# FEDERAL RESERVE RESPONSIBILITIES

ADDRESS BY

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As you know, there has long been a tendency to over-emphasize the effect of monetary and credit factors on business. The more one surveys monetary history the clearer it becomes that what can be accomplished through monetary and credit measures by themselves is strictly limited.

In stressing this point, however, I do not mean to minimize the influence of such measures. In their way they are highly important and by the same token the Federal Reserve System is a highly important instrumentality.

What is the Federal Reserve System?

The question may be answered from the legal point of view by saying that it is a system comprising about 6,400 member banks in all parts of the country, twelve Federal Reserve banks so situated as to serve the twelve regions into which the country is divided, the Board of Governors, which is the coordinating body situated in Washington, the Federal Advisory Council, which represents the bankers of the twelve Federal Reserve districts, and the Federal Open Market Committee, which comprises members of the Board in Washington and representatives of the twelve Federal Reserve Banks.

The same question - what is the Federal Reserve System? - may be answered from the functional point of view by saying that it possesses certain supervisory powers and exercises regulatory influence over the supply and cost of credit in the United States. It is an institution created for public service, not for private profit.

In its regional form of organization the Federal Reserve System is peculiarly an American institution, having central banking functions which it performs substantially as do the central banks of other countries. The term central banking, as I use it here, should not be confused or misunderstood. I am speaking of the functions of central banking rather than the form of the organization which performs those functions, however owned or controlled. Practically every civilized country has a central banking institution. In Canada, it is the Bank of Canada; in England, the Bank of England; in France, the Bank of France; in Germany, the Reichsbank. The entire list would cover the American, European, African, and Asiatic continents. In every case the central bank by its very nature stands in a unique relationship both to the Government of its country and to the other banks and financial institutions of its country. Its function in every case is that of influencing credit conditions in the public interest by the exercise of its financial and administrative powers. The most prominent of these powers are: To make loans to banks and other financial institutions, to fix the rediscount rate, and to buy and sell securities in the open market. The exercise of any one or all three of these powers has certain direct and to a large extent predictable effects upon the supply and cost of credit. In addition the central bank is usually a bank of issue. Its notes circulate as money. Formerly this was one of the most important powers of a central bank but now that deposit credit transferable by check has become the principal means of payment used in civilized countries, the power of issuing notes has come to be incidental rather than essential to central banking. A more important function at present is that of holding the basic reserves of the banking system - a practice which nearly all central banks perform either as a matter of law or of established custom. It is through the functions of holding reserves and issuing notes that central banks are enabled to exercise control over the credit supply, because the need for currency or for additional reserve balances is what impels commercial banks to borrow from the central bank.

A further incidental characteristic is that the central bank usually acts as fiscal agent of the Government. In this capacity it serves as a bridge between the financial activities of the Government and the financial activities of private business. Ordinarily the Government's bank account is the largest single bank account in the country. The Government's receipts, its expenditures, and its balances are so large that they require special adjustment to the credit activities of private interests. Otherwise the accumulation, transfer and disbursement of Government funds would seriously disturb the money market, and hence business at large.

Since the central banking organization ordinarily carries the reserves of commercial banking institutions as well as the checking accounts of the Government, it is natural that it should play an important part in the collection and clearance of checks and in the transfer of bank funds. In this respect, as in furnishing currency for circulation, the monetary nature of central bank functions becomes most apparent.

From country to country the nature of central bank operations and the character of central banking powers will vary in accordance with national institutions and business customs. Fundamentally, however, the processes of central banking are much the same in all countries.

Perhaps the most striking feature of the central banking organization of this country is that it comprises not a single institution but several regional institutions coordinated by a public body in Washington. The Bank of England, for instance, is a single institution with about nine branches which are merely detached offices of one corporate entity. The central banks of most other countries likewise are single institutions. There are several reasons why the central banking system of the United States comprises a number of federated institutions instead of one. Perhaps the most obvious is that the country is extremely large and the number of independent local banks which cover it is also large. Most other countries have a relatively smaller area to serve and a far smaller number of separate banks and financial institutions. The Federal Reserve System, through the twelve regional Federal Reserve Banks, effects a decentralization of banking reserves and gives to each region a large degree of credit autonomy. As its name indicates, it is a federal system, based upon the federal pattern which is distinctive of our American institutions.

The term "central banking" is not as familiar in the United States as it might be. The conception of what central banking is and of what are the essential functions of the Federal Reserve Banks is not widely understood. This is partly because the word "banking" suggests to most people the dealings they have with their own local banks. Consequently when the Federal Reserve Banks are thought of, the tendency is to consider their operations as merely differing in magnitude or degree from those of commercial banks. Yet this view is apt to generate serious misconceptions. The point of view of central banking differs profoundly from the point of view of commercial banking. It is the purpose of a Government to serve the public interest and the purpose of a central bank as a quasi-governmental institution is the same. Although the central banking mechanism, as, for example, in the case of our Federal Reserve Banks, has much the same form of corporate organization as a business corporation operated for profit and has a balance sheet showing assets and liabilities, including the item of paid-up capital and the item of gain or loss from operations, the purposes and objectives of its operations differ essentially from those of private business corporations. At the present time, for example, the twelve Federal Reserve Banks have cash and reserves of nearly nine and a half billion and earning assets of only two and a half billion. Such a position, which is quite different from what an enterprise operated for profit would choose to maintain, is entirely normal for a central banking organization.

When a Federal Reserve Bank makes a loan or purchases securities it is not doing so for the sake of profit as a commercial bank would be doing. The purpose of the loan or of the purchase of securities is to supply the money market with the additional funds which it appears to require. If the transaction is an individual loan, the additional funds are supplied by the transaction to some one individual bank which may or may not be experiencing the same demand that other banks are experiencing. If the transaction is an open market purchase of securities by the Federal Reserve Banks, the result is that the market as a whole is supplied with funds and no particular institution is singled out as experiencing the effect of the transaction any more than another.

In the same way, when, for example, the rediscount rate is advanced, the Federal Reserve Bank is not seeking an increase in its income as a commercial bank might under similar circumstances. Its purpose in raising the rediscount rate is to raise the cost of bank credit in general and thereby discourage tendencies to excessive use of credit.

It is significant of the importance of central banking functions that the Bank of England evolved into its position as a central bank in response to the requirements of the London money market without specific legislative action to that end. A few generations ago the Bank of England was primarily a private institution enjoying certain privileges but operated by its management as any other business enterprise might be in the pursuit of profit for its stockholders. The process by which it gradually changed its purpose, and subordinated the role of profits in its operations to that of serving the broad public purpose of stabilizing the money market was a long and gradual one. The assumption of its responsibilities was not so much the result of specific legislation as of voluntary action. The example I have just mentioned demonstrates how central banking functions came to be required by a business community and accordingly came to be performed even without provision by the legislature. Similarly, the need arose for our own Federal Reserve System and its functions have undergone evolution in gradual adaptation to the changing requirements imposed upon them by the economic world.

In addition to the essential central banking functions that I have been describing, the Federal Reserve System has a number of regulatory powers entrusted to it by Congress which are of more or less special nature. These include powers to fix reserve requirements within certain statutory limits, to fix margin requirements, and to examine banks and require of their management an abandonment of unsound banking practices on pain of dismissal. These administrative and regulatory powers of the Federal Reserve System are for the most part lodged in the Board of Governors in Washington. In performing them the Board is called upon to issue regulations, administrative rules, and orders. However, the Board does not function as a remote and detached body. In the case of open market operations, which are among the most important of Reserve Bank activities, the law provides that such operations must be conducted according to a uniform policy by all twelve Federal Reserve Banks in accordance with the directions of the Federal Open Market Committee. The Federal Open Market Committee comprises twelve members, seven of whom are the members of the Board of Governors, and five of whom are elected by the twelve Federal Reserve Banks. Thus the Federal Reserve Banks participate directly and responsibly in measures which are among the most important that can be taken by the Federal Reserve System. There is also the example of discount rates, which, as you know, are established by the Federal Reserve Banks subject to approval by the Board. In connection with various other matters also the Federal Reserve Banks are consulted. The Presidents of the Reserve Banks meet frequently in Washington and confer with the Board on questions having to do with the operation of the Federal Reserve System. When the Board is amending its regulations or issuing new ones, the drafts it prepares are submitted to the Federal Reserve Banks for their consideration, and their suggestions contribute substantially to the final form which the regulations take. In addition, drafts of regulations are usually submitted to responsible groups through the agency of banking or business associations. For example, the drafts of Regulations "T" and "U", which govern margin requirements, were submitted to exchanges for their consideration, and the Board feels that the many very practical comments received from the exchanges have been most helpful. The same holds true of other regulations, in the preparation of which bankers' groups and organizations are consulted. Furthermore, the Board is always accessible to those who wish to offer their suggestions, to criticize credit measures, or to ask for information.

The Board itself is an organization whose decisions are formulated by the vote of its members. In the interest of good administration, and as contemplated by the law, the Board is a unit.

In order to assist in the determination of its policies, the Board maintains what is probably the most comprehensive organization for the compilation and analysis of economic and financial information maintained by any central banking organization in the world. The Board has this information and the expert opinion of a staff of analysts constantly at its disposal. The result is that any decision of the Board or of the Federal Open Market Committee has behind it not only the judgment of Board members and Federal Reserve Bank officers, but of an experienced staff of specialists in economic and monetary fields who bring a trained critical ability to the consideration of proposed measures.

In this connection I wish also to remind you that the Federal Reserve System publishes more detailed and important information about its conditions and its action than any other central banking organization in the world. Much of this information appears in occasional and periodic press releases, and is contained in the Federal Reserve Bulletin and the annual report of the Board of Governors.

Having reviewed with you the general purposes and characteristics of central banking, or as some prefer to call it, reserve banking, and having also pointed out how in this country the central banking system is organized on distinctly American principles and formulates its policy in accordance with those principles, I wish now to review, as I did in Boston the other day before the Bankers' Committee of the New England Council in their Executive Session, the course of policy followed by reserve authorities during the past year or so.

As you know that policy has for several years been one of monetary ease. Statements to that effect have been frequently made by the Board, and I need not go into the considerations upon which the policy is based. I wish instead to point out briefly how the various measures which have been taken fit together as applications of central banking policy in given circumstances. The various steps which have been taken should be viewed not as isolated events, but as elements in a connected story.

To begin with, there was the increase in reserve requirements a year ago last August. I wish to emphasize the fact that the power to fix reserve requirements is not a customary means by which the central banking system effects current adjustments of the supply of credit to demand. It is in the first place a limited power - the Board cannot raise or lower requirements at will, but only within certain limits. Moreover it has not the flexible application that open market operations or discount powers have. It was exercised by the Board for the first time last August, and again last spring. The occasion of the exercise of this power was, as you know, the flow of gold into this country from abroad, and the resulting expansion of bank reserves to proportions quite beyond the possibilities of use as a basis for the legitimate expansion of credit. The circumstances were such that if the Federal Reserve System had desired to have easy money conditions regardless of the consequences that might ensue in case unsound and inflationary conditions developed, it could have adopted a policy of doing nothing at all. But it sought instead to reestablish the position it was intended by law to occupy - a position in which it could act promptly and effectively either in the direction of easing the credit situation further, or in the direction of restraint - whichever appeared to be in the public interest. Accordingly, when the Board raised reserve requirements, its purpose was not to abandon its policy of monetary ease but to continue that policy under conditions amenable to control.

Theoretically and historically, the technique of credit regulation has been considered most efficient when member banks have had a minimum of excess reserves and could expand the amount of credit outstanding when and as steps are taken to increase their reserves. This can be most readily effected by open market puchases, which have the effect of making funds available to the money market and of making it unnecessary for member banks in general to apply to the Federal Reserve Banks for advances. However, should individual banks still require funds, they may borrow from the Federal Reserve Bank and when they do so its discount rates can be reduced in conformity with a policy of ease, or conversely can be raised if an opposite policy is adopted. But, of course, when the banks are superabundantly supplied with reserve funds from an outside source and therefore have little, if any, occasion to seek additional funds from the Federal Reserve Banks, the discount rate and open market operations, as means of credit regulation, cease to be effective. The purpose of the increase in reserve requirements was, therefore, to offset the effect of gold imports and restore the base upon which normal measures of credit regulation would be effective.

Sterilization of incoming gold was a logical accompaniment of the increase in reserve requirements. As announced by the Secretary of the

Treasury, accordingly, it became the Treasury's policy, "whenever it is deemed advisable and in the public interest to do so, to take appropriate action with respect to net additional acquisitions or releases of gold by the Treasury Department. This will be accomplished by the sale of additional public-debt obligations, the proceeds of which will be used for the purchase of gold, and by the purchase or redemption of outstanding obligations in the case of movements in the reverse direction."

The Treasury's purchases of gold pursuant to this policy had the effect of keeping the gold from getting into bank reserves and swelling them to greater volume.

These measures, I repeat - the increase in reserve requirements by the Federal Reserve System and the sterilization of gold by the Treasury - were unusual measures taken to offset an unusual condition, namely, the enormous inflow of capital and gold from abroad. They were outside the category of normal measures of credit regulation. They were related to normal measures of credit regulation in somewhat the same way that reballasting a ship is related to its regular operation. They were measures intended to neutralize the effect of major financial disturbances originating abroad, and to keep the domestic credit situation amenable to the established technique of regulation.

As the Board explained, when it announced the final increases in reserve requirements, the System would be restored by this action to "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."

At this point perhaps I should briefly restate the process by which open-market operations achieve their purpose. In the first place, as you know, when a bank enlarges the amount of credit it has outstanding, either by additional loans to its customers or by additional purchases of investment securities, its reserves tend to be reduced. Consequently it cannot enlarge the amount of credit it has outstanding unless it has reserves in excess of what it is required to have. On their own initiative banks may procure additional reserve funds either by borrowing or by selling securities. Or the Federal Reserve System on its initiative may supply banks in general with additional reserve funds by open-market purchases of investment securities; for as the Federal Reserve Banks pay for the securities they buy, either by check or by credit, the reserves of member banks are increased. Contrariwise, if the Federal Reserve System sells securities, the process of paying for them, whether they are purchased by member banks or by the customers of member banks, will reduce the reserves of member banks. Purchases by the System tend to ease the money market, sales by the System tend to tighten it.

In August and September of this year a further step in pursuance of the System's established policy was taken when the Federal Reserve Bank rediscount rates were lowered. In approving the first of these changes the Board stated that its "approval was based upon the view that the reduction of discount rates at this time would assist in carrying out the System's policy of monetary ease and make Federal Reserve Bank credit readily available to member banks for the accommodation of commerce, business and agriculture, without encouraging member banks to borrow outside of their districts or to liquidate their portfolios in order to be in a position to meet the needs of present or prospective borrowers."

The Board went on to say "The reduction in discount rates, which have had little or no practical effect during the period when excess reserves were abnormally large and widely distributed throughout the System, brings the rates into closer relation with the interest rate structure generally prevailing, and affords to member banks the benefit of rates, on advances made by the Federal Reserve Bank, which are in line with those available in the money market. During the extended period when excess reserves of the banking system were between two and three billions of dollars, the occasion did not arise except in rare instances for member banks to borrow from the Federal Reserve Banks, and the discount rates were accordingly inoperative as a practical matter.

"As a result of the continued progress of the recovery movement, demands of agriculture, industry and commerce for bank accommodation have steadily increased and at the present time are augmented by seasonal requirements, particularly with relation to crop movements.

"It is the Board's view, therefore, that at this time the Federal Reserve System can best discharge its public responsibility and promote the continuance of recovery by making it possible for member banks to obtain accommodation from Federal Reserve Banks at rates which will encourage them to employ their funds to meet the needs of agriculture, industry and commerce."

Later in September, the Federal Open Market Committee announced that it had authorized purchase in the open market from time to time of "sufficient amounts of short-term United States Government obligations to provide funds to meet seasonal withdrawals of currency from the banks and other seasonal requirements." It said further:

"Reduction of the additional holdings in the open market portfolio is contemplated when the seasonal influences are reversed or other circumstances make their retention unnecessary.

"The purpose of this action is to maintain at member banks an aggregate volume of excess reserves adequate for the continuation of the System's policy of monetary ease for the furtherance of economic recovery."

At the same time, the Committee announced that at the request of the Board of Governors the Secretary of the Treasury had agreed to release - that is, to desterilize - approximately $300,000,000 of gold from the Treasury's inactive account. Accordingly, the Treasury was credited with that amount on the books of the Federal Reserve Banks which in the course of regular Treasury disbursements found its way into the reserve accounts of member banks and increased their available funds correspondingly. This was an effective means of utilizing our monetary measures to maintain the policy of ease. The Committee's statement made at the time pointed out that:

"This action is in conformity with the usual policy of the System to facilitate the financing of orderly marketing of crops and of autumn trade. Together with the recent reductions of discount rates at the several Federal Reserve Banks, it will enable the banks to meet readily any increased seasonal demands for credit and currency and contribute to the continuation of easy credit conditions."

As stated in the October Federal Reserve Bulletin, this action toward augmentation of member bank reserves was taken in order to anticipate the usual seasonal needs of member banks for currency and credit. The action of the System in bringing about an increase of available funds put banks in a still easier position to meet seasonal needs as well as increasing demands for bank credit. It was an exercise of credit technique under normal and typical conditions.

Before passing on to the latest measure of credit technique taken by the System, I want to mention a recent change in the regulations governing discounts by the Federal Reserve Banks. This change was effected by the issuance of Regulation A in revised form effective October 1. Its significance lies in the fact that in determining the eligibility of paper for discount, the form of the obligations to be discounted is considered of less importance than it used to be. Originally the privilege of rediscount at the Federal Reserve Banks had been restricted to relatively short-term paper arising from certain commercial and agricultural activities. As you know, the amount of such paper has tended in recent years to constitute a smaller and smaller proportion of the total amount of paper available to banks. To the extent that banks were dependent on such paper for discounts, the decrease in its amount meant in effect a curtailment of the power of the Federal Reserve Banks to extend credit. The Banking Act of 1933 and the Banking Act of 1935 both enlarged the classification of paper upon which individual member banks might procure funds from the Federal Reserve Banks for the replenishment of their reserves, and Regulation A as recently issued by the Board carries out the purpose of these changes in the law.

The new Regulation had been in preparation for a long period and the time of its issuance had no special bearing with respect to the current situation. It was rather a longer range measure. Moreover, its issuance was not of course a measure of credit regulation, like open market operations or changes in the discount rate, but a liberalization of the conditions under which the regular means of credit regulation are exercised.

The latest measure of credit regulation taken by the System was the change in margin requirements effective the first of this month. The power to fix margin requirements is, as you know, a new and special responsibility imposed upon the Board by the Securities Exchange Act which Congress adopted in 1934. Its effect is not general upon the whole field of credit. In this respect, it differs from other central banking powers. It is directed exclusively at the use of credit advanced by brokers, dealers and by banks for the purpose of purchasing or carrying registered securities. Theoretically, margin requirements can be raised when it appears advisable to restrain speculative use of credit and they can be lowered when it appears advisable to relax the restraints.

Because of the special nature of this particular power of credit regulation, it can be exercised independently of other measures by which the credit situation is influenced. Thus it is possible to pursue a restraining policy with respect to the use of credit for securities' speculation at the same time that an easy money policy is being pursued with respect to the use of credit for commerce, industry and agriculture. By its most recent action the Board eased credit conditions so far as securities' trading is concerned. It happens that this policy of ease in the special field of stock market trading coincided with the policy of ease which the Board has all along pursued in the general field of credit, but conditions do not always call for a parallel policy by any means. The peculiar character of the power to fix margin requirements is that it makes it possible to influence credit conditions in a particular field independently, if necessary, of what is done in other fields.

It is evident that the exercise of Federal Reserve functions, like those of any other organization, involves sometimes merely the use of certain tools according to accepted procedure, and sometimes a change in the tools themselves or in the conditions under which they are to be used. Open market operations and changes in discount rates are the customary tools regularly employed in performance of Federal Reserve System functions. They are practicable, flexible and tested tools, which can be used to ease money conditions at one time and to tighten them at another. They can be made to accomplish their purposes without shock - without violent and painful adjustments. They can be applied gradually so that their effect is barely perceptible. If necessary, they can be applied vigorously and sweepingly.

It almost goes without saying that the powers which I have been describing can only be exercised with the highest sense of public responsibility. The central banking authorities must formulate and execute their policies with a well-informed sense of the effect upon the country as a whole. Conflicting interests are present on every hand. Every action taken is certain to be approved by some and disapproved by others. Every step taken is sure to be subjected to the scrutiny of acute and well-informed critics. That is as it should be. It is the normal condition under which governmental institutions function in a democracy, and most of us believe it is on the whole the best condition.

Naturally enough the better you as specialists in the field of credit understand the responsibilities of the Federal Reserve System and the manner in which we try to meet them - and on the other hand, the better we of the Federal Reserve System understand your problems and the conditions under which you try to meet them - the more effectively will our credit machinery function for the common welfare of the country.