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WHAT IS THE FEDERAL RESERVE SYSTEM?

It is a great pleasure for me to be able to get away from my desk in Washington and meet the bankers of the country, whether individually or in gatherings like this. And it is more than a pleasure - I feel it is a necessity, for such visits give one an opportunity to break down the barriers which are apt to arise when one is secluded with administrative duties.

Every business has its public aspect, and in banking the public interest is especially important. The Board of Governors of the Federal Reserve System represents that interest. This however does not mean a conflict with the interest of bankers in their own business nor interference with matters of their proper initiative. The Board has the same aims and ideals for banking that bankers as a whole have. And bankers have a corresponding interest in supervision. Accordingly, I wish to speak to you about the Federal Reserve Banks and the Board of Governors and the duties they exercise with respect to the interest of the public as a whole in the banking business.

To begin with, I think the significance of the words "Federal Reserve" needs to be emphasized. Those words are descriptive. The Federal Reserve System is not a commercial banking system, nor a savings banking system, nor an investment banking system. It is not a system operated for profit. It deals with reserves, through which action may be taken to correct extreme tendencies one way or another in credit conditions. It is operated in the public interest. Its operations cross all state lines and cover the nation as a whole.

The organization of the Federal Reserve System is such that responsibility is partly centralized and partly decentralized. Certain general responsibilities are entrusted to the Board of Governors in Washington and to the Federal Open Market Committee; regional responsibilities are entrusted to the twelve Federal Reserve Banks. This does not signify a sharp division of responsibility, however, for there is close cooperation between the Board and the Federal Reserve Banks. For example, the Open Market Committee comprises members of the Board and five representatives elected from the Reserve Banks. Again, discount rates originate with these Banks, though they are subject to review and determination by the Board in Washington. The Federal Advisory Council, which consists of twelve bankers elected by the Boards of Directors of the twelve Federal Reserve Banks, and represents the System as a whole, meets periodically in Washington. Conferences of the presidents of the twelve Federal Reserve Banks are also held periodically in Washington. There are many other System conferences between the law departments, examination departments, research departments, and operating departments of the Banks with corresponding departments of the Board.

The Federal Reserve Banks select their own operating personnel, including their presidents and vice-presidents. The Board has no power to force an unacceptable appointment on a Federal Reserve Bank, but the president and first vice-president must in each case have the approval of the Board of Governors in Washington. This requires a meeting of minds between the directors of the bank and the Board in Washington in the selection of key officials, and contributes to a more harmonious operation of the System.

The System now comprises about 6,400 member banks. These include about 5,400 national banks and about 1,000 member state banks. Although member banks constitute less than half the total number of banks, they do about two-thirds of the total banking business of all banks in the country.

The officers of the Federal Reserve Banks try to keep in close touch with their member banks in order to insure that the service of the Federal Reserve Banks is satisfactory and that their facilities are fully known. The officers of the Federal Reserve Banks as well as the members of the Board welcome criticism and constructive suggestions, for it is their desire to do everything within their authorized powers to make the services of the Federal Reserve Banks useful and valuable to their member banks. Visits are also made to nonmember banks, in order that no bank interested in becoming a member of the Federal Reserve System need feel doubtful as to what the conditions and advantages ofmembership are.

Prior to the establishment of the System an outstanding weakness of our banking was the lack of satisfactory facilities for reserves. The panic of 1907 - which played a large part in bringing about the establishment of the Federal Reserve Banks - was largely due to this condition. At that time each country national bank was required to have reserves of 15 percent, 6 percent as cash on hand and 9 percent on deposit in correspondent banks in reserve cities or central reserve cities. National banks in reserve cities were required to keep reserves of 25 percent, at least 12-1/2 percent in cash and 12-1/2 percent on deposit with correspondent banks in central reserve cities. New York, Chicago, and St. Louis constituted the three central reserve cities, and the banks in these cities had to keep reserves of 25 percent — all in vault cash.

The reserve needs of banks all over the country converged therefore on a relatively few large banks in the money centers, but these banks were not always prepared to meet the full responsibilities of such a situation. They had their own local interests to protect. They were not primarily reserve banks, but banks serving their own communities and operated for profit. It was not to be expected, even if it had been legal, that they would abandon the purposes for which they were organized and voluntarily play the role which the Federal Reserve Banks now play. As things stood, therefore, banks in general had no certain means of augmenting their reserves except when conditions were easy. The Federal Reserve Banks, however, not being organized or operated for profit, having no local interests other than those of their member banks and of the public, and having been legally endowed with specific powers for the purpose, are under no such limitation. They are expected to do what the city correspondents could not be expected to do, that is, maintain themselves in readiness at all times to replenish member banks' reserves by the rediscount of paper and the purchase of securities offered by the member banks from their portfolios.

As you will recall, however, originally the rediscounts were limite to certain classes of paper, for it was the purpose of the original Federal Reserve Act to encourage banks to make commercial loans. The Act definitely discriminated in favor of such loans by limiting the paper eligible for discount (in the words of the Act) to "notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes." This paper, moreover, had to mature in three months or less from the time of discount, with the exception of agricultural paper, which might mature in six months.

This limitation did not in fact result in an abundance of such paper in the portfolios of banks; on the contrary such paper, for many years, has shown a tendency to occupy a relatively small place among bank assets In 1929 it amounted to about 12 percent of loans and investments of member banks. At the end of last year it was less than 8 percent. This reflects the fact that banks, instead of specializing in any one type of credit, have dealt in all kinds of credit - long term as well as short - according to the requirements of their communities. The result, therefore, has been to limit the power which it was originally intended that the Reserve Banks should have of discounting for member banks which wished to replenish their reserves.

The Banking Act of 1935 sought to correct this condition by an amendment authorizing the Federal Reserve Banks to make advances to member banks for not to exceed four months on any security satisfactory to the Reserve Banks. This change made it possible for a member bank to discount any sound asset at the Reserve Bank regardless of type, and had the effect, under existing member bank lending practice, of enlarging the lending powers of the Reserve Banks.

In recent years conditions have been such that the Reserve Banks hav had relatively little occasion to lend to member banks. There are two other services of the Reserve Banks that are always active, however. These are the services of currency supply and domestic exchange. With both of these activities, so essential in effecting the payments entailed in the business life of the country, you are entirely familiar, since the bring you into your most frequent contact with your Federal Reserve Bank. And I need not remind you how important it is to you bankers that currency and coin be always available in adequate volume and that checks anc similar items be collected and cleared as expeditiously as possible. Currency and coin are used in only about 10 percent of the volume of payments we make as a people, but that 10 percent includes the small and indispensable payments which everyone is making constantly with coin and small bills. Checks are used in the other 90 percent of payments and their use to this extent is largely due to our development in this countr of nation-wide means for their collection and clearance. At the center of the Federal Reserve System facilities for domestic exchange is the Interdistrict Settlement Fund operated by the Board in Washington, through which sums running into millions of dollars are transferred daily by wire between the Federal Reserve Banks, for their own account, for the account of the Treasury, and for the account of local banks. It is doubtful if any country in the world has a more efficient and comprehensive means of settling the balances between domestic institutions and money centers.

Next I wish to mention a Federal Reserve Bank function whose existence and importance are frequently overlooked. As you know, the Federal

Reserve Act provides that the Federal Reserve Banks "when required by the Secretary of the Treasury shall act as fiscal agents of the United States." The duties which the Federal Reserve Banks perform under this provision always have been extremely important to the government, and in recent years they have come to absorb a larger and larger part of the attention and time of the Federal Reserve Bank personnel. In addition to servicing the public debt, providing currency, and acting as depositary of the United States treasury, the Federal Reserve Banks perform a large amount of work for various government agencies, such as the Reconstruction Finance Corporation, the Federal Home Loan Banks, the Federal Home Owners' Loan Corporation, the Farm Credit Administration, the Public Works Administration, the War Department, Veterans Administration and an additional number of government agencies and bureaus. In the year 1935 the Federal Reserve Banks handled almost 69,000,000 Treasury checks and over 16,000,000 checks issued to work relief employees. This was an average of about 20,000 government checks a day at each of the twelve Federal Reserve Banks.

The transactions involved in servicing government securities are of great importance; they comprise receiving applications for new issues, delivery of securities to subscribers, exchanging securities of different denominations, meeting maturities, and paying interest. During the year 1935 the Federal Reserve Banks delivered to subscribers almost 1,600,000 bonds, notes, certificates, and bills sold by the Treasury, and redeemed over 4,000,000 different government obligations. They exchanged over a million obligations for the convenience of their holders and paid over 14,000,000 interest coupons. Last year they prepared and mailed over 24,000,000 bonus bonds to veterans, or practically the entire issue.

In addition to the services I have described, namely, holding the reserves of the United States banking system, making loans to member banks, furnishing an elastic currency which automatically increases or decreases according to the public demand, facilitating the clearance of checks and the inter-regional transfer of funds, acting as fiscal agents of the government in connection with the issue and retirement of government securities, the Federal Reserve System makes it possible to influence national credit conditions. This can be done through discounts, through open market operations, through direct action, through changes in reserve requirements, and through margin requirements.

Discounts

Rates of discount, under the terms of the Federal Reserve Act, must be established from time to time by each Federal Reserve Bank, subject to review and determination by the Board of Governors of the Federal Reserve System. The Banking Act of 1935 added the requirement that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board." This does not require that such rates must be changed every time, but they must be regularly and frequently reviewed.

At the time of the passage of the Federal Reserve Act it was the expectation that banks would borrow at the Federal Reserve Banks as a regular thing, since the rate they could charge their customers would be higher than the rate they would have to pay. Assuming this readiness of the banks to borrow, the rate of discount would of course influence them very positively; they would be encouraged to borrow by low rates and deterred from borrowing by high rates. But in fact, as you know, bankers do not follow such a principle. They are reluctant to borrow under any circumstances and as a rule will do so only when they must in order to maintain their reserves. The fact that the rate is high or low is not sufficient of itself to determine their action. Instead, the rate of discount is mainly significant as an index of the cost of money. It is not usually a very effective means of influencing credit conditions.

Open Market Operations

It must be obvious that the power of a Federal Reserve Bank to grant credit at predetermined rates of discount and interest can be exercised only when credit is asked for. Consequently, if the Reserve Bank had no other means of credit control than the power to discount the paper of member banks at given rates, or to refuse to discount, it would have to wait passively and idly until individual member banks decided that they would like to borrow. Then only would it have opportunity to act. As a consequence of the need of meeting the Federal Reserve System's responsibilities more positively, two other means of credit control have been developed. These are open market operations and direct action. Both are outgrowths of experience, primarily.

Open market operations consist of the purchase and sale by the Reserve Banks of certain classes of securities, mainly government obligations, for the purpose of increasing or decreasing the supply of credit available in the money market as a whole. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available. The reason for this is that in the process of paying for the securities that are sold the reserves of member banks become diminished, because every payment means a debit sooner or later to some member bank's reserve account. And as a member bank's reserves decline toward the legal minimum it is less able to make extensions of credit.

On the other hand, by purchasing securities the Reserve Banks place funds into the market and more credit becomes available; because the fund: which are released in payment flow directly or indirectly into the reserv accounts of the member banks and enlarge them. And as their reserves expand, they are in a position to extend more and more credit.

In principle, therefore, the Reserve Banks can increase or decrease the funds available for lending by local banks, accordingly as they buy or sell securities. Of course, there are in practice many limitations on the effectiveness of open market operations, but their tendency is to enable the Federal Reserve Banks to take corrective action with respect t(abnormal credit conditions on their own initiative.

The powers of the Reserve banks to buy and sell securities in the open market were granted in general terms in the original Federal Reserve Act, and at the time were not generally considered to be of very great importance. The first operations were carried on by the Federal Reserve Banks independently of one another, but it was soon found that action would have to be coordinated; otherwise the banks would be buying or selling in competition with one another and following different, and perhaps conflicting, policies. To avoid this, a committee was formed for the purpose of directing the operations. About the same time the purpose of the operations was clarified. For some time purchases had been made with the idea of providing income to meet expenses, but it was eventually realized that such an objective was in conflict with that of moderating a given condition of the money market, and must, therefore, be subordinated or even abandoned.

The Banking Act of 1933 gave specific recognition to open market operations as a System matter and established a Federal Open Market Committee of twelve members, one representing each Federal Reserve Bank, to take the place of the former non-statutory committee. At the same time the law adopted substantially the statement of purpose which had already governed open market operations. This was to the effect that they be conducted "with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made a further change by providing that the Federal Open Market Committee should comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen by the twelve Federal Reserve Banks. The law also makes the decisions of this committee obligatory upon the Federal Reserve Banks and provides that the record of the Committee's actions shall be included in the annual report of the Board submitted to Congress. Thus an activity which was barely recognized in the original Federal Reserve Act, and which was gradually developed in the process of administration of the System, has come to be emphasized in the law as one of the System's most important functions.

Direct Action

I also mentioned direct action as a means of credit control. Direct action means efforts by the Federal Reserve Banks or the Board to discourage credit policies of given menber banks in given circumstances. Opportunity for it occurs on various occasions, but particularly when a member bank is being examined, and when it is seeking to rediscount some of its paper. In this sense, direct action is aimed at the correction of specific conditions in particular banks. It may also be resorted to, however, with reference to general conditions and for the purpose of enforcing general credit policy.

Power to Change Reserve Requirements

Recent legislation has also established two other new forms of general credit control which previously did not exist. The first of these is the power given the Board to change reserve requirements. This power was first given the Board in 1933, under limitations which were later removed by the Banking Act of 1935. The Board is now authorized to change the reserve requirements "in order to prevent injurious credit expansion or contraction", but it is not permitted to lower them below the original requirements nor increase them to more than twice those requirements. Under this authority the Board has now taken action twice to increase the requirements, the first increase being effective August 15 last, and the second being effective in part the first of March and in par the first of May of this year. On the basis of the excess reserves that had accumulated, almost entirely as a result of the enormous imports of gold into the United States, the possibility existed for an expansion of credit which was quite beyond the present or prospective needs of commerce, industry, and agriculture, and which might be extremely injurious. The Board by its action in reducing the amount of excess has diminished the possibility of such an injurious credit expansion. I quote the following from the Board's statement of January 30, 1937, with respect to the action taken:

> "The Board estimates that, after the full increase has gone into effect, member banks will have excess reserves of approximately $500,000,000, an amount ample to finance further recovery and to maintain easy money conditions. At the same time the Federal Feserve System will be placed in a position where such reduction or expansion of member bank reserves as may be deemed in the public interest may be effected through open-market operations, a more flexible instrument, better adapted for keeping the reserve position of member banks currently in close adjustment to credit needs."

Under the law, the Board may reduce reserve requirements from their present level to the original legal requirements - and not below, but it cannot increase them beyond the requirements which will finally go into effect on May 1 of this year.

Margin Requirements

The second new form of general credit control recently authorized pertains to margin accounts and loans made for the purpose of purchasing or carrying registered securities. Authority for the Board to issue regulations in this field was granted by the Securities Exchange Act of 1934. This grant of authority was in line with various provisions of the Federal Reserve Act, such as I have already referred to, aimed at restricting the use of credit for speculative purposes.

Pursuant to these provisions the Board has issued twin Regulations, T and U. Regulation T, following Sections 7 and 8(a) of the Securities Exchange Act of 1934, governs the extension and maintenance of credit by brokers and dealers in securities for the purpose of purchasing or carrying securities. Regulation U, following Section 7(d) of the Act, governs loans made by banks for the purpose of purchasing or carrying stocks registered on exchanges.

As you will recall, one of the conditions at which the original provisions of the Federal Reserve Act were aimed was the use of bank funds to finance stock market speculation. It has always been clear that the Act sought to make credit ample for commercial, industrial, and agricultural purposes without encouraging its speculative use; but the difficulty has been to make measures of control work in one field without producing corresponding but undesired results in the other. A discount rate that was advantageous to agriculture was advantageous to speculation, and a rate that was disadvantageous to speculation was disadvantageous to agriculture. This difficulty in the way of discriminating between the possible uses to which credit might be put was characteristic of attempts to reach the objective by control from the angle of supply. It appears to be obviated in the new provisions, which, as I have said, attempt to reach the objective from the angle of demand.

This power which has been given the Board to impose and relax restraints upon the demand for credit for speculative purposes is definitely selective. It is aimed at a particular use of credit and at the specific channels through which demand becomes effective. For this purpose, the powers of the Board are extended outside the Federal Reserve System to reach directly also brokers and even nonmember banks. The new powers differ from those of discount, because while the latter may be exercised to discriminate against paper directly involved in speculative uses, they cannot prevent the speculative use of funds procured by the discount of paper not directly involved in speculation. The new powers also differ in effect from the power to conduct open market operations, which influence the total amount of funds but not the uses to which they can be put. The same thing is true of the power to alter reserve requirements. The power to take direct action can be used to discriminate against the speculative use of credit, but only in individual cases. The new powers with respect to margin requirements, however, are under no such limitations.

Conclusion - Limitation on Means of Credit Control

Although the five means I have discussed by which credit control may be exercised - discounts, open market operations, direct action, reserve requirements, and margin requirements - appear to be very comprehensive and powerful, it would be a mistake to convey the impression that a perfect control of credit will be effected through them. In the first place, their application cannot be mechanical nor governed by simple unvarying rules. Credit and economic relationships are extremely intricate, and the circumstances under which the need for action arises are always to some extent different and special. Let me mention a few things that complicate the task of credit control.

For one thing, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. It does not now. The majority of banks in the United States are outside the System, although it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country.

For another thing, United States Treasury activities must be taken into account. These have to do in part with the operations of the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve large sums and intimately affect the banking and credit situation.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold from abroad which I have already mentioned - a movement that in the last three years has added four billion dollars to the reserves of member banks.

These factors, among others, necessarily limit and modify the exercise of credit control.

As you know, the Board in Washington is constantly in touch, through the Federal Reserve Banks, with the general credit conditions of the country. The Board has data supplied to it by the Federal Reserve Banks' statistical departments, and it has its own research and statistical department in Washington, which presents facts and figures constantly, so that it may know what is going on. The Board compiles and publishes information bearing on banking and credit conditions, here and abroad, and includes data on production, employment, trade and prices. No other central banking organization in the world makes available such comprehensive information on domestic banking and business developments. You receive this information monthly in the Federal Reserve Bulletin.

Naturally, I hope that you already find it of use, or that you will in future find it of still greater use. It is one of the services that comes with membership in the Federal Reserve System. Its purpose, as is true of all the services of the Federal Reserve System, is to improve the business of banking. I say "improve" not because I think the business of banking is handled badly, but because in our complex, world-wide business life there are changes going on which are beyond our control and which are constantly making improvement necessary. The banking business must constantly be adapting itself to these changes, and this it cannot do without knowledge and understanding of the facts.