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THE FEDERAL RESERVE SYSTEM

The Federal Reserve System is not entirely new to you. You have heard of it, perhaps read about it; many of you no doubt have studied it, and some of you have specialized in the subject of its operations. Those of you who are with banks that are members of the System probably find that, at best, your work makes you familiar with only certain special details of Federal Reserve operations as a whole and that to know more of the System you have to add study to your experience. It is not possible for me to concentrate on just what you should like most to know, since some of you are more interested in one thing and others in another, and I think I am most apt to be helpful if I try to delineate the System as a whole, both in its structure and in its purposes and functions.

As established by the Federal Reserve Act, the Federal Reserve System comprises five parts. These are:

- The Federal Reserve Banks
- The Board of Governors
- The Federal Open Market Committee
- The Member Banks
- The Federal Advisory Council

The responsibilities for Federal Reserve System operations rest on the first three - that is, on the twelve Federal Reserve Banks, on the Board of Governors in Washington, and on the Federal Open Market Committee, which comprises the members of the Board and five representatives of the Banks.

The twelve Federal Reserve Banks are institutions set up under authority of Congress for the performance of monetary functions. While they have a corporate form of organization, their functions are of a governmental nature, and they are not operated for profit but in the public interest. Each has a board of nine directors, three of whom are bankers, three of whom are actively engaged in commerce, agriculture, or some other commercial pursuit, and three of whom, selected by the Board of Governors in Washington, are representative of the public interest.

The stock of each Federal Reserve Bank is owned by the member banks of its district. Dividends limited to six per cent per annum cumulative are paid thereon. The income of the Federal Reserve Banks is derived from their loans and their holdings of securities and other investment obligations, the amount of which is determined by public policy and other considerations apart from profits. At present the total assets of the twelve Federal Reserve Banks amount to about sixteen billion dollars, of which only about two and a half billion are earning assets, the balance consisting chiefly of cash and gold certificate reserves. Earning assets are only about 17 per cent of the total. At times in the past the Federal Reserve Banks have had a much higher percentage of earning assets, but in recent years the situation has been more nearly what it is at present. The income of the Federal Reserve Banks is ordinarily sufficient,

however, to cover their expenses, meet their dividend requirements, and provide additions to surplus. The surplus in the event of liquidation belongs to the United States Government.

The Federal Reserve Banks perform most of their services as regional institutions, particularly in providing currency for circulation and in facilitating the clearance and collection of checks. They also act as fiscal agents of the United States Government. They carry the checking accounts of the United States Government and do the servicing of the public debt. This includes handling subscriptions for issues of Government securities, paying interest, redeeming matured issues, and making conversions.

The primary function of the Federal Reserve Banks, however, is to hold bank reserves and to make additional reserve funds available, when necessary, by the extension of Federal Reserve Bank credit. I shall speak of this later.

The activities of the twelve Federal Reserve Banks are coordinated by the Board of Governors of the Federal Reserve System. The Board consists of seven members appointed by the President of the United States and approved by the Senate. It has important regulatory powers as the administrative head of the whole System. It is a governmental body, but its expenses are met by assessment upon the twelve Federal Reserve Banks.

The Federal Open Market Committee comprises the members of the Board and five representatives chosen by the Federal Reserve Banks as follows: one by Boston and New York, one by Philadelphia and Cleveland, one by Chicago and St. Louis, one by Richmond, Atlanta, and Dallas, and one by Minneapolis, Kansas City, and San Francisco. Its function is to direct the purchases and sales of investment securities and other obligations made by the Federal Reserve Banks for the purpose of enlarging or reducing, as the case may be, the volume of member bank reserve funds.

The member banks of the Federal Reserve System supply the capital stock of the Federal Reserve Banks and elect six of the nine directors of each Federal Reserve Bank. Member banks are now about 6,300 in number. About 5,200 are National banks and about 1,100 are State banks. Member banks, although less than half the total number of banks in the country, do from 80 to 85 per cent of the banking business.

The Federal Advisory Council consists of twelve members, one chosen by each Federal Reserve Bank. It consults with the Board of Governors and submits recommendations to the Board from time to time on current banking and monetary problems.

As I have already indicated, responsibility for Federal Reserve System operations lies with the Federal Reserve Banks, the Board of Governors, and the Federal Open Market Committee, who collectively may be spoken of as the Federal Reserve authorities. It is easier to understand the System's functions - especially its central banking functions - if they are thought of as a whole.

The first of these are the System's open market operations, already referred to. These are purchases or sales by the Federal Reserve Banks

of securities and other obligations. They are made not for purposes of investment or profit but to expand or reduce the volume of funds in the money market. For example, a purchase of several million dollars worth of Government obligations has the effect of putting that much money into the market and enlarging the reserves of banks. At times such operations may be called for in order to increase the available supply of credit; at other times they may be called for merely to maintain a stable condition. In a broad sense, the mechanism of these actions is very simple. For example, when a merchant is long on inventory and short on funds, he tries to get the public to increase its purchases and thereby turn his goods into cash. When the banks are long on investments and short on reserves, and therefore not in a position to enlarge their extensions of credit, the Federal Reserve authorities purchase investment securities and thereby turn the banks' investments into cash reserves.

In recent years the effectiveness of open market operations has been greatly circumscribed by the enormous accumulation of excess reserves of member banks. These excess reserves in turn have resulted from the movement of gold into the United States. Prior to the year 1934, the stock of monetary gold in the United States had never amounted to much more than four and one-half billion dollars. At the present time, it is over fifteen billion dollars. Over three billions of this increase is accounted for by revaluation, but a large part - perhaps the larger part - has come to the United States because of disturbed political and economic conditions elsewhere in the world. It has taken refuge here. It did not come because it was needed and it so far exceeds the requirements of the economic life of our people as to create a serious problem. More than one-half of the monetary gold in the world is now in our possession. We have far more than we need and other countries have less than they need.

The effectiveness of any action that the Federal Reserve authorities may take is conditioned by the presence of these enormous reserves. Member banks now have reserve balances with the Federal Reserve Banks of nine billion dollars. Of this about five and one-half billions represent required reserves and three and one-half represent excess reserves. Purchases of securities by the Federal Reserve Banks tend to maintain or increase this excess. On the other hand, since the Federal Reserve Banks own only about two and one-half billion of securities, it is obvious that if they sold the whole amount it would nowhere near absorb the excess.

Another important power of the Federal Reserve authorities is that of discount. When a member bank needs additional reserve funds it may borrow them from its Federal Reserve Bank. There have been times in the past when member banks borrowed very heavily from the Federal Reserve Banks, but under present conditions, as I have just described them, member banks in general have such a large volume of excess reserves that there is little occasion for them to borrow.

At times when there is an active demand for credit, the power of the Federal Reserve authorities to set the discount rate may be of considerable importance; a higher or lower rate will, of course, tend to influence the amount of borrowing. In recent years, the discount rates of the Federal Reserve Banks have been extremely low. At present they range from 1 to 2 per cent. These are the rates at which member banks

may borrow from the Federal Reserve Banks; they are not, as you know, rates on borrowing in general.

Open market powers and discount powers supplement each other. They are the means by which the Federal Reserve authorities accomplish the essential purpose of the Federal Reserve System - namely regulations of bank reserves. They are a means by which the volume of those reserves may be expanded or diminished. This power is exercisable by the Federal Reserve authorities on their own initiative when they find that the aggregate volume of available reserve funds is inadequate; or exercisable by the Federal Reserve authorities on the initiative of individual banks which find themselves with inadequate reserves. When acting on their own initiative, the Federal Reserve authorities supply funds by purchasing securities; when acting on the initiative of the member banks, the Federal Reserve authorities supply the additional funds by lending to the individual banks that wish to borrow. In both cases the act of the Federal Reserve authorities is essentially creative. The funds they lend to borrowing banks or that they pay to the sellers of securities are not funds already on hand - they are funds created in the act of acquiring an obligation and paying for it with a credit to the reserve balances carried on their books.

One might assume that with such powers the Federal Reserve authorities could perform monetary miracles. Nothing of the sort is true. The creation of funds by the Federal Reserve authorities is futile unless the funds have a use and a demand exists for them. The Federal Reserve authorities cannot force banks to lend, nor customers to borrow. Moreover, their power to decrease the volume of reserve funds is limited to those funds that they themselves create. They have no corresponding power to decrease the volume of reserve funds derived directly from the unprecedented growth in our stock of gold.

The Federal Reserve System is now twenty-five years old. The Federal Reserve Act was approved in December 1913, and the twelve Federal Reserve Banks began operations in November 1914. While the System has by no means made American banking perfect, it has accomplished great improvements. It has provided a means of currency supply that works smoothly and automatically; it has provided a nation-wide means for the clearance and collection of checks and the transfer of funds; it has provided the United States Government with indispensable fiscal agency services.

In these respects the Federal Reserve System has greatly improved certain services that were already in existence but were inadequate for the requirements of the banks, the public, and the Government. In another respect the System has provided facilities that did not exist before: it has provided a means whereby the reserve funds available to banks in meeting the requirements of their depositors and borrowers can be readily expanded when there is need and reduced when the need has passed or excessive use of bank credit has to be curbed.

The monetary policies of the Federal Reserve authorities are one of many important factors which help to make any given business situation what it is. Not one of these factors can be neglected; not one of them can be depended upon to accomplish all that is desired. In recent years, the Federal Reserve authorities have pursued what is called an easy money policy. They have endeavored to maintain such credit conditions as would

be most favorable for active business, increased employment, and general recovery.

In order that they may perform their duties properly, the Federal Reserve authorities require all the accurate information they can procure as to the state of banking and business not only in the United States but in the world at large. Such information as relates to banking is secured from examination reports and from reports of condition which member banks themselves submit to the Reserve authorities. Much of the essential financial information required is reflected in the operations of the Federal Reserve banks, for no important monetary trend can fail to manifest itself in one or more of the general accounts on the books of the Federal Reserve Banks.

From sources outside the Federal Reserve System, the Federal Reserve authorities draw information as to production, prices, international trade and exchange, domestic trade, pay rolls, and employment. Most of this information is procured in cooperation with other agencies.

A large and representative portion of the data bearing on Federal Reserve policy is published in the Federal Reserve Bulletin, and in its annual report the Board of Governors reviews credit developments and the conditions governing them. In the latest annual report, released a few weeks ago, the Board presents the results of studies it has made of the current problems of banking and bank supervision. You have already seen the report, and I hope you have read it, for it describes a situation which demands your thoughtful attention. Neither the Federal Reserve authorities, nor Congress, nor any governmental agency can settle important questions without the intelligent help of the public at large. You especially, as students of banking, should contribute your valued help. In order to enlist your interest I should like to conclude by reading the opening paragraphs of the report.

(First three paragraphs to be read)

It would require much more time than the occasion permits for me to read and discuss with you tonight the summary and the parts of the problems of Banking and Bank Supervision contained in our Annual Report - but let me urge you to read the twenty two pages contained in the pamphlet that is before you. You will, I am certain, find this reading and study very interesting, and, in my opinion, very helpful to you in a better understanding of our mutual problems - our problems - the Government's problems - and yes - your problems too.