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HOW THE FEDERAL RESERVE SYSTEM IS MEETING THE REQUIREMENTS

Address

of

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Member of the Federal Reserve Board

Delivered May 24, 1916

at the Annual Convention of the

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The financial outlook for the United States has never been so full of interesting possibilities as at the present time, nor has it ever called for a more definite understanding of whence we have come, where we are at, and whither we are going. In the course of the past year and a half we have replaced financial dependence upon Europe by dependence upon ourselves and we have also been able to extend a very considerable measure of financial service to some of the warring nations, and to many of the neutral countries of South America. The record of our material and financial progress in the past year and a half discloses results which are stupendous and seem little short of miraculous.

Much has been said of our new opportunities; but it is important that the banker, who has a very serious part in shaping the course of business and tempering the spirit of the community to a new situation, should recognize that the situation with which we are confronted is not alone pregnant with opportunity, but is also weighted with serious responsibility. It is, indeed, doubtful whether any country in the history of modern commerce has ever been faced by a situation so calculated to challenge the best of which it is capable in conceiving and carrying to fulfillment great plans. It is a situation which invites to a mastery in the world of finance and of large affairs; but to attain this mastery we must first become masters of ourselves and of our own by developing to highest efficiency instruments of direction and control which match our splendid resources. It calls, moreover, for a new type of business leadership and a capacity for co-ordinated action on a larger scale than we have been accustomed to in order that we may be able to act with wisdom, vigor and effect in this new region of affairs and responsibilities into which we have entered.

It is fortunate,- indeed it would be difficult to exaggerate the degree of our good fortune,- that the most important and considerable step toward fitting ourselves to meet the new occasion should have been taken in advance of the great changes in the sphere of international relationships, which are bound to come as one of the results of the war. I refer of course to the establishment of our new banking organization, the Federal Reserve System. That system, and what it stands for, must be, as indeed, it has already proved itself to be, our chief reliance in meeting our new responsibilities and in turning our new opportunities to profitable account for ourselves and to benefit for the rest of the world. No agency or resource in the field of finance which the nation today possesses or has ever possessed is comparable in its potentialities to the Federal Reserve System. It is, not only the newest thing in American finance, but also the best thing. Until we definitely understand this, we are not in a position to do our best in meeting the new occasion. To recognize this is the beginning of wisdom.

It is also well that we should recognize that the atmosphere was never so propitious for the discussion of questions of finance upon the broad and high plane of national interest and policy as now. I believe I speak truly and with strict fidelity to the historical record, when I say that for the first time since we, as a nation, began to make financial history, questions of currency and finance and banking have ceased to be political and party questions. To have taken the banking question out of politics, where it long lingered to the prejudice of the nation's commercial and financial interest, is a matter of sufficient moment and promise to entitle it to rank as a real achievement. Whatever differences may have existed on questions of banking policy before the establishment of the Federal Reserve System, they have pretty much ceased to exist since. The country, as you know, has set its approval upon the Federal Reserve Act as a piece of fundamental legislation on which to build and under which we are to develop the banking system of our expanding industry and commerce for decades to come. So well was the work of legislation done, and so completely has the result been accepted and approved by the business, banking and general public opinion, that the banking question has fortunately at last ceased to be a problem of legislation and has become one of administration. Congress has given us a superb instrumentality; it is for our bankers and those who are charged with the administration of the new law to do their part in using this new instrumentality wisely and effectively in strengthening the financial foundations of our industry and promoting its healthy, prosperous and steady growth.

The test of a banking system is the aid it gives to productive enterprise by supplying its credit needs. Banks become powerful and valuable auxiliaries in the industrial system in proportion as they give increased activity and mobility to the community's industrial and commercial capital;

and banking profits and prosperity are never so legitimate and so fair an indication of the character and quality of the service banks are rendering, as when they prosper and flourish along with the communities in which they exist. The changes which were made in our banking system under the Federal Reserve Act were designed to accomplish many different things, but the goal toward which everything pointed was that of making the nation's credit facilities more widely available in all useful and legitimate ways for industrial and commercial employment on terms of safety, and of such ease as is consistent with safety. How far the new banking system is fulfilling the promise of its sponsors and meeting the expectations of the nation, more particularly how it has met the tests which its first year and a half have brought, are questions of the kind which suggest themselves at a time when the nation, throughout its length and breadth, is taking stock of its capabilities and when "preparedness" is its watchword. For the new system is no longer a theory, but a fact. It is in actual operation, with a record which can be examined, and which can be tested by results.

The new banking organization has already found its place in the American financial system and has already made an enviable history for itself. Its influence has not only been felt in every part of the country, but has reached across the seas. It has had to meet conditions and circumstances in many respects more unusual than could have been contemplated by its framers, and yet so well contrived and so flexible is the structure of the new banking system that it has been found capable of adjusting itself to each new condition. It has thereby given evidence of its capacity for growth and development along with the changing and expanding needs of the American credit and business system. It is just this quality which takes the Federal Reserve Act out of the class of ordinary financial legislation and makes the new banking organization a system in a very real and far-reaching sense. In breadth of conception the Reserve Act is a constitution rather than a statute; a financial constitution characterized, as an organic act should be, by that quality of adaptiveness which has always been the boast of our great political constitution, and a quality which we have long since come to regard as an essential, not to say the sovereign, element in any great and vital piece of constructive legislation.

In reviewing the working of the Federal Reserve Banks I wish to direct your attention to four or five aspects of the new system which in my judgment are calculated to disclose the capabilities of the system and the temper and wisdom of its administration.

1. It has facilitated the growth and financing of the country's enormous foreign trade.

2. It has met the requirements of domestic trade, particularly the requirements of the crop-moving season and has shown a capacity to ease and steady discount rates.

3. It has shown capacity to absorb the redundant gold of the country and restrain inflation.

4. It has shown capacity to maintain an atmosphere of confidence.

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1. Growth and financing of foreign trade.

The financing of our foreign trade was always a sensitive point in our credit system, and foreign exchange has long been regarded as a very accurate barometer of our international position. The year 1915 witnessed the largest foreign trade ever experienced by this country, the export trade particularly attaining the colossal magnitude of $3,600,000,000, an amount $1,000,000,000 in excess of the highest amount hitherto recorded.

The large excess of exports over imports of merchandise created a balance of trade in our favor of unprecedented character and dimensions and subjected our purchasers to the necessity of resorting to the American money market in order to obtain funds with which to meet their obligations. The new banking system met every requirement of this unprecedented situation without difficulty. At no time since the opening of the Reserve banks has there ever been any doubt of the ability of our banking system, by means of the newly established system of acceptance credits or otherwise, to take care of the financing of the country's exports, however large the excess of these over imports might become. The growth in our exports has been continuous. The last month for which we have complete figures, March, 1916, shows exports over $100,000,000 in excess of March, 1915, an aggregate of $409,850,425, and which promises an estimated total for the year of between $4,000,000,000 and $5,000,000,000. When we contrast the ease with which we now finance a volume of trade which would have staggered the imagination a few years ago, with the clumsy shifts to which we were frequently reduced under our old methods of financing, we get some idea of how fundamentally and effectively our banking machinery has been improved by substituting for a precarious dependence upon foreign facilities those of our own making and control.

You bankers will recall the situation into which our foreign exchange was plunged at the beginning of the European war before our new banking machinery had been set in operation. Our bankers, as had long been their custom, had drawn heavily during the summer on England. The estimated amount of our short time indebtedness maturing before the first of January, 1915, was from four to five hundred millions of dollars. It had been expected that this would be taken care of by the proceeds of cotton and grain bills which would be drawn with the export of crops. The sudden suspension of our foreign trade and equally sudden termination of our foreign banking credits left us in a serious position. I recall a conference of momentous import, held in the office of the Federal Reserve Board and attended by leading bankers identified with international financing, at which was discussed whether and how our accruing obligations could be met. It was decided that they could be met and therefore should be met no matter at what inconvenience to ourselves and no matter at what cost in the loss of gold. By that act was laid a foundation for the future of America as a world banker and to the faith thus inspired in the integrity and the capacity of the American banking system we owe very largely the enviable position that we have, in the brief period of little more than a year, attained in the international money market. Such an embarrassment as we suffered in the early autumn of 1914 is all but unthinkable under our new banking system, unless there should be a breakdown of transportation facilities. This is not a theory; it is a fact which is thoroughly attested by the experience and events of the past year. We have not only received from Europe during the year 1915 over $400,000,000 in gold, but we have taken back American securities and arranged additional credits to a combined total estimated at $2,000,000,000.

A year ago dollar credits were practically unknown in foreign centers; today dollar exchange is a recognized and established medium of international commerce and one of the most prized, because the most stable, unit of international payment. The acceptance business, for many generations the peculiar domain of English banks and the source of much of England's prestige and power and profit in banking, has been successfully naturalized on American soil and is thriving. Complete and accurate figures are not available, but it is a safe statement that the volume of acceptance credits created in behalf of the foreign trade of this country has averaged for several months $100,000,000 and now amounts to over $200,000,000, and the amount held by the Reserve banks to $43,000,000. The certain knowledge that acceptances of a sound character will find ready discount or purchase at the counters of the Federal reserve banks and at rates as low as two per cent, which is lower than has ever been enjoyed by any class of commercial paper in this country, has given a feeling of assurance to our bankers in entering this new and unfamiliar field and has thus enabled them to gain a foothold in it and to make it for all time an important and invaluable department of American banking.

2. Domestic trade, crop-moving, and discount policy.

While this important extension of American banking enterprise into the foreign field was taking place, our banking system, with the support of the Federal Reserve Banks, was assisting in the recuperation and extension of our home trade and industry. The home trade is, after all, the basis of the country's industrial activity and prosperity. However large and important the foreign trade may bulk in the popular imagination, however much attention may be given to it in the financial columns, and however important it may be in fact, it is still the truth, which deserves to be emphasized, that ours is primarily a country of inland trade and industry. Among the nations which have reached a high degree of economic development, there is no other in which inland trade bears so large a proportion to foreign trade. According to competent estimates, it is at least twenty-fold the volume of our foreign trade and it is therefore the necessities and the interests of our home production and consumption that deserve especial consideration in any attempt to estimate how well it is being served by the banking organization. Are its needs being supplied on reasonable terms and with the assurance that accommodation can always be had on satisfactory security? To ask this question is to answer it, so universal is the knowledge of the comfortable conditions which have obtained in the money markets of the country and generally throughout the country since the Reserve banks were put into operation.

How completely the requirements of the crop-moving season have been met is also a matter of wide experience, if not of common knowledge. Never before within the recollection of this generation have the credit and currency needs incident to the gathering and the movement of the crops been met so easily and so smoothly and so quietly. The operation of the Gold Settlement Fund which has been established to facilitate the settlement of exchanges among the Reserve banks and to reduce to the lowest point the shipment of currency from one part of the country to another, is in large measure to be credited with the happy result which has been attained. The autumnal pressure on leading money markets and the consequent tightening of money rates has come to be regarded by many as something that was inevitable in a country subject to such large periodic requirements of cash for the movement of its staple crops. The last crop-moving season, the first which has had the benefit of the machinery of the Federal Reserve banking system, passed without any untoward incident and without any indication of perturbation or strain in the great money centers. Indeed, if the experience of the past year may be taken, as I believe it may, as prophetic of the great change wrought in our banking mechanism by the Federal Reserve Act, the disturbances associated in the past with the autumn requirements may be regarded as an easily manageable factor in our credit and banking situation. This, in itself, is a triumph which deserves to be signalized in estimating the workings of our new banking system.

With rates ruling as high as six per cent for commercial paper when the Federal Reserve Banks were opened in the late autumn of 1914, and when the financial disorders incident to the

European war still presented a troublesome situation, and with some variation of rates between different districts, the Reserve banks, during the year 1915, greatly reduced the general level of discount rates and maintained them at a remarkably steady level. The opening quarter of the year 1916 saw rates of from two to four per cent on bankers' acceptances, the rate in actual practice, however, running very close to the lower limit. Trade acceptances at rates of from three to three-and-a-half per cent, rates on short-term paper up to ninety days at rates of from four to four-and-a-half per cent, were the noteworthy features in the discount rate situation. The fact that rates as low as three and three-and-a-half per cent were established on commodity paper,(that is, notes and bills secured by readily marketable staples), and the further fact that the Reserve banks stood ready to take and have freely taken agricultural paper at rates of four-and-a-half to six per cent, shows that the banking accommodation provided by the new system is not restricted to any class of borrowers but is available to all classes where the security is of the type approved for Reserve bank operations.

These various rates are lower than have ever been enjoyed for like classes of paper in any considerable section of the country. What is perhaps more important from the point of view of the geographical distribution of the facilities of the new system, there has been a marked approach to uniformity of rates among the several Reserve banking districts, a nearer approach than has heretofore been experienced. Whether it will be practicable for a long time to come to maintain identical rates throughout the twelve Federal reserve districts has been questioned. Such an outcome may not be likely as long as there are marked differences in point of economic maturity in the different sections of the country, nor is the successful operation of the Federal reserve system predicated upon the assumption that discount rates must be uniform in all the reserve districts. One of the important features in which the regional system differs from the plan of the National Monetary Commission for a central bank with branches is that it does not require uniformity of discount rates but allows these rates to be adjusted to the conditions of demand and supply in the respective districts. These conditions are admittedly so divergent that any attempt to ignore them altogether in the determination of Reserve bank rates might well be regarded as undue interference with the necessary operation of natural forces and would sooner or later result in embarrassment. As long as the different sections of this vast country of ours are in different stages of economic development with respect to the need for, and the accumulation of, capital, it is to be expected that there will be differences in the rate of interest and also, therefore, of discount rates. But the disparity which long obtained between the rates in some of the younger and less highly developed sections and the older centers, was undoubtedly in large measure due to the peculiar banking policies and practices which had grown up under our old banking system, and which were, to a certain extent, fostered by the law. But whatever the causes, the result was an artificial disturbance of the natural distribution of the country's supply of credit facilities and a condition which threatened, if left to itself, to develop into an artificial and unwholesome interference with the free flow of the nation's credits. To the extent that such was the case, differences of commercial rates were without solid justification in economic law and to that extent at least we may expect that these differences will be mitigated, if not altogether eliminated, under the operation of the forces set in action by the Reserve Act for diffusion of credit facilities and for local control of credit conditions by regional banks.

The rates which have been maintained by the Reserve

Banks throughout the past year or more are probably not to be regarded as normal, except in a temporary sense. The conditions of the past year and a half have admittedly been extraordinary and have worked toward easy conditions in the credit markets of the country. When we have digested the immense volume of potential credit set free by the new banking reform and are no longer subject to the depressing influence on rates exercised by the great influx of gold which we have had, it is certain that rates will advance. How soon the demand will catch up with the supply can only be conjectured; so too, it is a matter of conjecture what the normal rate of discount will be when the demand and supply of loanable funds are more nearly in equilibrium. Much will depend upon what is one of the most difficult of the war's effects to forecast; namely, the effect of the interruption and suspension of a large part of the customary commerce and industry of the European world and the destruction of an untold amount of industrial capital, upon the permanent interest rate. In the long run the interest rate on fixed investments is bound to influence short term money rates. In the long run, too, there will be a tendency for both investment rates and commercial rates in the leading financial centers of the world to move toward a common level. The course of the money market in this country is, therefore, bound to be in very considerable degree influenced by the course of the leading money markets of Europe.

Speaking for myself, let me say that I am under no illusion with respect to the function of the Reserve Banks in our credit system, nor any with respect to the Federal Reserve Board's position and power as the ultimate authority in the determination of discount rates. The Federal Reserve Act has invested the Board with extensive powers, in the fixing of discount rates but it has also charged the Board with the responsibility of seeing to it that rates are so fixed as " to accommodate commerce and business", thus indicating that the fixing of discount rates is an exercise of economic and business judgment, not an arbitrary choice. No body of men in my opinion would be competent to shape the policies or guide the destinies of our new banking system, who did not realize that the determination of discount rates at their proper levels was more a matter of the wise application of economic law than of hasty or careless experimentation with statute law; a question of the conditions affecting the demand and supply of, loanable funds, present and prospective, as reflected in the market for short term commercial loans. The Reserve Banks will, therefore, show wisdom in recommending, and the

Federal Reserve Board will show wisdom in sanctioning only such rates as correctly interpret the trend of business and credit conditions and needs, so as, in a genuine sense, " to accommodate commerce and business". For the Federal Reserve System is not above or beyond economic law.

There is a magic in the Federal Reserve System but it is no venture in financial alchemy. It cannot make something out of nothing, nor for any length of time, and except at the cost of serious injury to the movement of the country's industry, maintain rates that are out of line with the natural economic trend. It would be poor policy, at any time, to favor present business at the expense of calculable future needs or requirements, nor should accommodation be withheld from present business because of undue solicitude or fear for possible future requirements. Such rates would not "accommodate". In the one case they would be too low, in the other too high; but the error committed and its mischievous effects would usually not become manifest until the results were well beyond control.

The Federal Reserve Banks as a whole might have maintained rates at a very much lower level than has been in effect during the past year or more, but it is hard for me to see what good purpose would have been served by such abnormally low rates. As I view it, the chief results would have probably been, first, to have given an unhealthful stimulation to business enterprise of doubtful validity, possibly going so far as to work a dangerous inflation of credit and the launching of undertakings that would later on have been caught in the grip of rising rates; and, second, to have narrowed the margin of banking profit, more especially in sections of the country which are for the first time experiencing the levelling influence on rates of a fluid credit system.

I need hardly point out that lower rates would have borne hard on those of you who still follow the costly practice of paying inordinately high rates of interest on depositors' accounts. It is a familiar fact that in many parts of the country, banking competition has raised the rate of interest paid on savings accounts to a point where industrial development is retarded and bankers' profits threatened. It is well to encourage thrift by suitable inducements, but the matter is overdone when the inducement in the shape of interest goes beyond the rate warranted by industrial conditions, and thereby diminishes the incentive to individual investment and enterprise. And this leads me to remark in passing that I believe that there must be a readjustment in the interest paid to depositors to conform to the reductions in the rates of interest and discount which will result under the moderating influence of the new banking conditions.

3. Absorption of redundant gold and checking of Inflationary tendencies.

I am afraid that the great influence exerted by the Federal Reserve Banks in steadying the movement and level of rates is not generally appreciated at its full value and significance. The wise policy of conservatism and self-restraint which has been pursued by the Reserve Banks as a whole has given to the movement of industrial expansion which has been under way for the past year, taking the country by and large, a quality of health and solidity that it would almost certainly not otherwise have possessed. In this, the first substantial trial of the Federal Reserve System's capacity for leadership, its success has been unquestionable. It has, so far as its situation permitted, created an atmosphere conducive to healthy expansion, and has used such influences as it could command to temper the spirit of reckless adventure and prevent it from becoming a menace to the country's welfare. The result has been that the forward movement in industry which every part of the country has been experiencing in greater or less degree, has been one of the most substantial that the country has ever known. How easily it might have been otherwise can be conjectured by those who have not forgotten how often incipient industrial prosperity has been turned into misadventure and collapse in the olden days, because of the lack of the guiding and steadying influence of such authoritative and competent leadership as the country now enjoys.

You will recall how frequently and confidently, up to the very last moment preceding the passage of the Federal Reserve Act, the prophecy was made that the new banking system would bring/about inflation, especially inflation of currency. One of the primary purposes of the Federal Reserve Act was to provide a method of elastic note issue. It is, of course, obvious that there can be no elasticity of circulation without the possibility of expansion which may, if the management of note issues is in incompetent hands, lead to inflation.

Discretion must lodge somewhere, and if it be abused, bad consequences will result. How carefully the new system has functioned in this respect, and how prudently it has used its issuing power to diminish, rather than aggravate any tendency toward inflation of credit is one of the most gratifying evidences of the wisdom of our new banking law and the ability of its managers. This deserves to be made clear, for there has been much misconception of the policy which has been pursued by the banks with respect to note issues.

The statement is sometimes made by persons who have not taken the trouble to inform themselves, that there has been a great expansion of the Federal reserve note circulation at a time and under conditions when there was no need of additional currency. What are the facts ?

If you look at the Daily Statement of the Treasury for May 13, 1916, you will find that $187,166,000 of Federal reserve notes have been issued by the Federal Reserve Agents or the Government to the Federal Reserve Banks. The Federal reserve notes are of course obligations of the Government as well as of the issuing banks and are issued by the Government to the banks and by them to the public. Before we can determine what, if any, influence has been exerted by the Federal reserve notes issued by the

Government in augmenting the money supply of the country, we need, of course, to know on what basis the banks have issued the notes to the public, and also what portion of the notes that have been issued by the Government to the banks are held in the bank's vaults.

On may 13, 1916, it appears that $27,218,000 of Federal reserve notes issued to the banks had not yet been issued to the public, and of the $159,948,000 outstanding and issued to the public, all but $9,567,000 had been issued in exchange for gold. That is to say, that except for $9,567,000 of Federal reserve notes outstanding against which the Government holds commercial paper for an equal amount and the banks hold a gold reserve of 40%, there was for every dollar of Federal reserve notes issued to the public by the Reserve Banks a dollar of gold taken from the public by the banks and deposited with the Federal Reserve Agents, representing the Government. In brief, to this extent the Federal reserve note is tantamount to a gold certificate or warehouse receipt for gold.

A dollar of reserve money is, by usual computation, estimated to be capable of supporting a volume of credit in the customary form of deposit liabilities, of four or five times itself. When, therefore, it is recalled that the Federal reserve note is not legal tender and cannot therefore be counted in the reserves of the national banks, you can readily see how the policy and method which the Federal Reserve Banks have pursued in the management of their Federal reserve issues, so far from inflating the bankable funds of the country, has actually reduced them by a large amount. In other words, of the vast amount of $419,356,000 of gold which the country received in settlement of the international balance during the year 1915, and which, if allowed to accumulate in the reserves of the banks would have threatened a serious unsettlement and disturbance in our credit situation, 36% (or $150,381,000) has been drained off and stored up in the keeping of the Federal Reserve Agents until such time as changed conditions and the interests of commerce and industry may require its use. The note-issuing policy pursued by the banks has thus had the twofold effect of actually diminishing the tendency to inflation through substituting the note in place of gold and, at the same time, has provided a definite reservoir of gold which can be tapped without producing any shock or anxiety when the inevitable demand begins for the return to Europe of some considerable part, if not the whole, of the gold which necessity has obliged Europe to part with to us. So far from being a source or cause of inflation, the very opposite is the case, and the country owes much to the salutary action of the Federal reserve issues in mitigating the effects of the gold influx.

Whether we could or how we would have dealt with the problem of the increasing gold supply had we not fortunately had the agency of the Federal Reserve Banks, may well be questioned; but it is worthy of remark and careful consideration that although a condition so extraordinary as this was probably never contemplated by the framers of the Federal Reserve Act, and therefore no special provision made for it, nevertheless, so well conceived was the general framework and machinery of the system that it was found that it could be turned to useful account in meeting the situation created by the presence of the redundant gold supplies.

4. <u>Commercial confidence</u>.

I have reviewed, perhaps at what has seemed to you tedious length, three distinct, important and difficult kinds of service which the Federal reserve organization has rendered in the first year and a half of its existence - a period characterized in its general aspects by much uncertainty and anxiety - in order to show how the new banking system is standing the test. It has met every requirement in the financing of the largest export trade the country has ever enjoyed; it has equalized and steadied discount rates at a low level throughout every district of the country and in this connection it has withstood the temptation to utilize its vast resources and power to depress discount rates to the point where both a dissipation of its resources and an unhealthful stimulus would result; and, thirdly, it has done much to check the inflationary tendency threatened by the huge influx of gold.

I come now to a fourth matter which is in some respects equal in importance to any of the others, if not of greater importance, because it has underlain each one of them and has made possible the definite and signal results which have been achieved. I refer to the atmosphere of confidence that has been induced and maintained from the very day and even before the day of the opening of the Federal Reserve Banks, and in every section of the country. It is, of course, hard, not to say impossible, to estimate the value of any element of business health and activity so intangible as confidence, and yet it is of the very essence and life of the modern business system. Business is largely a state of mind.

Business flourishes in the atmosphere of hope and the sunshine of cheer; it is chilled and choked by the poisonous vapors of fear and anxiety and is paralysed by the atmosphere of despair. The method of the Federal Reserve System, I trust you understand by this time, is the method of hope and of encouragement. It is this quality which distinguishes the Federal reserve legislation from any other important piece of legislation ever enacted by our Government touching the fortunes of business. It is this quality which entitles it to be regarded in a very genuine and critical sense as a product of constructive statesmanship. It is this quality which makes the advent of the Federal Reserve System mark an epoch in the business life of America and a step of incalculable length in the development of the new relations which the statesmanship of the future will seek to cultivate between the agencies of Government and the agencies of business.

That it has thus far succeeded in this vital function, the past year and a half bears eloquent testimony. A more striking contrast of conditions than those which confronted the country at the inception of the Federal Reserve System, when business and financial chaos was impending as a result of the outbreak of the European war, and those which have obtained since the banks were set in operation, can not be found. Our international relations during the year 1915 were marked by several critical episodes any one of which under ordinary conditions would have thrown business into convulsion. Public opinion and feeling has on several occasions been in a state of extreme tension. When we recall the Lusitania incident, the Arabic, Ancona, and Sussex, to say nothing of the Mexican tangle, we can readily understand why war at times seemed to many imminent, and to some a certainty, and yet throughout it all the business pulse has been strong and steady and firm. There has been little of a dramatic or sensational character to record in our recent business annals. There have been moments when that sensitive barometer of business feeling, the stock market, has registered some nervousness and hesitation, but nothing for a moment comparable with the disturbance and shock following threatened ruptures in our foreign relations on former occasions, so unqualified has been the confidence that the business community as a whole has felt in the new banking system. When President Cleveland, twenty years ago, sent to Congress his message defining the position of this country with respect to Great Britain's attitude on the Venezuela boundary dispute, the leading markets of the country were threatened with collapse. When President Wilson delivered his recent address to Congress with respect to the position of our country on Germany's methods of submarine warfare, though the situation was vastly more delicate and critical, our leading markets showed little weakness and less anxiety, and why? Because there was confidence that, come what might, we were possessed of a banking organization whose resources and management gave ample guaranties of financial safety. The gratifying evidence thus given of the feeling of security which our new banking system has inspired in the business community, is one of its greatest achievements and most valuable assets, For it may be laid down as axiomatic in modern finance that a financial and banking system, to meet the ultimate test, must not only <u>be</u> strong, but must also be generally <u>believed</u> to be strong - and adequate to any need. That difficult test has been successfully met.

Indeed, when we reflect upon the conditions of the past year, the establishment of the Federal Reserve System almost coincidently with the war seems almost to have been providential. Without the new system we should certainly have been floundering like a ship at sea without rudder or compass to guide it; with it we have sailed like a well-ballasted ship, steadily and securely. And all this has been accomplished with a very moderate, not to say insignificant, amount of activity, as business activity is commonly measured in these days, on the part of the Federal Reserve Banks, thus showing that it is not the amount of business done which measures the usefulness and effectiveness of the Reserve Banks, but the character and the extent of the influence exerted by them, whatever the ways in which that influence may be exerted. With money rates unprecedentedly low, as they have been during the past year and with the banks of the country pretty generally in liberal supply with respect to loanable funds, it is hard to see what good purpose could have been served by an attempt on the part of the Reserve Banks to force the use of their funds by demoralizing reductions of rates, even if they could have succeeded, by this means, in diverting business to themselves.

I do not doubt that as the natural expansion of business grows up to the supply of credit facilities with which we are now so richly blessed, the loaning power of the Reserve Banks will be drawn upon in increasing degree, and that most, if not all, of the Reserve Banks will have abundant opportunity to engage in activity which will be at once useful to the community and profitable to themselves. But until this point is reached, it would be shortsighted to complain because the Reserve Banks, as a whole, have not been dividend-earning institutions. Activity is the law of being of any ordinary business concern, but the Reserve Banks are not ordinary business concerns. They have a very sacred place and function in the country's credit system. Profit is not their object, and not, therefore, the test of their fitness. Not the amount of business done, but the amount of good done, is the proper standard by which to judge them. But when this is said or admitted, it should also be added by way of a warning word to those who would wish to see the operations of the Federal Reserve Banks circucumscribed within narrow limits, simply in order to avoid the effect of their competition with powerful member banks, that the limited amount of commercial operations in which the majority of the Reserve Banks have thus far engaged, is not for a moment to be taken as indicating the range of their normal activity. There will, in time, be much business that these banks will have to assist in order effectively to perform their functions as regulating and governing banks, and while this business should not be undertaken from motives of profit, we may confidently expect that it will, in the ordinary course, yield returns that will easily pay the expenses of maintaining the Reserve Banks and meet their dividend requirements, and thus satisfy the ordinary test of business success along with the other and more difficult tests; for let us not overlook the fact that higher and more difficult tests than any which the system has thus far had to meet may await it in the uncertain and troubled future toward which the whole commercial world seems moving, as a result of the terrific disorganization of industry, commerce, and finance which the gigantic struggle now in progress in Europe will entail.

Econimic Readjustment After the War:

It has been predicted on the one hand, that the leading countries of Europe will find themselves industrially and financially so weakened as a result of the war that they will be long in repairing the damage sustained by their industrial organication, and will be, in consequence, a factor of diminished importance in the sphere of international commerce. The mere destruction of large percentages of their working populations and the disability through injuries and disease, of other large percentages, to say nothing of the destruction of vast amounts of physical capital, it is suggested will result in such shrinkage of their productive power as to keep them busy at home for a long time in repairing waste and loss. The crushing burdens of taxation that will lie heavily upon the commerce and industry of Europe are also pointed to as factors that will retard industrial recovery. Germany, which before the war occupied a most formidable position in export trade and in ocean carrying, as a result of British domination of the sea, has been practically shut out from her customary over-seas trade. To what extent and how soon, she will recover her former position is regarded as highly problematical, and weakened competition in our markets and some of the new markets in which we have recently been acquiring a foothold, is, in consequence expected.

Others, however, predict that the economic recovery of Europe will be rapid, and that competition, both commercial and industrial, among the leading nations, more intense than has ever before been experienced, is to be expected soon after the close of the war. The animosities, rivalries, and ambitions for commercial and industrial supremacy, which had much to do with the making of the war, will, it is said, continue and give to the period after the war much of the unsettled and unsettling character of war times. Those who take this view predict that an era of protracted and bitter commercial warfare will follow the termination of the armed conflict, and that the differences and scores which were not settled on the field of battle will be fought to a finish on the field of commerce, and that neutral nations will inevitably be drawn into the struggle.

Without undertaking to pass judgment upon predictions of this character, I think it nevertheless well that we should be alive to the contingencies which may be ahead, and I do not hesitate to express my belief that Europe will give to the world an impressive exhibition of the recuperative powers of modern industry even after such a costly and exhausting war as has been in progress. Stupendous as are the examples that the past year and a half have given us of the destructive agencies of civilization when turned to war, I believe we shall get equally impressive examples at its close, of the constructive forces of modern civilzation when its energies and aspirations are turned to the healing work of peace. War destroys, but that is not all that it does. Fortunately for a world in which war is long likely to remain a persistent and recurring fact, war brings some industrial compensations, though the offset to the losses and injuries be far from complete. War, especially war of the kind which is going on in Europe and touching to passionate intensity the vital impulses of great communities of men, stiffens and steels their fibre and makes them more capable to bear the hard and heavy burden of modern industry, and therefore will make them more formidable competitors, in time , of nationa which have not had to face the discipline of war. No one can begin to approximate how much the industrial efficiency of the average man and woman in Europe will be raised as a result of the experiences and lessons which war has taught tham in unity of purpose and action, in organization and efficiency, in oconomy and thrift, in industry, and in devotion to duty. These things will tell, and I believe tell mightily, in the productive and competitive strength of the larger European nations after the war. Necessity has already worked some wonderful transformations in the industrial systems of the countries at war, and it is not unreasonable to expect that the nations which emerge from the trenches will, man for man and woman for woman, (for woman is clearly to play a role in the industrial economy of Europe in the future far more important than she has in the past) come more near to realizing their full productive capacity than ever before.

This war has also taught lessons to the warring nations which will not soon be forgotten or wasted, as to the momentous effect which an efficient credit organization can exert in maintaining a country's industry in a state of health and activity and just as the European credit system has shown a capacity to finance the costs of war which has far outrun the wildest expectation, so it may be expected that it will show a new and enormous power to meet the requirements of industrial recuperation. Let us not, therefore, make the mistake of supposing that it will be an industrially feeble and unambitious Europe which will emerge from the war.

The history of modern commerce affords no parallel to the situation which exists or may exist, and we can therefore learn little from history as to what we may expect. The nearest approach is the long period of economic disturbance following the close of the Napoleonic wars. It took fully fifteen years for the world of commerce and industry to work out the needed readjustments and recover a normal equilibrium, and the process was embittered and embarrassed by policies of commercial reprisal and tariff wars, similar to those which are now being planned by the contending groups in the European war. Neutrality was no protection then, nor will it be now. Our commerce and industry pursued a troubled course from 1815 to 1830, marked by a succession of alternating periods of fitful and feverish activity and industrial breakdowns. The process of readjustment which had to be gone through in order to determine what the relative positions of the several nations should be in the new commercial economy was a long and costly one for each and all. Uncertainty was everywhere. To recognize the possibility, not to say the probability of the recurrence of something similar would seem to be the part of prudence for us, and the first step in intelligent preparation for it. The one thing which is certain in forecasting the future is the uncertainty of the conditions with which we shall be surrounded.

Let me add however, in order to relieve unnecessary suspense, that I do not look for an immediate reaction in our industrial situation at large as a result of the close of the war. But I do expect that some of the industries which have been stimulated into frenzied activity by the forced draught of evanescent war orders, may have their troubles. Also I think that there is much danger that their troubles, unless localized and controlled, may breed trouble, uncertainty, and anxiety for others. There is a contagion of trouble as well as of prosperity. We know this from sad experience. This much, at least, may safely be said; that our industry and commerce are to travel uncertain and uncharted ways in the years which are ahead, and uncertainty, I need not tell you, is the great bane and foe of modern business. To eliminate it where we can, or to minimize it where we can not completely control it, is our clear duty. We shall not, therefore, if we are wise, neglect to strengthen our defenses so as to make them equal to any contingency with which we may be confronted. And this leads me, in conclusion, to say some frank words to the State banks, whose cooperation should be forthcoming in order to widen the base of our banking structure, to give the country the fullest sense of safety and security.

5. <u>How are State banks meeting their test.</u>

Speaking to a convention made up largely of State bankers I should be remiss in my duty if I did not avail myself of this opportunity to speak plainly to you. You know that the Federal Reserve Act was purposely planned upon a broad and generous scale in order that every bank in the country, whether State or National, doing a commercial banking business in safe and legitimate ways, might secure for itself and its customers the advantages and protection of the Federal Reserve and at the same time contribute its quota of strength to it. The State banks surpass in number the National banks and represent a substantial part of the commercial banking power of the nation. To what extent the proportion has declined since the establishment of the Federal Reserve System can not be approximated with accuracy but it is a fact that the National banking system has since the establishment of the Federal Reserve System shown an accelerated rate of growth and a greater capacity for growth than State banking during the same period, the increase in the deposits of the National banks having been estimated to be three or four times as great as those of the State Banks since the inauguration of the new System. What the relative growth of member and non-member banks will be in the future, I shall not undertake to prophesy but as long as there is a considerable portion of the banking power of the nation organized as State banks and which is eligible for membership in the Federal Reserve System and has not joined, the system will not have attained its fullest strength and its widest field of usefulness.

Why are you State banks not coming in to the new system ? The provisions of the law respecting State bank members are as liberal as could well be desired, and the regulations which the Federal Reserve Board has laid down on this subject are even more liberal. Those of you who have read the Act and the Regulations of the Board will, I believe, find no reasonable ground of complaint. You will find few restrictions upon your customary banking methods. The Board has even gone so far as to provide a way by which any State bank becoming a member bank may withdraw from the system in order that you need not be deterred by the feeling that membership means an irrevocable choice. The attitude of the Federal Reserve Board has been founded in the conviction that our new banking system should be as broad and as strong and as capable as the financial condition of the country will support and the limitations of the Reserve Act will permit.

It is almost a year now since this Board issued its regulations concerning the admission of State banks. Thirty-four banks have joined. The strong conviction which the business community in every part of the land has formed of the benefits of the new system require that it should be known why the growth of State bank membership has been so slow.

Are any of you holding back because of dissatisfaction with the provisions of the Federal Reserve Act or with its administration ? The Federal Reserve Act and the Federal Reserve System are here to stay. They have won the sanction of public opinion and are regarded as the essential bulwark of our financial safety. As to the administration of the Act and of the twelve Reserve Banks, little but good has been heard. But if the State banks are holding back because of dissatisfaction with the administration of the law or the banks, they should make it known in order that the defects may be remedied, and the country given the full advantage of a banking system carried to the highest point of strength and efficiency.

Coming to another reason, I have sometimes heard it suggested that financial conditions have so changed that there is no longer need of the kind of protection and security which the Federal Reserve System was designed to provide. It must be admitted that the financial situation during the past year has been so exceptionally easy that it might well have begotten in the minds of those who are not in the habit of looking beneath the surface of things, the idea that financial strain and convulsion is a thing of the past. They are likely to experience some surprises. I have already given my reasons for expecting that the years which are ahead and which will reap the consequences of the financial disorganization and demoralization growing out of the great war, will be years of uncertainty and disturbance for us in common with the rest of the world; years filled with anxiety, and requiring for the good management and the protection of our national interests, the guidance and support of the Federal Reserve System. Whatever other mistakes we make, let us not deceive ourselves on this point, and be lulled into a blinding passivity; for when trouble comes, as sooner or later it will and State banks in overwhelming numbers run to cover under the shelter of the Federal Reserve Banks, they may find some difficulty in getting in as quickly as they would like.

There is also a feeling abroad in some parts of the country that in some mysterious way the Federal Reserve System, with the membership of the National banks, has produced a situation in which the beneficent effects of the new banking system, like the rains of heaven which fall alike upon the just and the unjust, will be so inevitably and widely diffused that non-member banks, no less than member banks, will reap the full advantages. Let me say very frankly that I believe there is some truth in this - yes, much truth - but not so much as is frequently assumed.

To the extent that the success and effectiveness of the new system will depend upon the feeling of security that it inspires - in other words, to the extent that the success of the system depends upon what may be entitled its psychological reserve - it is no doubt true that all the banks, irrespective of their connection with the new system, will participate in the result. But it may readily happen, and it will probably happen, that from time to time - no one can say in the face of the critical years that are ahead of us how frequently these times will occur - the needs which the community will have of the Reserve Banks will call for more than psychological reserves and will at times cut deeply into their gold reserves, and then will it become clear that the strength of the system is measured also by the cash that it holds in hand. The State bank, therefore, which conducts a banking business that qualifies it for membership in the system under the liberal conditions laid down by the Federal Reserve Board, and which sustains relations with the business community of the kind that give rise to financial difficulties and embarrassments of the sort which have called forth the establishment of the Reserve Banks as a means of protecting the community, are taking the responsibility for themselves and, what is of far more serious consequence, for the communities of customers which they serve, of keeping the new system from becoming in the fullest sense an American system, equal to any demands that may be made upon it.

You are the bankers of a community which is served mostly by State banks. Your State has extensive agricultural, manufacturing and merchandising interests. They are precious to your people. Their condition makes or mars your prosperity and your condition may make or mar theirs. I see no good reason why the people of Missouri, or Arkansas, or Mississippi, should not enjoy in all circumstances the same sense of security as is enjoyed by the farmer, the manufacturer, and the merchant in States or sections of the country which are served preponderantly by National banks. I believe the welfare and security of the Missouri farmer, merchant, or manufacturer was just as much in the mind of Congress when it enacted the Federal Reserve Act as that of manufacturer, merchant, or farmer of Massachusetts or Connecticut. He is entitled to all the good that can be reaped from the new banking system and he is entitled to know it, if his existing banking connections do not secure him the fullest and freest access to it.

The Reserve Bank affords an ever ready means by which good commercial paper can, at a moment's notice, on presentation at the counters of the Federal Reserve Bank, be turned into either credit or currency. No such thing as a currency famine can overtake the customer of a bank that, by reason of its membership in the Federal Reserve System, has the right and ability to go to that bank and get gold, credit or currency. Non-member banks may get it as a matter of favor, but I believe that people as they come to understand these matters more fully, will see the difference between dealing with a bank that, as a matter of right and of course, can go to a Federal Reserve Bank for assistance in the certain knowledge that it will be forthcoming, and those banks which, if they get such assistance at all, will get it indirectly and as a matter of favor and of public spirited generosity on the part of the member banks and of the Reserve Banks. In matters of such vital concern to its industry and agriculture, no community can afford, or will be willing, to pin its faith to banks which are on the outside of the Federal Reserve System.

Those of you who need a more personal and cogent reason for becoming member banks will soon find it, I believe when the plan which has been devised for the clearing and collection of checks has been put into operation by the Federal Reserve Banks. The Federal Reserve Bank of St.Louis will soon issue a circular giving complete information and I am confident that the plan will have been in operation but a short time before many non-member banks will realize the necessity of joining the Federal Reserve System in order to participate in its new collection plan.

The plan is well conceived. The Federal Reserve Banks will extend unsurpassed collection facilities to such of their members as choose to avail themselves of them, but the system is optional. No member bank will be obliged to clear through its Federal Reserve Bank. The only element of compulsion is that every bank, whether member or non-member, will be obliged to pay without deduction checks drawn upon it and presented at its counter for payment by the Federal Reserve Bank or its representative, either in acceptable exchange or in lawful money. The plan is reasonable: many letters that are coming to the Federal Reserve Board from those who have been the victims of excessive exchange charges prove this. The plan is also practicable and is going to be effective : this is proved by the objections that are being urged against the plan by those banks that are now taking tribute from the commerce and business of the country in the shape of unreasonable exchange charges. It has been estimated that as soon as the plan has been put into operation checks upon at least fifteen thousand banks, National banks, State banks, and trust companies, throughout the United States can be handled at par through Federal Reserve Banks, subject to a small service charge. Par collections will be the rule. State banks whose checks cannot be collected at par will be a small and rapidly diminishing minority and, as they will find it difficult to retain much good business when checks drawn upon them are at a discount while checks drawn upon the majority of banks can circulate at par, the day is near at hand when checks upon practically all banks can be handled at par by Federal Reserve Banks.

If the reasons I have advanced for State bank membership in the Federal Reserve System are sound, as I believe you will, on sober reflection conclude they are, why, then, I repeat, are you State bankers hesitating and waiting ?

I asked this question the other day of one of the largest bankers in this district and his answer as ,"most of them don't know. They can't tell you. But you will get them in quickly enough when trouble comes." I have spoken to little effect if the logic of my words does not say to you, "Don't wait 'till trouble comes, but make the assurance of the new banking system for yourselves and those you serve, doubly secure by coming in now, and doing your part in giving to this country of ours a banking system worthy of its name and worthy of its future." To falter is, therefore, to fail. To fail in this vital test, at this vital time, is unbusinesslike, is ungenerous; is, therefore, un-American and unpatriotic.

A. C. M.

5/19/16