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THE ROLE OF CENTRAL BANKING IN OUR FREE ENTERPRISE SOCIETY

An address by Thomas B. McCabe, Chairman of the  
Board of Governors of the Federal Reserve System,  
before the Alabama Dinner of the American Newcomen  
Society, Birmingham, Alabama, December 12, 1950.

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I am here tonight to pay off two of your beloved townsmen -- Ed Norton and Thad Holt. I still think it was a miracle that we were able to get Ed Norton to serve on the Board of Governors. I doubt that it would have been possible without the efforts of Thad Holt. In return for his support of the cause, I had to promise to speak before the Birmingham Kiwanis Club of which Thad is President. As for Ed, before he would take the oath of office, I had to promise him I would accept your invitation for tonight. On a strictly horse-trading basis I am convinced I outraded them both.

Ed's friends here overwhelmed him with a barrage of glowing press notices at the time of his appointment. I am happy to say from close association with him over the past three months that he has more than lived up to your and to my highest expectations.

It is a great honor and privilege to meet again with my friends in Newcomen, and especially here in this delightful setting. The gracious hospitality of your Alabama Committee is matched by the heart-warming fellowship which always permeates the inspirational atmosphere of a Newcomen meeting.

It is always a treat for me to have an excuse to come to this part of the country. My admiration for the spirit and rich tradition of the South was nurtured by my early boyhood in Virginia and later on the Eastern Shore. It blossomed into full flower as I spent long periods traveling through all parts of the country as a Sales Manager and more recently in developing some wood-pulp properties in the neighboring State of Georgia.

Believe me, I have an intimate and personal first-hand knowledge of the progress, growth, and future of this highly important part of our

great land. Were I ever to lapse in knowledge or accuracy of the facts, I can assure you that Ed Norton would never let me forget it.

As a Newcomen member myself, I harbor a deep and devoted respect for the record of this organization in adding to the common appreciation of the finest in American and British tradition. It has sought earnestly and diligently to set forth an objective and non-partisan analysis of the basic elements -- both human and mechanical -- that have added to the progress of mankind. Its efforts to knit more closely the friendly ties uniting Great Britain and the United States have found rich reward through the years. Today these two countries are a part of the bulwark in the vital defense line against further encroachment on the freedom loving peoples of the world. The preservation of all that we hold dear depends largely upon the strength, stamina, and moral courage of our allies and the wisdom, foresight and initiative of our leaders. I am sure the conferences last week between our President and the British Prime Minister were conducted with the same good will and objectives of this Society.

The tradition of the Newcomen Society is to study the framework of modern society against the lessons of the past. I will adhere to that tradition and confine myself as much as possible to your long-established custom by showing how the lessons of history apply to the subject which I would like to discuss with you tonight.

In the present crisis -- two great questions are of supreme importance to our people at home and to adherents of human freedom throughout the world. The first is how can we build up our defenses to meet the threat of world aggression by the Communist forces? The second is how can we maintain the value of the American dollar? You can't have a defense program

without a sound dollar. I am convinced that you can't have anything that approaches a peaceful world without a sound dollar. Since I am not qualified to discuss the military problems, I want to confine our attention to the second of these important questions which is so much in the center of every citizen's attention these days. I want to show you what the role of a central bank like the Federal Reserve is in the preservation of a sound dollar.

Since the Federal Reserve System has the statutory responsibility of regulating the volume, cost and availability of money and credit, it is of paramount importance that all of us have a clear understanding of its history, purpose, and its present objectives.

The role of the central bank in this country and in fact other countries of the world has often been a mysterious one. The Old Lady of Threadneedle Street was never fully understood -- what lady is? -- but for generations the Bank of England/<sup>has</sup>commanded the admiration and respect of the English speaking peoples of the world. I welcome the opportunity to talk to a thoughtful and public spirited audience like this on this subject which I feel you want to understand and which is so vital to the preservation of our kind of a free-enterprise capitalistic economy.

Now, first, of all, what do central banks do? You are all familiar with regular housekeeping functions we perform: supplying coins and currency, check clearing, transferring funds from one section of the country to another, serving as fiscal agents in the distribution of savings bonds and other responsibilities of this general nature. I have in mind, however, the more basic things a central bank does that bear directly upon the functioning,

and therefore the future, of the private enterprise system.

All economic societies, except the most primitive, have some form of money. Through a succession of painful and costly experiences society has learned that in a complex and highly organized system centered around personal enterprise and initiative, "money does not manage itself."

The flow of money from hand to hand reflects the decision of millions of producers and consumers. But the uninhibited operation of money systems in the past created great problems for those who lived and did business under them. In the days when coins constituted the money supply, heads of State were not above clipping away part of a coin to recapture funds for the royal treasury. After the use of currency became prevalent, differences in the size and value of a great variety of notes circulated by numerous issuing agencies were a source not only of inconvenience but of heavy losses when holders were unable to redeem their notes. All of you are familiar with the old phrase -- "Not worth a continental". Some of your forefathers had to struggle with an almost worthless currency.

Today our money supply consists only partly of coins and currency and primarily of checkable bank deposits which arise largely from advances of credit. The supply of money -- mostly bank deposits -- is therefore a far more flexible and volatile factor in our present economy than in earlier periods of history. Under those conditions, we sometimes have too little or too much money in relation to the needs of the economy. Let's be concrete and see what happens if the mixture gets too rich -- if we get too much money or credit in the business stream. As the supply of money expands, people are able to buy more -- demand increases. "That's good," you say. "Just what we want!"

But suppose, as is the case today, the economy is already bursting at the seams. Full employment is reached. In view of the ever-increasing military demands production for civilian consumption cannot be increased although money incomes continue to expand. So the natural consequence is for prices to rise as too many dollars bid for too few goods. Thus, the value of the dollar goes down. Of course it can work the other way too. If the supply of money becomes too small or cannot expand in relation to the supply of goods, prices fall as too many goods compete for too few dollars. The result may well be widespread unemployment.

Under a system of private enterprise in normal peacetime conditions, we count on the marketplace to determine what goods are produced. Ordinarily no government authority dictates the allocation and use of resources. Our production expands or contracts in particular lines of activity in response to signals given by a free market. If the price situation looks right we go ahead; if it looks unfavorable we hold back, or shift into other lines.

Now we have already seen that changes in the supply of money and credit have a direct relationship to prices. Therefore, if money is to have stable value and thus contribute to stability and the steady progress of the economy, the supply of money and credit must be kept in proper relation to the flow of goods.

Central banks then have this primary and challenging responsibility -- to influence monetary and credit developments so as to assist in promoting economic stability. I use the word "assist" advisedly, because you realize that other governmental policies such as fiscal policies have an important influence on economic stability. Private enterprise

must be able to operate in an economic climate that is as free as possible from the distortions of an unstable monetary system. Only then is there an opportunity for individual businesses -- large or small -- to go forward with confidence in the spirit of dynamic and adventuresome enterprise. This competitive spirit has made our productive machine the envy of every people of the world and our standard of living beyond any measure of comparison.

The charge upon central banks is a heavy one and it is well worth our taking the time tonight to survey some of the traditions of Anglo-Saxon central banking that are now reflected in the Federal Reserve System.

To understand the why and how of central banks, it is first essential to understand the double-edged character of the most normal commercial bank activity -- that of lending money. It is easy to overlook the prime importance of the fact that at the same time banks increase their loans, they are actually creating additional money.

No one who believes in the system of private enterprise would want -- except under unusual circumstances -- to turn over to a public institution the crucial function of choosing among private business borrowers. The commercial bank in making these choices is helping to determine the business and community leadership of tomorrow. This is a little discussed but most important function of commercial banking. It is a primary justification for a private independent commercial banking system.

On the other hand, the creation (or destruction) of money is fraught with such possibilities for evil, as well as good, that the public interest is acutely involved. The development of central banking tradition reflects the gradual acceptance of the idea that regulation of

the money supply must be attuned to, but independent of, the private commercial banking structure. The establishment of a central bank, then, leaves to individual commercial banks, privately owned and privately operated, the responsibility for selecting which of their customers shall be financed out of the total money available for lending by the entire banking system. It leaves to the central bank the responsibility for at least partially determining what that total amount shall be.

While I do not intend to discuss in any detail the techniques of central bank operations, it is important to keep in mind the fact that a central bank functions largely through organized markets in the traditional sense. Its primary tools involve the buying and selling of Government securities -- open market operations -- and variations in discount rates. More recently there has been added the instrument of changes in reserve requirements. These tools are purely impersonal means of affecting the overall availability and cost of credit. By affecting the supply of credit under a system of credit money, a central bank also influences the total amount of money in the economy. The mechanism works this way: tighter availability and higher cost of credit checks the expansion of the supply of money in relation to the output of goods; easier availability and lower cost of credit accelerates monetary expansion in relation to the output of goods.

In very recent times and partly because of special circumstances associated with war and national defense financing, the Federal Reserve System has had added to its tools certain instruments known as selective credit controls. The Federal Reserve System's Regulation W, relating to



consumer instalment credit, and its Regulation X, relating to mortgage credit, are examples of these tools. The System's regulation of margin requirements on loans to buy or carry listed stocks is another example. Instruments of this type affect credit conditions by setting terms for the extension of credit. These regulatory terms bear upon demand and not upon supply. Selective tools can be made to apply only to a narrowly defined credit area. They are therefore not general. Hence, the description "selective" tools. They are in no sense a substitute for the general tools of the central bank. They merely reinforce them.

Historically, in country after country, it has been difficult to decide just how a central bank should be organized and what relation it should have to government and to private enterprise. The combination of public responsibilities and private functions complicates the problem. Until relatively recently central banks have commonly operated under special charters from their governments as privately owned institutions. I understand that George Washington, for one, owned shares of the Bank of England during the Revolutionary War and when the war was over collected his accumulated dividends. Today, the shares of the Bank of England are all owned by the government. While private ownership has had the advantage of insuring relative freedom from political influences, it has been difficult to avoid the charge that national monetary and credit policy was being determined primarily for the benefit of the private banks rather than in the public interest.

Many governments have made their central banks wholly public owned, either by initially setting them up in this way, or by buying up privately held shares. In this way the emphasis is more directly on the public character of their responsibilities. Even in such instances,

however, the central banks have usually continued to function as semi-independent organizations.

The great size and diversity of the United States and of its economy has led to the establishment of twelve separate Federal Reserve Banks, which are partly autonomous but are placed under the general supervision of the Board of Governors, appointed by the President for long terms of 14 years each, and responsible to Congress. The Federal Reserve Banks carry on the operations ordinarily performed by central banks while general policy decisions, which in most countries are also made by central banks, are vested largely with the Board of Governors and with the Federal Open Market Committee. This latter group is established by statute and provides for the rotating representation of five Federal Reserve Banks by their Presidents. The Federal Reserve System receives its authority from the Congress and is responsible to it.

Whatever its form of organization, a central bank obviously must be a "public" institution. Its powers must be used in the public interest, and only in the public interest. It must steer a true course between the private financial community on the one hand and the Government on the other.

In the early days some of the supporters of the Federal Reserve System referred to it as the Supreme Court of Finance. This comparison was not strictly accurate but it did convey the idea of the founders that the Federal Reserve should be independent of both political and private financial interests.

From the very outset, attempts to organize a central bank in the United States faced one great hurdle -- a healthy distrust of any

centralization of power. Failure to renew the charters of the First and Second Banks of the United States can largely be explained on this ground. As Federally chartered but privately managed banks they were suspect because the management was entirely in private hands. Further, there was a general feeling that neither bank represented adequately the frontier interests.

In his famous "Report on a National Bank", Alexander Hamilton, who fathered the First Bank of the United States, said: "To attach full confidence to an institution of this nature, it appears to be an essential ingredient in its structure that it shall be under a private not a public direction -- under guidance of individual interest, not of public policy." History has shown the weakness of this thesis. The First and Second Banks of the United States were both organized on the basis of dominant private ownership and control.

Andrew Jackson's successful fight to prevent a renewal of the charter of the Second Bank of the United States was largely based on opposition to private control. The result of this controversy was to deprive the country of the advantages of a central banking system for nearly 80 years. In the meantime, however, the basic problems of regulating money and credit remained unsolved. The next step -- some 25 years after the lapse of the second charter -- was to establish the National Banking System. From the standpoint of our discussion, the significant thing about the National Bank Act was that it provided for the regulation of the issuance of bank notes by requiring the deposit of substantial security.

This again failed to solve the problem of adequate monetary control for two principal reasons. First, because checks on deposit became a more important type of currency. While sharp restrictions were put on the issuance of bank notes, the power of the banks to expand check currency was left uncontrolled. Second, repeated experience with money panics subsequently showed that there was such a thing as too little currency, as well as too much, and that there had to be means of expanding the money supply in response to the needs of a rapidly growing country. A succession of money panics near the turn of the century focused public attention on money and credit problems. The panic of 1893 provided the initial stimulus and the panic of 1907 furnished the final push necessary for the appointment of a National Monetary Commission. This body made the most thorough study of monetary and banking systems throughout the world that has ever been made. It submitted recommendations for remedying the defects which were revealed in our system.

The passage of the Federal Reserve Act in 1913 created a System which was unique in the history of central banking. First of all, that act clearly established central banking as a most vital and essential public function in this country. Further, in keeping with the traditional status of such banks, it provided that the Federal Reserve should have an independent status in the government structure reporting directly to the Congress. This is in accord with the philosophies of checks and balances inherent in our constitution. Finally, conscious of the danger of rigidity and remoteness in a highly centralized authority, the framers of the Act provided for an efficient and effective combination of public and private management. The Federal Reserve System today consists of a Board of Governors which

operates through a decentralized network of regional banks and branches in intimate contact with every commercial area in the country.

I repeat what I have said many times that I am thoroughly convinced that the authors of the Federal Reserve Act gave us a monumental piece of legislation -- a system tailor-made for the economic expansion of our country. The System might be compared to a great pyramid with its base in the grass roots of our economy, and its apex in the Board of Governors. The breadth and strength of the pyramid are in its base, with the member banks and the Reserve Banks as elevations in the slope toward the top.

I am more convinced than ever of the truth of that statement. For more than ten years I served on the board of the Philadelphia Federal Reserve Bank, and for almost three years more I have served with the Board of Governors in Washington. It has been a great experience to observe the intricate workings of our credit and monetary machine and to view its relationship to the national economy.

I have seen the System adapt itself flexibly to changing economic conditions. I have benefitted by the decentralized organization with its 12 banks, 24 branches and more than 250 directors who constitute a representative cross-section of the finest our free enterprise system can offer.

Most of you are familiar too with the highly valuable research services of the Federal Reserve, not only the regular services but special studies of regional developments such as those prepared by the staff of the Atlanta Bank with the help of the branch offices. I have, as I hope you do, a wholesome respect for the highly professional work of the research organizations of the Banks and our Washington staff. The end product of their efforts has established a new level of professional competence in

this field. These men have an uncanny understanding of current problems and they have supplied constructive suggestions for future courses of action. In fact, this exceptionally high level of professional competence extends throughout the System's official and staff personnel.

It would be impossible for me here to give proper credit to all those who have had a prominent part in the establishment of the Federal Reserve System. But I would be greatly remiss if I did not note that the lion's share of the credit must go to two Southerners -- Woodrow Wilson and Carter Glass. They understood clearly two fundamental propositions:

First, that unless some way was found to regulate effectively the supply of money and credit we were running the risk of destroying the very foundations of the free enterprise system which, in so many of its aspects, embodies a Jeffersonian insistence on the rights of individuals against the encroachments of an all powerful State.

Second, that a Jeffersonian distrust of the centralization of financial power can be met by the recognition of central banking as a public function subject to public control.

To say that central banking must be regarded as a public function subject to public control is another way of saying that a central bank cannot regard itself as immune to the will of the people. This raises a fundamental question which has plagued central bank authorities from the very beginning. In a democracy such as ours we generally think of the will of the people as being reflected through duly elected members of the Congress and through the Executive Branch of Government. What then should be the relation of a central bank to other public authorities in a democracy determined to preserve the private enterprise system? How are we to reconcile the necessity for public control and yet avoid the danger of domination?

This general question, in its broadest terms, was exactly the question that the liberty-loving founders of our Nation put to themselves when they established our system of government. For example, the architects of that system recognized the public character of the administration of justice. That did not prevent them, however, from setting up a system of courts organized independently of the Executive and the Department of Justice.

The Federal Reserve System itself is an example of this conception of public control in relation to other branches of government. The Federal Reserve System was created by Congress. There is not the slightest doubt that it could likewise be destroyed by Congress, or that it would be destroyed or radically altered if it pursued policies against the public interest, as interpreted by the people's elected representatives. But the point I wish particularly to emphasize is that the Congress deliberately sought to insulate the Federal Reserve from predatory and political pressures. It did so because it recognized that there may well be divergent views as to what is, and what is not, in the public interest. It did so, I believe, because of the importance it attached to the responsibility of maintaining economic stability.

Not only is the Federal Reserve System unique in its combination of a public and private form of organization, but it has a unique relationship with the other agencies of government. Every agency of government has statutory responsibilities to carry out. Many of their operations inevitably affect the supply of money and credit. Among the agencies that have credit programs and policies affecting this picture are the R.F.C., the Housing and Home Finance Agency, the Department of Agriculture and the various international agencies.

It is only natural that the Federal Reserve with its responsibilities in this field should affect, and be affected by, the actions of these other agencies. That is why it is so important that we strive to attain a higher degree of integration and coordination of all governmental policies which ultimately affect the monetary and credit situation.

The relation of monetary and credit policies, and fiscal and debt management policies is most important of all. These interrelationships have become increasingly important and binding as a result of the tremendous war-time expansion of the public debt to a dominant position in the over-all financial structure.

Fiscal policies are in the final analysis determined by Congress in authorizing appropriations and legislating taxes. Of course the President and the various executive agencies of the government have a major influence upon these policies in their recommendations for legislation and in carrying out the measures voted by the Congress. The Treasury has a primary responsibility for recommendations as to tax policy, as well as for the collection of taxes. It has important discretionary authority with reference to the management of the public debt. This includes decisions as to the timing and nature of borrowing and of debt retirement. The Treasury also possesses certain monetary powers and it has important responsibility with reference to the international financial operations of the government. These various Treasury operations have a direct bearing on and are affected by conditions in the money market, with which the Federal Reserve is concerned.

The functions of the Federal Reserve are primarily monetary. As I have said, the System has primary responsibility for influencing the supply, availability, and cost of bank reserves, which provide the basis for the bulk



of the country's supply of money and credit. Federal Reserve authorities, by exercising an influence on the cost and availability of reserves, can affect not only the level of interest rates but also the ability and willingness of banks to lend and invest. These policies necessarily impinge upon public-debt operations. Moreover, the magnitude of public debt offerings (or retirements), the rates of interest paid by the Treasury, and the maturities and other features of the various issues are reflected in the demands for credit and can thereby influence the supply of money and the demands upon the Federal Reserve.

The rates of interest which the Treasury finds it necessary to offer on new issues of securities are to a substantial degree affected by the Federal Reserve's influence on the money market. Obviously if the Treasury and the Federal Reserve were preoccupied solely with the question of rates, they would sacrifice all other considerations to this end. Both, of course, must take account of the many broad aspects of their respective policies and the effects upon the entire economic structure. Because measures adopted by either agency must be taken into consideration by the other in determining its policies, it is most essential that they unify their efforts and direct their respective policies toward common broad objectives of national policy.

It is most fortunate that public discussion of fiscal, monetary, debt management and other policies has been on so high a plane. A short time ago, I addressed the Committee for Economic Development and was deeply impressed with their recent public statements which grappled in a most constructive way with the problems inherent in administering and coordinating monetary and debt management policies. The search for the right answers that

will best serve public interest demands the highest statesmanship on the part of the leaders of finance, industry, labor, education and government. It is greatly to the credit of the President, government officials, and members of Congress concerned with these problems that they have approached them in a broad, non-partisan and unprejudiced spirit. There has been a most earnest and sincere desire on the part of everyone to find the right solutions that will contribute to the common objective of orderly economic progress.

Today we are engaged in a great defense effort, the purpose of which is to assure the continuance of our way of life. We all agree that it is in the public interest to regard the requirements of defense as having priority over all other activities. I am sure we are agreed that the way of life which we wish to defend is one in which the private enterprise system will continue to play a central role.

I wish to state here and now that in this critical period the Federal Reserve System will use all of its resources and powers in conjunction with the Treasury to assure the successful financing of the defense program. Furthermore, we will continue to wage a relentless fight on inflation. Nothing could be more damaging to our morale or to our ability to back up the military than inflation. Inflation diminishes incentives. It misdirects tremendous amounts of effort into nonproductive areas. It destroys the savings impulse of our people that has been so vital a factor in making our nation great.

While I have outlined how the Federal Reserve, the Treasury, and the other government agencies will work to combat inflation, it is, of course, everyone's job. The fact is that unless every one of us, as individuals, recognizes and combats this problem the efforts of our

government will fail. Inflation is a matter that vitally concerns each of us and it can only be avoided if each of us is willing to exercise the restraints and make the sacrifices required.

I have tried tonight to stress the development of the idea of central banking as a means of strengthening the financial stability of a modern national economy. In this country, the Federal Reserve System, a unique "decentralized" central bank, was developed to meet our particular type of highly competitive expanding capitalism. Its purpose is to exert influence through the banking system and the money market, to provide for an expanding economy and at the same time to help preserve the value of the American dollar.

On a number of occasions I have called the Federal Reserve System a great and vital bulwark of the enterprise system which has so enriched this country and made it strong. Our strength at home and abroad rests fundamentally upon the preservation of this System and the integrity of the dollar which symbolizes our strength -- and, indeed, our hopes -- for the future.