
THE SIGNIFICANCE OF MEMBERSHIP IN THE FEDERAL RESERVE SYSTEM*

This annual meeting of the Stockholders of the Boston Federal Reserve Bank is a distinctly New England custom. It is so favorably known throughout the Federal Reserve System that I was very happy to accept the cordial invitation of your Chairman and my good friend, Albert Creighton, to come here and participate in your discussions.

During the six months that I have been in my present position I have visited and attended meetings in seven of the twelve Federal Reserve districts. I expect to visit three districts within the next month. During most of my business career it was my practice to make frequent trips throughout the country, for no man can follow the progress of his business except on the firing line. When I was Foreign Liquidation Commissioner in 1945 and 1946, I traveled 56,000 miles during a period of six months in order to obtain firsthand information about what was taking place in various countries of the world. My associates say that whenever I receive a call to go to a Federal Reserve district I am off on the run like an old firehorse who has heard the gong again. I have always relied to a great extent on personal contact with the people who are in daily touch with operating problems before making decisions.

Of course it is no hardship for me to come to New England, because I truly love this country. My family goes to Maine for most of each summer and I generally find plenty of excuses to join them.

I want to commend you Stockholders for your record in exercising one of the most important responsibilities of the member banks to the System—the election of six of the nine directors of the regional Federal Reserve Bank and, through them, the selection and guidance of its management. Each Board of Directors also elects a member of the Federal Advisory Council, a most important body in the development of Federal Reserve policy. The Boston Bank has been noted for its distinguished presidents. One of them, Ralph Flanders, your good friend and mine, was drafted by the

citizens of Vermont to go to the United States Senate. Your latest president, Laurence Whittemore, has just been selected to run one of your great railroads. Two former governors of the Federal Reserve Board, W. P. G. Harding and Roy Young, who is now president of one of your leading banks, also typify the high character and ability of your past presidents. It is a tribute to your Board of Directors that these men were chosen for such positions and is the finest indicator of the public's high regard for the Boston Bank. Although the loss of good men creates temporary difficulties of replacement because it seems that in each instance they are indispensable, yet broadly speaking, there is compensation in the loss of some of our good men to the community because these ex-officers are helpful in giving the various segments of our economy a better understanding of the nation's monetary and credit policies, of which there is a grave lack of understanding.

When I implore you to value your stockholder's responsibility highly and discharge it with all the ability at your command, I do so from experience and deep conviction. As you know, I was on the Board of the Philadelphia Bank for more than ten years before taking this assignment. Our Philadelphia directors were of invaluable aid not only in executive personnel matters but in advising the Bank on policies and procedure and in keeping it close to current economic and banking problems. The directors of the twelve Banks, with their branch directors, are a representative cross-section of the leaders in finance, commerce, and agriculture of their respective regions. Since going to Washington, I have found the directors' advice and judgment, expressed both directly and through their various officers and members of the Advisory Council, of the greatest help.

As a result of my experience, I cannot urge you too strongly to continue your vigilance in selecting and electing the most outstanding leaders. Some of the Banks have followed the principle of rotation in order to acquaint more of their leaders with the problems of the System.

This meeting affords an excellent opportunity to

*Address by Thomas B. McCabe, Chairman, Board of Governors of the Federal Reserve System, at the annual meeting of the Stockholders of the Federal Reserve Bank of Boston, on October 26, 1948.

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discuss the significance of membership in the Federal Reserve System. Two-thirds of all commercial banks in New England, holding four-fifths of demand deposits, are members. Holders of 63 per cent of the demand deposits of State banks have voluntarily chosen to become members. Those percentages speak for themselves and indicate pretty general belief in the importance of membership. It is especially noteworthy, I think, in this area of traditional Yankee shrewdness.

As you men know, two of the earliest constructive plans to stabilize banking by cooperative effort were made in New England. I refer to the Suffolk System and the Bank of Mutual Redemption. These two were voluntary steps toward the establishment of more effective control over the issuance of money. So you might say that the seeds of the Federal Reserve System germinated right here.

This System is a unique creation in the history of central banking. All economic societies, except the most primitive, have some form of money. In highly productive societies such as ours, organized around personal enterprise and initiative, money will not manage itself. A positive provision for the proper exercise of the central banking function is therefore inescapable. The problem of how to organize central banking functions, however, has no easy solution. Many experiments have been tried. Although central banking is a public function just as the administration of justice is a public function, experience has proved that central banks should be organized independently of the Executive and of the Treasury, just as Courts of Law are organized independently of the Executive and of the Department of Justice.

In Europe the solution to this difficulty long took the form of privately-owned central banks, operating under special charters from the sovereign. This type of organization has tended to insure relative freedom to central banks from political encroachment but it has left them vulnerable to accusations that they were operated for private advantage, at the expense of the public interest. Recently, the pendulum has swung away from this pattern in many countries. In order to accent the public nature of the functions which central banks perform and the public responsibilities with which they are entrusted, some governments have purchased the privately-held shares of their central banks and have made them wholly publicly-owned

institutions. These central banks are still organized, however, as completely separate institutions.

The truth is that central banks *must* function solely in the public interest. In doing this effectively they must of course maintain close contact and cooperation both with the private financial community and with the Executive, including particularly the Treasury. Whatever their form of organization, they cannot escape this dual role.

The financial history of the United States before the creation of the Federal Reserve System illustrates repeatedly the difficulties of this problem. The First and Second Banks of the United States represented attempts to organize the central banking function in this country by chartering a privately-managed single central bank. In both cases, this type of organization proved politically vulnerable. It was politically suspect because the management was entirely in private hands and because the central bank, due to its eastern location, was felt to be out of touch with conditions nearer the frontiers. Both banks were allowed to lapse without regard to the effects such action would have on the financial stability of the country.

These attempts taught one lesson that has conditioned our banking and financial structure ever since, namely, that the American people are determined to avoid centralized financial power whether it is public or private. It is in response to this determination that our dual banking system has evolved with its emphasis on individual unit banks. It is also because of this inherent characteristic of our people that the banks of this country operated for nearly three generations under the constant overhanging threat of recurrent money panic. The passage of the Federal Reserve Act put an end to this danger, and with its provisions for decentralization of power, organized the function of central banking in an ingenious combination of public and private management. I am thoroughly convinced that the authors of the Federal Reserve Act gave us a monumental piece of legislation—a system tailor-made for the economic expansion of our country. The System might be compared to a great pyramid with its base in the grass roots of our economy, and its apex in the Board of Governors. The breadth and strength of the pyramid is in its base, with the member banks and the Reserve Banks as elevations in the slope toward the top.

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The history of the Federal Reserve is singularly free of political bias. Although in the light of hindsight there may not be agreement that the System has always done the right thing at the right time, there is general agreement that partisanship has had no place in its operations. For this, again much credit must be given to the framers of the Federal Reserve Act, who were meticulous in their efforts to safeguard the System from the pressure of special interests or partisan groups.

The operation of the System is also free from profit motivation. Whether the Federal Reserve earns income over and above expenses has no influence on its policies. As you know, at present our earnings are large. Last year 90 per cent of the System's net earnings were turned over to the Treasury.

The System is thus free of the two influences which might distract it from acting with impartial, studied judgment on matters of monetary and credit policy, solely in the public interest.

In addition to this great continuing responsibility for nonpolitical, nonprofit administration of money in the public interest, the System is the lender of last resort, with vast powers to extend credit in time of need. Its powers in this respect have been greatly liberalized, so that the Reserve Banks may now lend on all sound assets of member banks.

Our banking and credit economy consists of an incredibly complex structure of interlocked assets and liabilities. No bank can operate that cannot convert its assets quickly into cash when depositors' use of funds results in a drain. Our markets are so organized that in normal times this conversion can take place in enormous magnitude without resort to the Reserve Bank. In periods of financial strain, however, there is no alternative but recourse to the Reserve System. This recourse to funds is always available to a member bank, with full assurance that the Federal Reserve will be in a position to meet its requirements, whatever they may be. Membership from this point of view may be thought of as that of a contributing member to a local volunteer fire company. So long as enough neighbors contribute, the protection will be adequate. Of course, in case of a conflagration noncontributors can also receive service. This is somewhat inequitable but is both humane and necessary to prevent spreading

of the danger to the whole community. However, in the existence and majority support of the organization there lies great security.

I don't need to tell this audience of the day-to-day tangible advantages of Federal Reserve membership. These include the supplying of coin and currency as needed, collection of checks, collection of noncash items, telegraphic transfers of funds, safekeeping of securities, purchase and sale of government securities, and examinations conducted in a helpful and practical spirit. It is the policy of the System constantly to improve all of these operations. Your suggestions as to improvement of any of these operations will be appreciated. One of the primary objectives of the Federal Reserve System when it was organized was to improve methods of check clearing and collection in this country. A great effort has been made to obtain this objective with the minimum of disturbance to correspondent and interbank relationships.

I know you also value highly the research services of the Federal Reserve, not only the regular services, but special studies such as the exhaustive one by Alfred Neal of the Boston Bank, which points out that the New England economy is far from static, as some sob-sisters would have you believe. On the contrary, it is still growing and has excellent opportunities for much further growth.

My first over-all impression of the System gave me a wholesome respect for the highly professionalized work of the research organizations of the banks and the Washington staff. Many of you have cooperated with the members of the research group and I know you will agree with me that the end product has established a new level of professional competence in this field. We must strive to increase their effectiveness still further. They supply the yardsticks of the present and are our eyes for the future.

Membership makes possible the performance of these services. You and I know, however, that members are subject to certain limitations relative to nonmembers. Members are prohibited from charging exchange on checks, are required to have larger capital to maintain out-of-town branches, are subject to greater restrictions on investments and loans of member banks, and on holding companies and interlocking directorates; are required to carry deposit insurance, and must

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carry large reserves with the Federal Reserve Banks.

These limitations have been developed out of experience, especially in periods of banking difficulty, and are in the interests of sound banking. By far the most serious and burdensome to you at this time is the requirement on reserves. Because of the large gold inflow of the 1930's and the legacies of war finance in the 1940's, reserves have had to be substantially increased.

It has been said that the recent increase of reserve requirements was politically inspired. That allegation does not deserve the dignity of a denial. The increase was one of the moves that we, in our best judgment, felt was necessary to restrain the growth of the money supply.

I fully realize that this instrument of monetary management has definite shortcomings. It is neither as flexible nor as selective as we would like. Especially, it is unfair under present conditions because it restricts the commercial banking system while leaving unfettered other segments of the credit structure which have access to the Federal Reserve System through sales of Government securities. It is also unfair in that the increases have not been made applicable to all nonmember banks. Some states, however, have been quick to respond to the action of the Federal Reserve by raising their requirements.

Quite naturally, a member banker may ask, "Why am I the goat when so many of my competitors go Scot-free?" There is no question but that many other agencies, public as well as private, are extending credit freely. But, gentlemen, we of the Federal Reserve have a grave responsibility to curb the rapid expansion of credit in the area in which we operate. As a member of the Board of Governors I could not be true to myself or my oath of office unless I fulfilled my responsibilities. You as members of the System also have a responsibility. If we live in a community where there are other citizens who do not accept their civic responsibilities, that does not excuse us from doing our duty. You who live in New England and carry the burden of a New England conscience will understand me, I am sure.

I have frequently stressed that this inflation will not be cured by the action of any one agency. The cooperative action of the American Bankers Association to persuade their members to restrain unnecessary lending has been very laudable, but in

spite of it loans at commercial banks have increased over 6 billion dollars in the year ending June 1948. In addition, commercial banks' holdings of securities, other than Governments, have increased over 700 million dollars during this period. This expansion of credit occurred at banks located in all sections of the country and at banks of all sizes, but particularly in rural areas and small cities.

One of the principal reasons for the increase in reserve requirements was to immobilize the reserves which have been created in the banking system during very recent months as a result of sales of Government bonds to the Federal Reserve from nonbank portfolios. Since June these purchases have been far in excess of the recent increase in reserve requirements. In other words, this action has not reduced either the earning assets or the lending power of the member banks *as a whole* below what they were as late as midyear. In the meantime, the moves of Treasury and the Federal Reserve to raise short-term interest rates have had the incidental effect of increasing the earning power of bank assets. I fully appreciate, however, that in some individual cases the reserve increase has worked a temporary hardship and it will take expert management to adjust to the situation.

As I see it, reserves are each bank's contribution to an effective national monetary policy. It is unfortunate that this contribution is not made equally by all, for the benefits are enjoyed by all. I do not see that any threat to our dual banking system is involved in the request that reserve requirements apply equally to member and nonmember banks. I am heartily in favor of the dual banking system, as I stated at the Louisville meeting of the National Association of Supervisors of State Banks. But I do think that in respect to a credit control instrument as powerful as reserves and one so vitally affecting the earning assets of banks, some degree of uniformity of application is essential to the strength and soundness of banking in this country. I do not feel that the need for preserving the respective authorities and jurisdictions of the State and national authorities in this matter presents any great difficulty. I am confident that it could be worked out satisfactorily in consultation with the State banking authorities.

There are many in this audience, I know, who would like me to say something about the support of Government bonds which made it possible for

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nonbank bond sales to swell commercial bank reserves.

I will here repeat what I told the House Banking and Currency Committee on August second, and said again in a talk just a month ago at Philadelphia:

It is my view that the System is obligated to maintain a market for Government securities and to assure orderly conditions in that market, not primarily because of an implied commitment to wartime investors that their savings would be protected, nor to aid the Treasury in refunding maturing debt, but because of the widespread repercussions that would ensue throughout the economy if the vast holdings of the public debt were felt to be of unstable value.

When you consider that the public debt is one and a half times all other debt in the country combined, it seems obvious to me that the market for the Government debt securities must be one where investors can deal at all times with confidence. I remain of the conviction that for the foreseeable future the support program should be continued. This conviction is shared by all the members of the Board of Governors, the members of the Federal Open Market Committee, and by the Treasury. It is also supported by the weight of financial opinion in the country.

In the last twenty years monetary influences have assumed new prominence in the eyes of the people. Whether this is because such influences have indeed become more prominent or because the public, made more economically sophisticated by education, has come to realize the true significance, I will leave to the theorists. Suffice it to say that the boom of the late 20's, the disastrous collapse, war financing, the huge public debt, and our present inflation have all focused the attention of the public on the importance of money and credit.

So far I have dealt with the Federal Reserve System in its relation with its members in the past. In conclusion, let us turn the telescope toward the future. Admittedly, the horizon is low and the readings are very obscure. We can see, on the one hand, great promise for the American economy.

Never has it had the potential that it has today. Our external relations, however, our place in the world environment that is emerging, indicate responsibilities beyond the power of man to evaluate. What will be the role of the Federal Reserve System, of the Board of Governors, of the twelve Federal Reserve Banks, and of the member banks in that future?

This much we can surely say, at present. The Board of Governors in Washington will continue to bear the major responsibility for the broad formulation of monetary and credit policies, adapted to the necessities of our domestic and foreign economic relations. The twelve Federal Reserve Banks, each in its region, will continue to bear the major operating responsibilities. They are the eyes, the ears, the hands of the System, adapting their operations to the regional requirements of our economy. They are also our principal advisers, providing wise counsel for System policies. They are staffed by an exceptionally competent group of individuals of the highest professional caliber. We must vigorously strive to raise the caliber even higher. You, who are in charge of the member banks, will continue to be primarily responsible for the ultimate decisions that make an enterprise system operate. Specifically, you determine who is financed and for how much.

The responsibilities of you, the Reserve Banks, and the Board of Governors are inextricably bound together. No one of them can be performed successfully without parallel performance by the other two. Personally, however, I feel that your role is the most indispensable of all. Not least is your part in shaping the business leadership in this country. When you exercise your individual credit judgment, you really decide who, among all the applicants for credit, will be financed. In making that decision in the past you have played a part in providing this country with the virile, enterprising, economic leadership for which it is famous. May you continue to play your role with wisdom, for in the days to come the world will need that leadership as never before.