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THE FEDERAL RESERVE SYSTEM

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We are indebted to our host, the Federal Reserve Bank of Boston, for arranging this seminar meeting. The opportunity it has given us to look into the workings of the Federal Reserve System as a national institution and critically to appraise its performance has been rewarding. The mid-point we have now reached in the program seems to me to be a good time to survey the System's duties through a look back into its history and a look forward into its destiny.

The Federal Reserve System was forged on the anvil of crisis and the turning points in the evolution of its functions have likewise been the product of crisis. It is important to mark the word evolution because it has been from an evolutionary response to experience gained from the ordeal of crisis that the System has proven its adaptability to changed conditions and has set out on new courses of public usefulness.

Looking back into the financial history of this century reveals that the Federal Reserve System was created as an outgrowth of the panic of 1907. The damaging effects of that crisis on the national economy roused a demand for devising ways and means of preventing a similar crisis at sometime in the future. Answering this public demand, Congress appointed a National Monetary Commission in 1908 to ferret out faults in our financial system and propose reforms. On January 8, 1912, the Commission submitted a report that was the basis for framing and enacting the Federal Reserve Act of 1913.

It was then discovered that an extreme shortage of actual currency with which to carry on business had caused the breakdown in our financial machinery that crystallized into the panic of 1907. To cure this kind of financial malady, which had occurred before in less aggravated form, the Federal Reserve Act provided for an elastic currency that would expand automatically during the seasons of the year when the use of currency was in greatest demand and would then contract as the demands subsided, leaving the public at all times in possession of just enough currency to carry on the commerce, industry, and agriculture of the nation.

The key to working this plan was the authority granted to the Federal Reserve Banks to discount short-term commercial and agricultural paper for their member banks against the proceeds of which Federal Reserve notes could be issued and put in circulation. Then as the discounted paper was paid off, the Federal Reserve notes originally issued at the time of discount would flow back into the Federal Reserve Banks and be withdrawn from circulation. At that time it was also believed that this discount mechanism, besides establishing an elastic currency, would also provide member banks a means for making emergency loans from their Federal Reserve Banks at times when they were under heavy pressure from deposit withdrawals.

The elastic currency mechanisms set up in the Federal Reserve Act of 1913 have successfully prevented the recurrence of the kind of currency shortages that touched off the panic of 1907. However, in the 1930's, the country suffered from a devastating kind of banking crisis that went deeper than the sort of distress situation that an elastic currency and short-term borrowing privileges at the Federal Reserve Banks were designed to cope with. In this instance, the commercial banks were faced with abnormally heavy deposit withdrawals at a time when their assets had become frozen and could only be realized upon at forced liquidation and at distress values. The cumulative results of what was a liquidity crisis were a wave of bank failures and a downward spiraling of all values.

It became clear from investigating this situation that permanent emergency relief measures must be devised that would allow commercial banks to meet unusual deposit withdrawals at a time of economic tension without having to sacrifice the value of their assets in doing so. Accordingly, Congress amended the Federal Reserve Act in 1933 and 1935 by enlarging the lending powers of the Federal Reserve Banks from authority to discount only short-term commercial paper to authority to make advances to their member banks on the collateral of any qualified assets. The great value of this legislation is in the means that it has provided for preserving commercial bank liquidity in a way that, as applied to any single bank, will prevent public concern about its condition from spreading contagiously to other banks, thereby starting a broad-scale forced liquidation of bank assets and the destruction of values.

All told, there is good reason to believe that repetition of the liquidity problems with which the banking system was afflicted in the 1930's has been eliminated by these amendments to the Federal Reserve Act as effectively as the elastic currency provisions of the original act have prevented a recurrence of the kind of currency shortages that were responsible for the panic of 1907.

In looking back at these two great financial crises which led to the enactment of the Federal Reserve Act in 1913 and to its major amendments in 1933 and 1935, it is evident that the corrective measures then taken dealt primarily with the effects rather than with the causes of the crises. In each instance a period of high economic activity had preceded a financial crisis, and the remedial legislation subsequently enacted was aimed not at preventing excesses of the kind that lead from a boom to a bust, but at correcting the difficulties that stem out of a bust.

Fortunately, however, the means for restraining any undesirable effects of a boom are inherent in the administrative powers contained in the Federal Reserve Act and, therefore, the possibility is lessened that any active use of its emergency provisions will prove necessary. Reference is, of course, made to the power of the Federal Reserve System to regulate the volume of credit through its operations in the open market. Considering the vast amount of business that is transacted through the use of credit, the power of the Federal Reserve to restrain or, conversely, to stimulate the use of credit has a far-reaching influence on general economic activity. This power is particularly useful where it is the purpose of Federal Reserve System policy to prevent the sort of credit excesses that end up in the boom-and-bust type of financial crisis which has played so important a part in making Federal Reserve legislative history.

Turning back to the theme that periodic crises have been responsible for evolutionary changes in the functions and responsibilities of the Federal Reserve System, it is interesting to note that the kind of crises from which the System developed an effective use of open market operations had to do with war and not finance. That the crises of two world wars should have presented the Federal Reserve System with improved tools for conducting its open market policies does not offer an apology for the evil of war, but merely takes account of an accomplished fact that has been turned to useful purposes. Therefore, as the ends of Federal Reserve monetary and credit policy are held to be useful, so it is that the instruments composing our national debt are helpful tools for carrying out that policy for, as is well known, monetary and credit policy is effectuated through open market transactions in U. S. Government securities. Furthermore, the very size of the national debt has its redeeming side in that the broad distribution of the different types of obligations of which it is composed helps to accent the penetrating economic effects sought from System policy actions.

It is generally agreed that Federal Reserve System monetary and credit policy has great merit as a stabilizing instrument for ironing out the kinds of wide economic fluctuations that in the past developed into financial crises. There are those, however, who fear that the direct influence of Federal Reserve System policy on commercial bank operations tends to be adulterated by the credit-granting activities of such other financial institutions as insurance companies, savings and loan associations, mutual savings banks, and credit unions whose operations are not subjected directly to its regulation and control.

They then argue that a new National Monetary Commission should be created by Congress to study the entire financial scheme of things and recommend whatever reforms are found to be necessary. Their argument is strengthened by the contention that as the first National Monetary Commission was set up only after the nation had suffered from a severe financial crisis, we should not wait for a new crisis to expose defects in our financial mechanisms, but should explore in advance where such defects may exist and then take corrective action. These arguments for creating a new National Monetary Commission are persuasive and strong support for the proposal is in order. Whether the product of a new Commission's labors can serve to forestall future financial disturbances of a kind that leads to economic depressions, or whether it takes the acid test of unforeseen experience and unexpected weaknesses to produce corrective measures, remains to be seen.

Whatever may be the outcome of study by a new National Monetary Commission, there is evidence that Federal Reserve monetary and credit policy is more far-reaching and effective in preventing the causes of economic disturbances than would seem superficially to be the case. Therefore, the constructiveness of the work of a new National Monetary Commission may lie as much in tidying up and systematizing conflicting and inconsistent financial practices among all credit-granting institutions as in proposing any new authority for the Federal Reserve System or the creation of a new governmental body to operate in the field of credit.

Our discourse this evening began with the National Monetary Commission to which the Federal Reserve System owes its paternity and has completed a full circle to a proposal for creating a new National Monetary Commission. We hope that a new Commission will be created and that its efforts will be as fruitful as those of its progenitor.