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WHAT IS THE FEDERAL RESERVE SYSTEM?

As created by the Federal Reserve Act the Federal Reserve System consists of five parts. These are: the member banks, the Federal Reserve Banks, the Board of Governors, the Federal Open Market Committee, and the Federal Advisory Council.

The characteristic functions of the System as a central banking organization devolve upon three of these parts, which for most purposes of explanation can be spoken of as if they were one. In some cases the law puts the primary responsibility upon the Reserve Banks, in some cases upon the Board, and in some cases upon the Committee. Your own contacts, however, are directly with your Federal Reserve Bank and so for the sake of simplicity I wish to disregard the divisions of responsibility established by the law and speak of whatever is done as done by the Federal Reserve Bank.

The purpose of a central banking organization is to exercise a stabilizing influence upon the supply and cost of credit. Thus the operations of the Federal Reserve Banks as central banking institutions differ profoundly from those of privately managed and competitive institutions operated for profit. When the Federal Reserve Bank makes a loan or purchases securities, the transaction is in one sense like that of a privately managed bank, but its purpose and motivation are quite different. The transaction of the privately managed bank is one of competitive profit-seeking enterprise. The transaction of the Federal Reserve Bank is essentially govermental, being aimed at the regulation of credit conditions in the general interest. For this reason the powers possessed by the Federal Reserve Banks are special and such as are not possessed by privately managed institutions. Both in purpose and in powers, therefore, Federal Reserve Banks are essentially unlike the institutions which you as commercial bankers have under your control.

In spite of these essential differences, the tendency to think of the Federal Reserve Banks in terms applicable to the operations of privately managed banks is almost irresistible, particularly among bankers. This was recently brought to my attention by the statement of a banker to the effect that when the Federal Reserve Banks make loans they use funds supplied by member banks. Such a statement represents a view of the matter that I am afraid is very common. The idea seems to be that the reserves which the member banks are required to maintain with the Federal Reserve Banks constitute the funds which the Federal Reserve Banks lend, and that the ability of the Federal Reserve Banks to lend depends upon the amount of the member bank reserves. This is far from the truth.

The ability of the Federal Reserve Banks to lend arises from their statutory authority to exchange their own liabilities for the liabilities of others - in other words, to enter credits to the reserve accounts of member banks and to issue Federal Reserve notes in exchange for promissory notes, bills, bonds, and other forms of obligation. Consequently, the Federal Reserve Banks could make loans and purchase securities without having a penny of member bank reserves to start with.

You all are familiar with the fact that if you procure funds from the Federal Reserve Bank - either by the sale of securities or by borrowing - you receive the proceeds of the transaction in the form of funds credited to your reserve account. It is obvious that in such a transaction the Federal Reserve Bank parts with nothing. When it acquires one of your obligations, it does not pay for it in cash as a merchant would do when he acquires inventory assets; instead it balances the increase in its earning assets by a corresponding increase in its liabilities. This increase in its liabilities is not wiped out until the obligation is settled. If, after having the proceeds of your borrowing credited to your reserve account, you withdraw Federal Reserve notes, the liabilities of the Federal Reserve Bank are not thereby reduced; they are merely shifted from one form to another - from a deposit liability to a note liability. Similarly, if your reserve account is drawn down by a net balance of clearings against you, the liabilities of the Federal Reserve Bank are not thereby reduced; there is merely a shift of deposit liability from one bank's reserve account to another bank's reserve account.

The same transaction by which the Federal Reserve Bank enlarges your reserve account in exchange for earning assets acquired from you may of course be repeated with member bank after member bank, and in the process Federal Reserve Bank deposits will be continuously expanded. This process might be begun, as I said, without the Federal Reserve Bank having a single penny of deposits to start with. Under the law the Reserve Bank would need to have only a stock of gold, which it might acquire by the sale of its capital stock, and this gold would have to be a little more than a third of the amount to which the Reserve Bank's liabilities were expanded. This requirement of the law - that the Federal Reserve Bank's reserves, which consist mainly of gold certificates, shall be not less than 35 per cent of their deposit liabilities and not less than 40 per cent of their note liabilities - is the only limitation upon the power of the Federal Reserve Banks to build up their own assets and the reserves of their member banks. It is a limitation that under present circumstances would permit expansion far beyond any probable need.

You are familiar with the process I have been describing because it is one which in principle you follow when you make loans to your own customers. Your own institutions, however, are under natural limitations which in practice make the operation quite different from what the Federal Reserve Banks can do. You can, for example, accept the promissory note of one of your borrowers and give him credit in his checking account for the amount thereof. You increase your assets and your liabilities simultaneously and the transaction involves not a penny of cash nor any deposits you may or may not have already. Up to this point the situation is the same as when a Federal Reserve Bank makes a loan to one of you and credits your reserve account with the proceeds. But here the difference arises. The proceeds of the loan made by the Federal Reserve Bank will not be checked out and the Reserve Bank will lose none of its reserves. The proceeds of the loan that a member bank makes will be checked out and the member bank will lose reserves; for a member bank's customer borrows because he needs the funds and he must be expected to check out the greater part of what he borrows. For this reason when you make extensions of credit you always have in mind the question whether your reserves are adequate or not to meet the withdrawals that you must expect will follow. When your reserves are being built up you feel free to lend and to purchase securities, but when your reserves begin to decline you realize that your extensions of credit must be curtailed and collections effected.

It is a paradox of competitive banking that though bank deposits are increased by the loans which a bankers makes to his customers, it is not his own deposits but those of his competitors that are increased. In other words, bankers increase each other's deposits. The First National makes a loan to a customer, and he checks the money out to someone who deposits it in the Second National. The Second National makes a loan to a customer, and he checks it out to someone who deposits it in the First National. Occasionally funds may for a time stay in the bank that lends them, but that is unusual; on the whole, funds are undergoing too active a use to stay long at the point where they originate. It is their nature not to stand still but to circulate.

Because there are many banks and because they are in active competition, any active circulation of the funds created by them is from bank to bank. But because in a given district there is only one Federal Reserve Bank, any active circulation of the funds created by it is merely from one reserve account to another without ever leaving the Reserve Bank's books. There is an exception when funds leave the Federal Reserve district in which they originate, but the bulk of the circulation is intra-district rather than inter-district; and even in the case of inter-district movements the Reserve Banks can make adjustments among themselves so that none will have inadequate reserves.

Accordingly, it is possible for the Federal Reserve Bank to expand its deposit liabilities - i.e., your reserves - almost indefinitely, and in its power to do so, being a central bank, it is not dependent upon its depositors. Both from the point of view of power therefor as well as from the point of view of purpose, its operations are by no means analogous to those of a privately managed bank. A loan or a purchase of securities by the Federal Reserve Bank is always to be thought of as resembling only superficially, and as a bookkeeping transaction, a loan or a purchase of securities which you as commercial bankers may make; in purpose and in the conditions under which it is effected it does not resemble but essentially differs from such loans and purchases.

A few moments ago I spoke of your reserves as indicators of your ability to lend. That fact holds universally just as a sane and necessary rule of good banking; it was observed by bankers before there were legal requirements as to reserves, and it would continue to be observed if there were no such requirements now.

Since extensions of credit depend upon adequacy of reserves, it is evident that control over reserves - with the power to expand and contract them - is control over the expansibility of bank deposits. In a very significant sense, therefore, the word "reserve" is a key word that by its presence in the terms "Federal Reserve System", "Federal Reserve Bank", and "Federal Reserve Act" indicates where the emphasis should lie in consideration of what the System is. The reserves which member banks maintain with the System are the means by which the supply and cost of credit are regulated. It is to facilitate such regulation that reserves are maintained with the Federal Reserve Banks and that the Federal Reserve Banks are given very special powers to expand and contract those reserves through lending and open market operations. Accordingly, instead of saying that the lending powers of the Federal Reserve Banks depend upon the reserve deposits lodged with them, it is more accurate to say that the volume of those reserve deposits depends upon the Federal Reserve Bank's use of its powers, which by the deposits can be either enlarged or reduced.

In recent years two conditions have made it difficult to observe the central banking powers of the Federal Reserve Banks in normal operation. One is the enormous volume of reserve funds that have come into the possession of American banks as a result of the inflow of gold into this country from abroad. The other is the reluctance of you bankers to borrow. Taken together these two things mean that at present bankers have relatively little occasion to use the lending facilities of the Federal Reserve Banks and abstain as much as possible from using them even when there is occasion.

Under normal conditions of central bank operation this will not be true. Banks will have ample reserves to meet an active but essentially stable credit demand but they will have no great excess of reserves; their funds will be employed and turning over efficiently and profitably. When on occasion there are seasonal or other legitimate increases in the demand for credit, the reserve funds available to meet the increased demand will be enlarged by central bank action - funds will be lent to individual banks or open market purchases of securities will be made. When the seasonable demand has passed, the additional funds will disappear - securities or bills will be sold in the open market and the member bank borrowings will be paid off.

Such recourse to the central banking organization should be regarded as normal and desirable. When the legitimate seasonal requirements of a given community are in excess of the local supply of funds, it is proper that the banks concerned should turn to the central banking organization for additional funds. At such times it is no reflection upon a bank that it is indebted to the Federal Reserve Bank. On the contrary, it is evidence that the bank is making normal and proper use of the institutions established for the purpose of enabling it at all times to meet the legitimate credit needs of its customers. Such recourse to the Federal Reserve Bank will, of course, as I have indicated, be seasonal and occasional. It will not mean that the bank in question is embarrassed any more than the seasonal borrowings of a merchant or a farmer are signs of embarrassment.

But, as I have said, conditions prevailing in recent years have given little opportunity for what we think of in principle as the normal and typical working of central bank functions. The volume of discounts has remained small, the inflow of gold has lessened the need for open market purchases, and at the same time occasion has not arisen for open market sales of securities. Instead, the System has had to be preoccupied with the problems presented by abnormal conditions - notably, of course, the state of business activity prevailing in recent years and the immense expansion of bank reserves resulting from increases in the gold stock. In this situation the System has sought on the one hand to maintain the easy money policy which it believed was called for by the economic condition of the country and on the other hand to maintain the effectiveness of the normal powers of credit regulation entrusted to it by Congress.

Meanwhile the other functions of the Federal Reserve Banks - the provision of currency, the clearance and collection of checks, bank supervision, and fiscal agency for the Federal Government - have continued. They make up the bulk of the System's routine, and constitute the channels of more frequent contact between the institutions you manage and the Federal Reserve Banks. But, in considering in a broad sense what the Federal Reserve System is, these routine functions should not obscure the fact that the fundamental concern of the Federal Reserve System is reserves.

The functions and purposes which I have been speaking of are stated in the Federal Reserve Act, which makes it an aim of the System's operations to accommodate commerce and business in the interest of the general credit situation of the country. The Act also makes it an aim of the System to discriminate against the speculative use of credit. These objectives have been emphasized by Congress in various ways - not only in the statement of purpose which is to govern the System's operations, but in the conditions governing the appointment of members of the Board and directors of the Federal Reserve Banks. The functions of the System, as stated in the Act, also include the issue of currency, the clearance and collection of checks, the examination of member banks, and fiscal agency of the United States government.

In carrying out these purposes for which the law created it, the System has recourse not only to its own statistical and research services, but to the assistance of outside groups. It seeks at all times to inform itself as carefully as possible as to the conditions to which its regulations are to apply. Its object is to serve, as the law requires, the interests of industry, commerce, and agriculture, and in pursuance of this objective it draws on the experience and the judgment of all the interests involved.