The Relationship

of the

Federal Reserve

to the

Dual Banking System

ADDRESS BEFORE THE
NINTH VIRGINIA BANKERS CONFERENCE
Charlottesville, Virginia, September 8, 1949

BY

LAWRENCE CLAYTON

Member
Board of Governors
of the Federal Reserve System
Washington, D. C.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

It is an honor to address the Ninth Virginia Bankers Conference and a pleasure to mingle with the members of your Association in such a delightful and historic Virginia community. Any member of the Federal Reserve Board is constantly reminded of the very important impetus given by two distinguished Virginians to the establishment of a central banking mechanism in our country. In the entrance lobby of the beautiful Federal Reserve Building in Washington are two bronze plaques. One bears the likeness of Woodrow Wilson and hails him as the founder of the Federal Reserve System. On the wall opposite is a likeness of Carter Glass as the defender of the Federal Reserve System. I think the texts chosen to illustrate the role each played are so excellent that they can bear repeating before this audience.

In his first inaugural, President Wilson said:

> "We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon and step by step we shall make it what it should be."

From Senator Glass' book "An Adventure in Constructive Finance", the chosen text reads:

> "In the Federal Reserve Act we instituted a great and vital banking system, not merely to correct and cure periodical financial debauches, not simply, indeed, to aid the banking community alone; but to give vision and scope and security to commerce and amplify the opportunities, as well as to increase the capabilities of our industrial life at home and among foreign nations."

As we take note of these noble ideas so eloquently expressed, we may well ask whether the System has justified the hopes of its founders and what further might be done to advance their objectives.

From the standpoint of size and strength, the System has probably exceeded any expectation of 1914. But the extent of membership among State banks is somewhat disappointing. While the nearly 7,000-odd member banks hold about

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

85 per cent of all deposits in commercial banks, there remain more than 7,000 State banks which, although they share some of the benefits, have none of the responsibilities of this "great and vital banking system". You may ask "What are these responsibilities and benefits? Why should nonmember banks join the Federal Reserve System?" A full answer to these questions would require a different talk from the one that I wish to give here today, but let me cite the most important example.

As its name implies, the Federal Reserve System administers the bank reserves of the country. In the beginning of the System, one of its stated purposes was "to mobilize bank reserves". This implies that the reserves belonging to member banks were deposited in the Federal Reserve Banks. Actually this was done, but as the currency and credit needs of the country expanded, the Federal Reserve Banks have supplied additional reserves to the banking system. These reserves have gone indirectly to nonmember as well as to member banks. It is the basic task of the Federal Reserve authorities to administer the supply of reserves available to banks in a manner that will help to promote healthy growth of the economy without extreme fluctuations.

Nonmember banks, although indirectly affected by the credit policy actions of the Federal Reserve, are not directly subject to the regulations with respect to reserve requirements that the System authorities must impose in the interest of national credit policies. In a few States, very few in fact, State banking laws have been enacted which approximate the Federal regulations prescribing reserves against deposits. In the vast majority of States, however, the reserve requirements are around 10 per cent, with no regulation whatever in Illinois. Nor are "reserves" defined in even substantial uniformity. Deposits with other commercial banks, vault cash, U. S. securities, and even municipal securities, are counted as reserves in many States. Truly

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

it must be admitted in all fairness that the regulation of bank reserves among the 48 States is a hodgepodge. While it may be stoutly maintained by some nonmember banks that such a meaningless pattern is the badge of State sovereignty and individual initiative, it may well be asked whether the communities served by relatively unregulated banking are blessed or threatened.

If there be no merit in the regulation of bank reserves in the interest of sound national credit policy, then all commercial banks, national as well as State, should be allowed to escape it. If, as seems more reasonable, there is merit in a national policy, all banks which share in the creation and distribution of the country's money supply should be reasonably subject to it. I say "reasonably" because it may not be essential that all nonmember banks be subjected to identical requirements. The proposal submitted to Congress was only for supplemental reserves, in case of extreme need. In any event any requirement applicable to nonmember banks could contain suitable modifications that would prevent undue interference with the practice of correspondent banking.

This brings us face to face with the fundamental question whether the System has achieved and maintained the effective use of the powers granted by the original act to influence the cost, volume and availability of credit. It seems to me this effectiveness was achieved fairly early in the System's life, but in recent years has been somewhat sacrificed to war and post-war considerations of paramount importance. Within recent weeks, the System has regained a part of its lost ground. But this fundamental authority over bank credit is still less effective than when first granted. The problem for the Congress and the country's bankers is whether this effectiveness should be restored. Here attitudes are mixed, with a predominant feeling among organized bankers that no further legislation is desirable until and unless an emergency is

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

upon us, which may be too late.

Since this is an official gathering of the Virginia Bankers Association, I take it that it would be appropriate to discuss the official attitude of your Association and of most, if not all, of the State associations as well as of the American Bankers Association regarding the Federal Reserve System. During the current year, in particular, there has evolved a sort of party line in the public addresses of A. B. A. and local association officials. The line, in general, is to the effect that the Federal Reserve must be contained to its present area of authority in the banking field; also that within this area its powers should not be enlarged. It is conceived to be a threat to the dual banking system if the Federal Reserve, and the Board of Governors in particular, should be granted additional powers. Indeed, the American Bankers Association made a strong fight against the continuation by Congress of the very modest temporary authority over bank reserves and instalment credit which expired on June 30, last. The fight was successful although, as President Woolen has since said, the victory was not a happy one, because of the implications in a struggle between organized banking on the one side and the Federal Reserve on the other. Nor has it made any difference as yet, because in view of the economic situation the reserve powers would not have been used and the consumer credit controls would have been modified or perhaps removed. The problem, however, is one of long-term powers to do a job.

In addition to this organizational attitude, there are a good many bankers and bank supervisors who express the individual opinion that even the present structure and powers of the Federal Reserve System are a threat to the dual banking system. I do not think such a proposition has any basis in fact. Perhaps some confusion is due to a difference of understanding as to what the dual banking system is. Looking back to the days before the National Bank Act,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

there was only a single banking system, namely, a system of State chartered banks, most of which issued their own bank notes which circulated in various degrees of parity as the country's currency. History shows that this system did not provide the country with an adequate and safe banking structure.

Following the National Bank Act, charters were issued not only by the States but also by the Comptroller of the Currency, and thus there evolved a system of national banks and State banks operating side by side throughout the country. This was and is the dual banking system. But as originally established it did not have adequate flexibility to meet the needs of a growing economy or to prevent monetary panics.

The Federal Reserve System was set up to correct these defects. Its members constituted all national banks in the continental United States and any State banks which desired to join the System and met the qualifications. At that point in the development of the country's banking system, I would not myself say that we had gone from a dual banking system into a triple banking system. The existing banking structure was not changed by the Federal Reserve Act. The new System was fit into that dual structure. Independent unit banks continued to exist, there was no interference with State chartering of banks, and the practice of correspondent banking continued. Moreover, member banks were given a voice in the management of the new system, a privilege not accorded by the dual banking system theretofore.

In view of these facts, I can not accept the proposition that when a State bank joins the Federal Reserve System there is a loss to the State chartered banking system. I wonder whether the Commissioner of Banks in your own State of Virginia considers that he loses anything in the way of his supervisory authority if one of his State banks joins the Federal Reserve System. If so, I submit that there would be no sound basis for such a feeling. Certainly,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

any such bank is still subject to every State statute and every regulation of the Commissioner to which it had been subject before. The Commissioner would supervise and the State bank examiners would likewise continue to examine the bank as before. Assuming that the bank was an insured bank, the principal difference would be that whereas, before, the bank would be examined jointly by the State bank examiner and the FDIC examiner, it would henceforth be examined jointly by the State bank examiner and the Federal Reserve examiner. Thus, the only change from a supervisory standpoint would be a switch from one Federal agency to another Federal agency in the joint examination. True, the bank in question would now be subject to reserve requirements and other regulations of the Federal Reserve Board, but it would not be relieved of any of its obligations to the State banking authority. Thus, it seems to me quite untenable to maintain that an increase in membership of State banks in the Federal Reserve System holds any threat to the dual banking system.

With this clarification out of the way, let us now examine the more important proposition advanced by banking associations - both national and State - that an enlargement of Federal Reserve authority along the lines suggested by the Federal Reserve Board over the past several years would constitute a threat to private banking generally in this country.

Here, again, it is necessary to define what we mean by enlargement of Federal Reserve authority. The legislation suggested by the Board would <u>in form</u> be an enlargement of authority, but in substance it would be rather a restoration of authority which it was always intended from the very beginning that the Federal Reserve System should have. The fundamental power granted by the Federal Reserve Act in the monetary field was the ability of the System to control the volume, availability, and cost of credit in the banking system. In the early days of the System, additional reserves could be obtained only by

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

rediscounting at the Reserve Banks. Member bank borrowing was commonplace and at times in very large volume. The discount rate was therefore a very potent weapon. In the intervening years, there has been a great shift of emphasis in the monetary powers of the System. The great growth of the United States debt, and therefore in the volume of marketable U. S. securities, has made the open market operations of the System a much more powerful and more often-used instrument than the rediscount rate. Member banks make only occasional and moderate use of their privilege of borrowing at Federal Reserve Banks; they prefer to obtain funds through the sale of some of their large holdings of U. S. Government securities, principally bills and certificates. Thus, the ability of member banks to expand their loans and investments depends only slightly upon the discount policy of the Federal Reserve authorities. This is particularly true at a time when the Federal Open Market Committee feels it necessary in the public interest to support the market for U. S. securities, as was the situation during the recent war and post-war period. Although the Federal Open Market Committee recently discontinued the maintenance of a relatively fixed pattern of yields and prices of U. S. securities, a degree of support is still necessary to maintain orderly conditions in the market, and no one can safely say that conditions may not recur when it will again be deemed desirable in the broad public interest to resume more rigid supports.

In such a situation, it is apparent that the Federal Reserve authorities do not have the degree of power to control the volume and cost of bank credit which they had when the System was first established. With around $60 billions of U. S. securities in the portfolios of the member banks, they have access to a supported market for funds for reserve purposes or to expand loans or other investments at times contrary to the national credit policy pursued by the Federal Reserve. At such times the imposition of higher reserve requirements

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

up to the maximum now permitted in the law would have only moderate restraint upon the expansion of bank credit. The 1947-1948 situation was a perfect illustration of this proposition. The country was in a very pronounced inflationary upsurge, with prices advancing on all fronts. The Federal Reserve authorities were attempting by every means at their disposal to restrain bank credit expansion in order to reduce the upward pressure on prices. Reserve requirements were at the maximum and the rediscount rate had been increased, but the expansion in bank lending was greater in 1947 than at any period in our history. Bank leadership, spearheaded by the American Bankers Association, recognized the dangers in the situation and endeavored to retard the overall growth in credit by urging individual banks to be more cautious and selective in their lending. This campaign was most laudable but it would have been much more successful if the Federal Reserve had been in a position to make its own anti-inflation policy more effective. When the inflation had practically run its course, Congress belatedly gave the Federal Reserve Board the temporary authority over supplemental reserves, a part of which was immediately used. Had such authority been granted a year or more earlier when it was first requested by the Board, there would likely have been less inflation in 1947 and 1948 and, by the same token, less recession in 1949.

The present level of reserve requirements may appear high when we compare percentages with those in effect 15 years ago. But the structure of bank assets and the country's gold supply have undergone profound changes during this period, so that bank reserves are greatly higher. The restraints imposed by the present statutory maximums are in my opinion considerably less onerous and therefore less effective than were the fixed requirements during the first 20 years of the System, when the percentages were half of the present maximums. Nor have banks suffered; their earning assets have tripled on the basis of additional

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

reserves supplied by the gold inflow and Federal Reserve open market operations.

Reflection upon these matters indicates, it seems to me, that the Federal Reserve authorities today have in fact less control over the volume and cost of bank credit than they had a generation ago. And so I say that the authority suggested by the Board in recent years - either in the form of supplemental reserve requirements or the so-called special or optional reserve plan, should be regarded as a restoration rather than an enlargement of the traditional controls in the credit field that were contemplated in the original Federal Reserve Act and reaffirmed by Congress in the Banking Act of 1935.

This brief recital of past history and analysis of monetary powers have been given because it is useful to keep in mind the origins and course of development of our institutions, so that we can have a better understanding of why they are as they are. It is more fruitful, however, and more important to consider them in the light of existing and probable future needs. At the last session of the Graduate School of Banking at Rutgers, Dr. Randolph Burgess gave a seminar lecture on the future of the Federal Reserve System. There are few people better qualified than Dr. Burgess to view this problem. He has had years of experience in the System and outside. He has been a student of the operations of the System and has written informative books on the subject. His views are accepted by bankers and others as authoritative. Dr. Burgess makes a strong plea for maintaining a strong Federal Reserve System but he begins his speech with a note of alarm. He says:

> "....Today the System is in danger. It is being diverted from the purposes and principles of its founding. It is being changed in ways that have short term plausibility but may spell long term failure.
>
> "The Federal Reserve System was established after more than a decade of public discussion of the principles of central

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

banking. On the whole, its structure, modified gradually over the years by practice and legislation, has proved sound. But the original act was passed a generation ago. The gravest threat is that this generation is treating the Federal Reserve System as just one more government agency, is losing sight of its major purposes, and is neglecting the safeguards which are necessary to protect it in the fulfilment of its great objectives."

This objective, he goes on to point out, is fundamentally to provide stability and to moderate business fluctuations. He is careful to indicate that the Federal Reserve can not do this alone because there is no single constant cause for depression. Recognizing that Government has a great influence on business fluctuations, he believes that the influence of Government can be best exercised through monetary regulation, which affects the volume, availability, and cost of money, rather than through direct controls or fiscal policies. There is a school of thought, he says, which sponsors the view that governmental stabilizing policies can best be exerted through more direct fiscal means, that is, by increasing or decreasing expenditures or by changes in taxation. This concept considers Federal Reserve monetary policy as of subsidiary importance to the Federal budget in lessening economic instability. Dr. Burgess, however, is not too sanguine of success in the fiscal field. He believes there are great advantages in trying to moderate fluctuations through the money supply because, he says, experience shows that it can be done and because it is a method that is "consistent with democracy", that is, it "involves the least interference with the freedom of the individual to make his own choices in his economic life". Dr. Burgess draws this conclusion:

"The point to note is that the control of money is a very powerful influence, and is one of the few that can be consciously directed to economic stability. The Reserve System is our agency for that purpose. In the interest of sound banking and a sound national economy, the Reserve System must be preserved and defended; and bankers, who know it best, have that peculiar duty."

To this analysis and conclusion, I can say "Amen".

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

After making such a convincing case for the use of monetary powers as against direct Government controls and for the preservation and defense of the Reserve System as the agency to exercise the monetary powers, Dr. Burgess gives himself over to fears and criticisms respecting the present and future of the System. What is the source of these negative expressions? In my opinion, one must consider the human element. Dr. Burgess is not only a distinguished and experienced central banker and an able protagonist of the Federal Reserve, he is also a recent president of the A. B. A. and the Reserve City Bankers Association, as well as one of organized banking's chief spokesmen regarding Federal Reserve problems. Can it be that Dr. Burgess, finding himself making such a convincing case for the Reserve System, felt obliged to even the score somewhat by moving over toward the party line? At least, it seems to me that his arguments of opposition are labored and, happily, leave his affirmative case unshaken.

It is not my purpose to discuss in detail the several points of criticism in Dr. Burgess' able paper. A recital of their captions will, however, indicate their purport. He raises three questions of Federal Reserve organization. First is the relation of the System to the President and the Treasury. I doubt that it can be successfully maintained that recent Federal Reserve actions or policies have been dictated by the Executive. In fact, financial writers during last winter and spring frequently described our actions as being divergent from general administration economic policy. The fact is, however, that it was a period when the Reserve System demonstrated a degree of detachment and independence which Dr. Burgess so well advocates in his paper. Yet he properly recognizes that "the central banking system, in working for the public interest, must inevitably consider the needs of the Treasury as a major factor in its decisions." Next Dr. Burgess raises the question of the balance of power within the System.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Certainly no change has actually occurred since the Banking Act of 1935 in the System's structure. A task force report made for the Hoover Commission is given considerable attention but the Commission did not approve it, so one can scarcely call it a threat. At this point, however, Dr. Burgess includes the legislative suggestions of the Federal Reserve Board as a move to concentrate more and more power in Washington. Here, he calls for greater utilization of the Federal Reserve Banks so as to avoid important decisions being made "in the detached statistical and political atmosphere of Washington". In answer to this, I might say that there is currently the greatest degree of joint discussion of policy between the Board and the Reserve Banks. Not only is there close contact with the Reserve Bank presidents, but with the Bank chairmen and the boards of directors as well. The latter have been asked for their opinion on many policy problems and the Federal Advisory Council is not only regularly consulted, in accordance with statutory provisions, but frequently more often.

The third question posed by Dr. Burgess relating to Federal Reserve organization and operation is what he calls "the trend toward controls". He recognizes the propriety of margin controls permanently and of instalment credit control in time of "war or serious inflation". He then states that "one school of monetary economists would project the Federal Reserve Board still further into what may be called 'qualitative' credit controls by giving the power to make detailed rules to govern the making of real estate loans and other specific forms of loans." Whoever may constitute this "school of monetary economists", I don't know, but they carry no weight with the authorities in the Reserve System. As a matter of fact, the Board of Governors itself in recent years has resisted suggestions, sometimes made from responsible sources, that other forms of credit, such as real estate loans and capital issues, be subjected to its regulation. So it would appear that the threat of direct controls is more bogey-man than real. But

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Dr. Burgess goes on to say that "all of these suggestions have in common more than a suggestion of the totalitarian principle that some one in a Government bureau can make wiser decisions than management on the job." He then mentions the destructive effect of totalitarian controls in Europe today. With these extreme words as an introduction, he then makes the formidable charge that in two respects the Federal Reserve tends toward these totalitarian controls. One is the Board's recent request for more power over reserve requirements (which I have endeavored to show is a restoration, not an enlargement) and the other is "the present detailed control by the Reserve System of prices and trading in the Government securities market".

Dr. Burgess' paper was delivered on June 24, a week before the announcement of the Federal Open Market Committee to the effect that it was discontinuing the maintenance of a relatively fixed pattern of prices and yields. Consequently, it may well be that Dr. Burgess would have modified his criticism somewhat a week later.

In any event, I wish that he had discussed these subjects more fully because they go to the heart of the problem which was the theme of his speech, namely, The Future of the Federal Reserve System. Instead he concludes his remarks with a paragraph that I would like to quote in full and take as a basis for my further remarks:

> "It would be easy to leave this statement as a negative plea, opposing all controls. The positive side of it is a reaffirmation of the need for vigorous monetary management as the most powerful and best instrument government possesses for moderating business fluctuations. Its effective use depends on the time-honored powers to influence the cost and volume of credit rather than on detailed control. The use of these powers in turn depends on a revitalized Federal Reserve System with growing independence of Treasury policies as the war recedes into the past. The effectiveness of credit policies also will be greatly enhanced as they become cooperative national policies rather than surprise moves imposed by a Washington agency. In bringing this about, bankers have themselves an equal responsibility with the Reserve System."

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

This paragraph expresses generally desirable aims but it raises fundamental questions about the future of the Federal Reserve System that need to be answered. What is meant by "vigorous monetary management" and by "time-honored powers to influence the cost and volume of credit?" The question must be answered, not against the background of the conditions of the past, but in the sort of monetary and credit situation that exists today. One of the important characteristics of the Federal Reserve System has been its ability to adjust its policies to changing situations. The financial situation in this country today is different in many important respects from what it has ever been before.

The principal new characteristic is the tremendous volume of the Federal debt, which now amounts to about 255 billion dollars, or six to ten times what it was when Dr. Burgess participated in the task of managing the open market operations of the System. It is now more than one-half of the total public and private debt of the country, whereas before the war it was less than a fourth of the total. Of this public debt, 75 billion is owned by banks and 115 billions of marketable securities are owned by individuals, insurance companies and other corporations and associations. These holdings are viewed by the owners as liquid investments which can be converted into cash at will. As suggested heretofore, they provide to the banking system the liquidity that was formerly obtained largely through the New York money market, and the banks are constantly shifting their holdings to balance the flow of funds.

It would not be possible, in any short period of time at least, to develop a broad enough market in this country which could take care of all the buying and selling of Government securities that may occur day by day. The Federal Reserve System must therefore act to absorb securities offered or to supply those demanded in a magnitude that might otherwise create disorderly market conditions. The System's operations amount to millions and frequently hundreds of millions of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

dollars a day. They must be conducted at some price or rate. To leave the determination of this price wholly to the play of market forces would inevitably mean extremely wide fluctuations from day to day and perhaps even from hour to hour. Many of you will recall the fluctuations that used to occur in the New York call money market when it served as the source of liquidity for the banking system. The fluctuations that could occur in Treasury bill and certificate rates if left entirely to market forces might easily be as great as those in call money rates in the past.

At the end of June and in early July we had a little indication of what might happen in a market completely free from Federal Reserve influence. Congress permitted the temporary reserve requirements to expire and at the same time the System for a short period refrained from selling Government securities. Interest rates dropped sharply as banks endeavored to invest their released funds. The short-term rate might well have gone down close to zero had not the System stepped in to supply the demand. After the additional reserves had been absorbed, the rate would no doubt have shot back up very rapidly if the System had continued to stay out of the market. It is simply not realistic under existing conditions, as I am sure Dr. Burgess well knows, to suggest that the Federal Reserve should not engage in constant and detailed operations in the Government securities market.

This does not mean that there should not be a greater degree of flexibility in this market than was possible during the war and early post-war period. It has been the System policy to move toward the attainment of greater flexibility and a freer expression of market forces. We must, nevertheless, be active buyers and sellers and must recognize that our policies in effect largely determine the general level of rates, even though short-term fluctuations are permitted.

It is questionable, however, to what extent the System can rely upon fluctuations in short-term interest rates as an instrument for following a vigorous

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

monetary policy. While I would not want to take a position that fluctuations in interest rates have no influence, I would point out that it has become increasingly evident that changes in the availability of money are a more important influence than changes in the level of interest rates. Interest rates should be considered more as a result of changes in credit availability relative to demand than as influences which in themselves limit or stimulate demands for credit.

The large volume of public debt outstanding and the necessity for the Federal Reserve System to participate actively in the market for Government securities provide a source for the creation of new money. This situation makes it difficult for the Federal Reserve to limit the available supply of credit. It is different from that which existed before the Federal Reserve System, when there was no source of new money available to banks, or even in the first two decades of the System's history, when new reserves could be obtained only by member bank borrowing unless the System chose to supply them by open market purchases. Under existing conditions new funds can be readily obtained at the initiative of the holders of Government securities. These new funds enter the banking system as reserves and can be used as a basis for multiple expansion of credit.

The problem of the future of the Federal Reserve System, therefore, is how can it follow a vigorous monetary policy in accordance with the objectives for which it was established and at the same time meet its responsibility for maintaining a relatively stable Government securities market, which is also an essential for economic stability. It is to meet this problem that the System needs and has requested the Congress for additional power to increase the reserve requirements of commercial banks. We must recognize that careful management of the public debt may inevitably result in the creation of new money and that powers must exist to immobilize this money so as to prevent it from becoming the basis of an excessive credit expansion. This does not mean that the earning assets of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

banks would be reduced, because on balance only newly created reserves would be absorbed.

Operations of the Federal Reserve System in the Government security market and the use of the power to increase reserve requirements, I submit, are in accordance with the time-honored objectives and instruments used by the System to influence the cost and volume of credit. They do not represent a movement toward totalitarianism or socialism, as is implied by Dr. Burgess. In fact, they exactly fit his prescription that fluctuations can and should be moderated through variations in the money supply, a method which is "consistent with democracy". These powers are and would be exercised through the mechanism of the Federal Reserve System, an agency founded for this very purpose, in the management of which bankers and businessmen, as well as other private citizens, participate in a joint effort to serve the public interest.

In regarding the Federal Reserve as a threat to the dual banking system and in opposing the efforts of the Reserve authorities to maintain adequate powers over bank reserves, the bankers make a great mistake, in my opinion. They are seeing ghosts. The Federal Reserve is a part and parcel of the banking system. In carrying out its duties, it is constantly sensitive to bankers' problems, including bank earnings. For many years, the Board in Washington has resisted, sometimes single-handed, encroachments upon private banking, including those by the Savings and Loan System and by Government credit agencies.

Rather, the bankers should join with the Federal Reserve in fighting off threats which are not ghosts, but very live and formidable forces. Among them are rapidly multiplying agencies of the Federal Government to loan federal funds directly to groups of citizens or to individuals, displacing billions of dollars of private credit. Worse still, these mechanisms, started as emergency or temporary aids, become permanent and offer excuses for other groups to plead their

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

special cases before Congress. Thus the area in which the Government competes with the private banking system is constantly growing. It would be wise for organized banking to cease its resistance to adequate regulation and to stand side by side with the Federal Reserve in the struggle to preserve the area of private finance and private enterprise. I am personally sure that the Federal Reserve Board would welcome such an ally in that great enterprise.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis