended. Mere lip service is scarcely adequate.

If borrowers had not enjoyed it for so long as to take it for granted, they would place great store upon freedom of choice in the securing of credit. If an entrepreneur could get a loan only by applying at the office of some government agency, or if there were only one private banking institution to which he could turn, he would suspect that considerations other than his ability to repay were taken into account. Freedom to choose one's bank was not among the freedoms listed in the Atlantic Charter, but this freedom would seem very significant indeed if it had to be re-won.

Then, there is the freedom that we associate with the choice of a job. Job opportunities have been so abundant during the past decade as to provide wide election to men and women entering the labor market. During the first half of this decade, about 700,000 new workers needed to be absorbed each year. In the first half of the 1960's, however, it will be necessary to provide job opportunities each year to 1.2 million youngsters. That will be the period during which the war babies will be seeking employment. To enable young people to choose the jobs best suited to their respective tastes and abilities will call for a high level of employment and the full use of our productive resources and facilities.

And then there is the freedom to buy what one chooses. Consumers who have the requisite buying power now enjoy a selection of products neither known nor imagined when I was a boy. This abundance is to be credited chiefly to the spectacular advances in technology. As Dr. Kenneth Mees has pointed out, the rate of technological advance has been increasing at a rate that has itself been increasing. But the point that is appropriate here is that the ability of businessmen to manufacture and sell new things has been aided by their ability to secure the requisite funds. In the main, these funds have come from private sources.

In brief, there are certain economic freedoms in addition to the traditional freedoms of speech, religion and conscience. The preservation of these freedoms, infinitely precious to all citizens, is a particular responsibility of those who are part of the banking community.