THE FEDERAL RESERVE SYSTEM IN A CHANGING WORLD

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The University of Minnesota and its School of Business Administration are so widely and favorably known among the great institutions of learning in this country that I feel it a profound privilege to meet with you and your business and financial friends tonight.

The subject of my remarks is -- The Federal Reserve System in a Changing World. My experience as a businessman, before I was appointed to the Board of Governors in 1938, goes back to the days when there was no Federal Reserve System. In those days the smaller banks throughout the country maintained a major portion of their reserve balances with correspondent banks in larger, so-called reserve cities. And banks in reserve cities, in turn, maintained about half their reserves with correspondents in the three large metropolitan centers, St. Louis, Chicago, and New York, where national banks were required to hold all their reserves in their own vaults, in cash. The focal point of this correspondent relationship was, of course, New York.

These correspondent banks performed a variety of indispensable tasks for business and the banking system as a whole. They served as repositories for reserves. They supplied currency, cleared checks, and after a fashion afforded a rediscount market.

But these matters properly belong to the special province of central banking. They are public, not private responsibilities.

The banks that assumed them simply took on extra-curricular activities that no group of privately managed banks could have been expected to perform satisfactorily. Furthermore, the big correspondent banks had no outside resource of reserve credit to which they could turn in times of money stringency. They enjoyed no statutory powers, as do the Federal Reserve banks, that enabled them to meet exceptional demands for credit. There was no provision for pooling reserves, or relaxing reserve requirements. There was no central guiding and coordinating influence. Finally, in periods of stress, the banks that were performing these essential central banking functions could only turn to a market already feverish and exhausted, and that market was likely to be completely demoralized by the knowledge that the big banks were hard pressed for funds.

Although this situation happened over and over again in the old days, conditions were sometimes confused as to their basic cause. But the panic of 1907 was a clear-cut crisis. It was a money panic and everybody knew it. In response to widespread demands for reform, Congress in 1908 created the National Monetary Commission with instructions to study banking conditions in this and other countries, and to make a report that could be used as a basis for remedial legislation.

Four years later the Commission made its report, in 40 volumes. After a year of discussion, proposals and counter proposals, the Federal Reserve Act emerged.

The title of that Act shows clearly what the founders had in mind: "An Act", it reads in part, "to provide for the establishment of Federal Reserve banks, to furnish an elastic currency, (and) to afford means of rediscounting commercial paper .

You know that twelve Federal Reserve banks were established throughout the country in which member banks were required to deposit their legal reserves. This arrangement had the merit of bringing together in twelve great public institutions an enormous volume of funds -- with powers to create more -- that could be used impartially to meet all legitimate needs of commerce, industry and agriculture.

A flexible currency was another main objective -- flexible, that is, as to volume. The Federal Reserve Act provided that any member bank could secure currency from the Federal Reserve bank of its district simply by rediscounting specified kinds of assets. As the public's need for currency increased, seasonally or otherwise, commercial banks would be provided with the assets required to secure additional currency. And as the need diminished, contraction would take place automatically and painlessly.

Closely related to the currency objective was the necessity to provide a ready and dependable means of rediscounting commercial paper so that the banks, and especially the smaller banks, could always convert the sound obligations of their customers into reserve funds. This meant that the Federal Reserve banks should have the power to transform selected assets into forms of money that could either be used as lawful reserves or converted into currency.

So much for the original objectives of the Federal Reserve System, namely, reserve reservoirs, flexible currency, and rediscount accommodations. These were among the main objectives in 1913. And while I do not wish to minimize their importance, either in 1913 or in 1939, nevertheless it is a fact that much has happened during the 26-year interval. Providing an elastic currency is now mere routine; affording a rediscount market -- well, instead of member banks borrowing a billion dollars from the Reserve banks as they did a bare decade ago, today, except for a few scattered instances, they borrow nothing at all. Indeed, member banks need not borrow. They have today more than 4 billions in excess reserves.

The central problem of the Federal Reserve System today is, therefore, the problem of credit control. And although the necessity for credit control was recognized in the original Federal Reserve Act, the devices we now employ were not recognized as such or not even mentioned. They are: (1) open-market operations; (2) the power to establish reserve requirements; (3) the power to establish margin requirements on security loans.

Open-market operations consist of the purchase and sale by the Reserve banks of certain classes of securities, principally Government obligations. Reserve bank purchases, since they are paid for with funds created for that purpose, increase the supply of reserves available to the banking system as a whole. And under our system the creation of a given volume of reserves provides the basis for the creation of a considerably larger volume of commercial bank credit in the banking system as a whole. Conversely, when the Reserve banks sell securities from their holdings, commercial bank reserves are absorbed, and a given contraction in reserves may precipitate a considerably larger contraction in the volume of commercial bank credit available to the bank-using public.

No provision whatever was made in the original Federal Reserve Act for systematic and unified open-market operations. It was not until the Banking Act of 1933 that the open-market device as an instrument of credit control was given formal legal status.

The power of the Board of Governors to set reserve requirements, that is, the ratio of reserves to deposit liabilities, is of still more recent origin. From 1917 to 1933 reserves were fixed by statute at 7, 10, and 13 per cent of demand deposit liabilities, depending on the location of the bank, and 3 per cent for time deposits, applicable to all member banks.

In the Banking Acts of 1933 and 1935, Congress gave the Board of Governors power to alter reserve requirements within specified limits when, in the Board's judgment, such action was deemed necessary to prevent injurious credit expansion or contraction.

This grant of power represented a radical departure in the theory of the function of reserves. The older view held that a bank's reserve was simply a liquid fund available at all times to meet liabilities. The newer view is that reserve requirements constitute a vital instrument of credit control, especially from the long-run point of view. As you know, an increase in the ratio of reserves to deposits contracts the limits of the total volume of bank credit that might be made available to the public, and a reduction in the reserve ratio extends those limits. These changes in theory and practice with respect to reserves are among the more important Federal Reserve policy developments of recent years.

The power to fix margin requirements for security loans is likewise a new instrument of credit policy. Under the Securities Exchange Act of 1934 the Board of Governors was first granted authority to prescribe rules and regulations with respect to the amount of credit that may be extended on securities. Under the regulations now in effect, stock exchange members, brokers and dealers may not lend their customers more than 60 per cent of market value of securities posted as collateral, and a similar limitation applies to loans on securities by banks. These regulations do not apply to ordinary bank loans for business purposes, even though stocks are pledged as collateral.

In short, the power to raise or lower margin requirements enables the Board to restrict the volume of credit employed in security markets by regulating directly the amount that a buyer may borrow from a broker or bank. Through this device -- and it is a highly specialized device -- Federal Reserve authorities can affect the use of credit for speculative purposes without in any way disturbing the general supply of credit available for other purposes.

To those who have only a passing acquaintance with this subject, the three instruments of credit control that I have just discussed -- open market operations, reserve and margin requirements -- probably appear to be comprehensive and powerful. Actually, they are not so effective as they are generally supposed to be. I stress this point because, as you know, some people think that prosperity can be turned on and off at will by timely and appropriate shifts in Federal Reserve policy.

Nothing could be further from reality. For instance, the Federal Reserve authorities do not and cannot control the uses to which funds obtained from the Reserve banks are put. But this is the minor part of the problem. The major part is that under our system of reserves, once banks have obtained a given volume of reserves from the Reserve banks, through gold imports or otherwise, they can create a total volume of credit several times as large as these reserves.

Furthermore, a given action with respect to open-market operations or reserve requirements that is intended to pinch those who employ credit in ways harmful to the economy may at the same time pinch everybody else as well. In the opposite situation, when

Federal Reserve authorities act to increase the supply of reserve funds in the hope of stimulating credit expansion, we run into a very different problem. We can make additional funds available. There is no question about that. But we cannot force the banks to put those funds to work any more than the banks themselves can force their customers to come in and apply for sound loans. Moreover, whether the total volume of commercial bank deposits is turned over 26 times, as in 1929, or only 12 times, as in 1938, is a matter of the greatest importance that is entirely beyond the control of our monetary authorities.

Finally, even if we grant the assumption, so often implied, that through monetary action alone we can control the direction and activity of the major forces in our economic life, we must still face two puzzling facts:

First, we have not one but several supervisory authorities;

Second, these authorities cannot always be expected to agree either as to objectives or methods.

The reasons are obvious. The banks in this country have been subject to public supervision for about a hundred years. But the development of the mechanism for supervision, like the system itself, has been piecemeal rather than comprehensive. Out of the process has emerged a crazy-quilt of conflicting powers and overlapping jurisdictions; of onerous restrictions and gaps in authority.

Forty-eight State authorities share with the Federal Government the responsibility for bank supervision. And within the

Federal Government, the Comptroller of the Currency has primary responsibility over the chartering, examination, and liquidation of national banks. The Federal Reserve has a certain amount of control over all member banks, consisting of about 6,350 national and State banks out of a total of 15,000 banks. In matters relating to national banks it shares that responsibility with the Comptroller, and in matters relating to State banks, with 48 State supervisory authorities. Finally, the Federal Deposit Insurance Corporation has authority over all insured banks.

With authority scattered amongst so many agencies it is no wonder that the banks are sometimes bewildered. It is no wonder that the policy of one agency may be offset by the policies of other agencies operating under a different set of objectives and instructions. It is evident that in the past our banking and credit mechanism has at times aggravated the depressions in our economic life. And although we have effected enormous improvements in the mechanism in recent years, we may find in the future that we have not yet improved it enough.

The phenomenal growth in bank reserves in recent years suggests that equally grave dangers lie in the other direction. Since 1933, the monetary gold stocks of the United States have increased about 11-1/2 billions, 8-1/2 of which have found their way into member bank reserve balances. In 1936 the Board of Governors, fearing that the credit situation might get out of hand, initiated a series of steps that resulted in raising reserve requirements. Later, in 1938, they were slightly reduced to the present level, about 75 per cent above the old statutory ratios. We still have power to impose a slight additional increase. However, if we raised reserves to the limit, which would absorb only about 800 million, and at the same time disposed of all our security holdings, about 2-1/2 billion dollars worth, we could only absorb 3.3 billions of excess reserves.

That is not enough. Member banks already have more than 4 billions in excess reserves, and that excess might be more than doubled if the United States Treasury decided to disburse the gold it holds in the Stabilization Fund and elsewhere, and to issue silver certificates against silver bullion in its possession. Additional gold imports will place the banks still further beyond the reach of any remedies at our disposal. So will additional acquisitions of silver under the Treasury's silver purchase program.

In conclusion, I wish to assure you that I see no immediate prospect of excessive credit expansion, and hence no reason to change our present policy of monetary ease. But I do believe that the proper authorities should scrutinize our banking, credit, and monetary structure, and consider what changes might be in the public interest.