

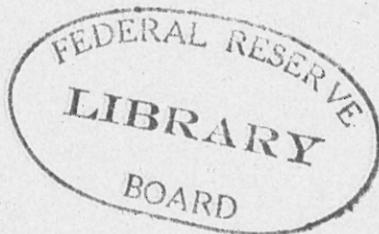
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"THE FEDERAL RESERVE SYSTEM"

BY

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It is a pleasure to be able to speak in Chicago to a north west side audience, where I lived my life from the day and hour of my birth.

I left Chicago nearly two and one-half years ago to assume my present duties as one of the members of the Federal Reserve Board in Washington. During these years I have had the privilege of participating in the work of the Federal Reserve System and studying its operations during one of the most trying periods of its twenty-odd years of existence.

These two and one-half years have been very difficult ones for me. They have been very trying. It is a grave responsibility to serve one's country during a critical time in an organization so vital to the nation's well-being as is the Federal Reserve System - especially when one is suddenly transplanted - away from home.

What I want to do today is to see you and talk to you briefly about the part which this great banking system plays in the financial and economic life of our country. I am truly happy to be here with you - thinking together - you and I.

In recent years, and particularly during the past year, there have been frequent discussions of the Federal Reserve System in the newspapers and magazines. Much of what has been said seems only remotely connected with our every day life. There have been arguments about control over the supply of money, about the kind of organization which should be responsible for so-called open-market operations, whether all

banks should be required to join the System, and whether more flexible lending powers of Federal Reserve banks would hasten recovery or, on the other hand, would tend to encourage unsound banking. A good deal of what has been said has been more confusing than revealing to those who try to understand the real functions of the Federal Reserve System.

It is important, however, to realize that these are not academic questions. They are of vital importance in the successful operation of banks, whether or not they are members of the Federal Reserve System.

This talk, then, is not argumentative or news-providing - but explanatory and factual. In saying this I do not mean to suggest that we should all attempt to acquaint ourselves with the details of the System's work. That is a big subject involving many technical details understood by comparatively few people. The System has been exhaustively described in a number of large books which make interesting reading only to the few whose business it is to know intimately how our banking institutions work.

On the other hand, it has always seemed to me that if our banks are to operate effectively, the fundamental principles of their operations must be understood by all of us. I believe it is particularly worth while, after the enactment of such important legislation as the Banking Act of 1935, to consider briefly what the Federal Reserve System is and what functions it performs for the country. So I should like to try, briefly, to brush away the great mass of details and to discuss

simply the main facts which should be helpful for us all to know and understand, as citizens of this country.

The Federal Reserve System was established in 1913 by the Federal Reserve Act, one of the most important pieces of financial legislation ever passed in this country. The System was created after many years of dissatisfaction with our banking and currency facilities, brought to a head by the panic of 1907, and after a thorough study of banking here and abroad by a National Monetary Commission established by Congress in 1908.

Since 1913, on the basis of actual experience and in response to new developments, numerous amendments have been made to the original Federal Reserve Act. During the depression changes were made by the Glass-Steagall Act of 1932, the Emergency Banking Act, the Banking Act of 1933, the Gold Reserve Act of 1934, and other acts. The recent legislation, approved August 23, 1935, makes important permanent changes so that the System can be more effective in the future in meeting the credit needs of the country.

Federal Reserve banks

In talking about the System today I shall begin by considering the mechanics of its operations which include chiefly the work of the Federal Reserve banks with the banking institutions of the country. I shall follow that by a discussion of its broader responsibilities for directing the credit policy of the nation which is the work of the

central organization in Washington, now known as the Board of Governors of the Federal Reserve System.

When the Federal Reserve System was established some of our banks were operating under national and some under State charters, and the System was superimposed upon this unwieldy structure. It might be said that the purpose of the Reserve banks was to strengthen existing banking institutions and to coordinate their credit operations in the interest of the country as a whole.

There are twelve Federal Reserve banks, one in each of the twelve Federal Reserve districts into which the whole country is divided. Several of the Federal Reserve banks have branches which operate in different parts of their district. Chicago has a branch at Detroit. There are now in all twenty-five branches and two agencies.

The banks of the country become eligible to use the facilities offered by the Reserve banks by becoming members of the Federal Reserve System. All national banks were required by law to join and State banks are permitted to become members if they fulfill certain requirements as to capital structure and as to the general nature of their business.

About forty percent of the banks in the country now belong to the Federal Reserve System and these banks account for about seventy percent of the country's banking resources. The member banks include 5,425 national banks and 985 State banks and trust companies. The State banking institutions which are still outside the System are for the

most part small banking organizations.

Under provisions of the Banking Act of 1935 State nonmember banks, with certain exceptions, having average deposits of \$1,000,000 or over, must become members of the System after July 1, 1942 or lose the right of having their deposits insured with the Federal Deposit Insurance Corporation.

The Federal Reserve banks differ from ordinary commercial banks in both their organization and their functions. Generally speaking, they do not deal directly with the public. Their customers are the member banks who come to secure credit or currency just as the public goes to the local banks. The capital stock of the Federal Reserve banks is owned by the member banks, which are required by law to subscribe to capital stock equal to six percent of their capital and surplus. One-half of such subscription is paid in cash and the other half is subject to call. The management of the bank is in the hands of a board of directors which represents not only the member banks but other business interests of the community. Of the nine directors of each Federal Reserve bank, three known as Class C directors are selected by the Board of Governors of the Federal Reserve System and six are selected by the member banks, three known as Class A directors representing the stock holding member banks, and three known as Class B directors representing commerce, agriculture, or industry in the district. The chief executive officer of the bank, designated as president under the new banking act, is appointed by the board of directors of the bank subject to the approval by the Board of

Governors of the System. The legal requirements for ownership and management of the Reserve banks, therefore, recognize that their functions must be performed in the public interest and that their management must take account of both the banking and the general business interests of the community.

Holding member bank reserves

One of the purposes of the Federal Reserve Act was to provide institutions which would hold the reserves of the nation's banking system. It is necessary for all banks to keep a certain proportion of their deposits liquid, that is, in cash, in order to meet emergency demands of their customers. Before the establishment of the Federal Reserve System, national banks were required to keep part of their reserves in their own vaults and part on deposit in other banks, usually city banks. Banks in the central reserve cities, however, of which there were then three, New York, Chicago and St. Louis, had to hold all their reserves in cash. When there was a scarcity of funds and country banks everywhere wanted to withdraw their funds from their city correspondents, a currency and credit crisis of greater or less magnitude was likely to occur. Country banks had difficulty in securing their deposits from city banks and the public in turn had difficulty in withdrawing deposits from the country banks, as well as from the city banks.

Now all member banks are required by law to keep their reserves on deposit in the Federal Reserve bank of their district and it is the

business of the Reserve banks to supply member banks with credit or cash in such emergencies.

The required reserves vary with the type of deposit and the class of bank. For banks in the largest cities, called central reserve cities, now only New York and Chicago, the law requires reserves equal to thirteen percent of demand deposits, that is, deposits which can be withdrawn without advance notice. If a customer of a Chicago bank borrows \$1,000, his deposit balance is credited with \$1,000 and the bank in turn must provide for \$130 of reserve deposit at the Federal Reserve Bank of Chicago, unless its reserve balance prior to the loan was already in excess of required reserves by that amount or more. For banks in so-called reserve cities, of which there are about sixty, the reserve requirements for demand deposits are ten percent and for all other banks seven percent while reserves of three percent are required against time deposits in all banks. Member bank reserve balances on deposit with the twelve Reserve banks amount today to over \$5,000,000,000. Owing to unusual conditions, the total of these balances is about twice as much as the banks are required to have.

The Reserve banks are sometimes known as the central reservoirs of credit of our banking system because of this function of holding in trust the reserves of the member banks. Under the Federal Reserve System our banks no longer have any fear that they will be unable to get their reserves when needed. One important risk has been eliminated

from commercial banking.

Loans to member banks

Equally important with their function of holding member bank reserves is the power of the Reserve banks to make loans to member banks. Through these loans the member banks are able to increase their deposit balances and thus provide the reserves necessary for the expansion of credit. The Reserve banks may supply funds to member banks by rediscounting paper or by making advances to member banks, as provided by law and Board regulations, or by purchasing bills and securities, and entering corresponding credits to the account of the member banks, thus increasing their reserve balances. Member banks in turn can increase their loans to the public in the aggregate by an amount several times the amount of the additional reserves.

The Federal Reserve Act, however, places limitations on the character of paper on which loans may be obtained from the Reserve banks. For many years Reserve banks have had the power to discount only short-term self-liquidating commercial paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial industrial and agricultural transactions, and to make advances to member banks on their promissory notes backed by paper eligible for discount or purchase or by United States Government obligations. They were not authorized to make advances on a wide range of other assets

which made up an important part of the total earning assets of banks. These included real estate loans, securities other than those of the United States Government, and loans to business men which did not meet the requirements of the narrowly-defined eligible commercial paper.

As a consequence of many developments in our financial organization, paper which qualified for borrowing from the Reserve banks has constituted a constantly decreasing proportion of the total assets of member banks ever since the System was established. In 1929 it was only about twelve percent of total loans and investments of such banks, and in 1934 it was but eight percent.

In these circumstances banks were dependent for help from the Reserve banks upon their eligible paper and Government obligations. In 1931 and 1932 when the great liquidation occurred, many banks with assets which were good but technically ineligible for borrowing at Reserve banks, were obliged either to dump them on a falling market, suffer severe loss and contribute to the deflation in values or to close their doors.

The new banking act corrects this situation. It authorizes the Reserve banks to make advances to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank, at a rate of interest at least one-half of one percent above the

highest discount rate in effect at the particular Reserve bank.

This amendment modifies and makes permanent the emergency legislation which it was necessary to pass in 1932 after many banks closed in order to meet a critical situation.

Currency issued by Reserve banks

Another phase of the activity of the Reserve banks is the issuance of Federal Reserve notes, which are the paper money put out by the Reserve bank under the provisions of the act for supplying the country an elastic currency.

By elastic currency we mean currency whose volume can be readily increased or decreased according to the public demand for it. For example, during the Christmas season we all need extra money for shopping. On holidays such as the Fourth of July and Labor Day, people get extra pocket cash from their banks for trips and other celebrations. On such occasions, the public expects to go to the banks and draw more cash than usual against deposit balances. On the other hand, shop keepers and others who receive cash for what they sell expect to deposit their extra cash in the banks.

Federal Reserve notes are obligations of the United States and are secured by specific collateral pledged by the issuing bank. The bank is required to keep reserves in gold certificates at least equal to forty percent of the notes in actual circulation. The Federal Reserve banks, however, do not supply the entire currency of the country. The

Government issues silver dollars, minor coin and some paper money and, until July of this year, the national banks continued to have the privilege of issuing national bank notes. The larger part of money in circulation, however, consists of Federal Reserve notes.

A bank that has satisfactory assets can always secure all the currency that it needs. If a customer wants more cash than the bank has in its vaults, such a bank can readily obtain Federal Reserve notes at its Reserve bank. It can borrow and take the proceeds in notes or it can draw against its account and restore the account to the required level by borrowing. When customers deposit more currency at a bank than it requires, the bank sends this cash over to the Reserve bank to be added to its reserve account.

The function of supplying elastic currency is important but it is not as vital a factor as the lending power of banks because currency does not play a major role in present-day business transactions. About ninety percent of our business is conducted by the use of checks with the use of no currency at all. Currency is used by the public as pocket cash for such transactions as retail purchases, gasoline for automobiles, car fares and, by employers, for pay rolls. These account for only about ten percent of the total transactions in the country. Of course, there are fluctuations in the demand for currency which appear regularly such as on pay days, during the period of Christmas shopping, and near holidays. The machinery provided by the Federal Reserve Act meets these needs completely.

The currency-issuing function is by many viewed as the most important function of the Federal Reserve System. This is for the reason that it was currency shortage that appeared to have caused our panics in pre-Reserve days. Also our confidence in the banks depends on whether we can get cash whenever we want it. A system which provides for special institutions to hold bank reserves and to supply currency whenever needed is indispensable.

Other activities of Reserve banks

The work of the Reserve banks in holding the banking reserves of the country, in making loans to member banks, and in supplying currency when needed is their principal contribution to our banking system. They have, however, other important functions which facilitate the smoother working of our financial machinery.

The Reserve banks have greatly simplified the procedure whereby banks collect checks they receive which are drawn against other banks. This has been very useful to business men because it has permitted more prompt and cheaper settlement of many business transactions. The Reserve banks in effect act as a nation-wide clearing house. Banks merely send the checks against other banks to the Reserve bank of their district. Checks on banks in the district are cleared on the books of the Reserve bank and those on banks in other districts are cleared through the other Reserve banks. The Reserve banks perform similar services in connection with other credit items such as collection of notes, drafts, bonds and coupons, and the acceptance of exchange drafts.

Machinery has also been set up for prompt payment of funds from one part of the country to another without actual movement of currency. The System maintains a fund in Washington called the Gold Settlement Fund established by deposits of the twelve Federal Reserve banks. Transfers from one district to another are made daily by adjusting the accounts of the various Reserve banks.

The Federal Reserve System has centralized the work of the fiscal agencies of the United States Government. The Reserve banks act as fiscal agents in connection with the issue and retirement of Government debt and in administering deposit accounts of the Government in the Reserve banks.

Central control of credit policy

I wish to turn now from this discussion of the functions which the Federal Reserve banks perform for the local banks to consider how these activities tie in with the general responsibility of the System, through its Board of Governors, for the nation's credit policy.

When the Federal Reserve System was established it was realized that for certain activities, particularly those related to local banking conditions, a regional organization would be necessary. Only in this way could the System be organized for understanding local bank needs in a country as large as the United States where economic conditions vary so much from one section to another. The System was planned to take account of the fact that the directors of these regional banks would have the intimate knowledge of business developments

in agriculture, commerce and industry in their district and of any special credit needs and problems. The principle was also established by the original Federal Reserve Act that the Reserve banks have final responsibility in their dealings with member banks under the authority given them by the Federal Reserve Act and the regulations of the Board.

It was also realized that the credit policy of the different Federal Reserve banks must be coordinated so that conditions in one district would not be harmful to those in another. More than that, there should be a credit policy for the country as a whole which would take account of general business and credit conditions. This is the work of the Board of Governors of the Federal Reserve System, which is the central organization located in Washington. It is aided by other organizations which work closely with it, the Federal Advisory Council and the Federal Open Market Committee.

Board of Governors

The most important duties of the Board of Governors in Washington relate to the broad credit policy for the country as a whole and are sometimes spoken of as its power to influence the volume and cost of credit. Experience has indicated that powers of the Board which affect the expansion and contraction of the general supply of credit are of vital importance to the country, since the volume of credit is a factor in determining the course of business, and proper changes in the cost and volume of credit may exert an influence toward moderating excessive expansion or contraction of business, or, in other words may

reduce the danger of inflation and deflation.

The Board's instruments for influencing the volume of credit are its power to change discount rates and reserve requirements, and through its majority of members on the Federal Open Market Committee, to determine open-market policies.

Discount rates

Discount rates are the rates charged by the Federal Reserve banks on loans to member banks. These rates determine the cost of borrowing by member banks and consequently affect the cost at which the public can borrow from these banks. Indirectly they affect other rates in the money market. Under the Federal Reserve Act changes in discount rates made by the various Federal Reserve banks are subject to review and determination by the Board of Governors. This gives the Board final responsibility on the discount rates so that the cost of borrowing in the different sections of the country may be kept consistent with general credit conditions for the country as a whole.

The new banking act strengthens the Board's power to control these rates by making the further provision that discount rates must be submitted to the Board of Governors every fourteen days. This establishes as a matter of law the requirement that the discount rate policy shall be reviewed at least every two weeks.

Reserve requirements

The Board of Governors also has the power to change the reserve requirements of member banks. The volume of credit which any member

bank may extend is limited by the amount of reserves which are required by law to be maintained against its deposit liabilities. An increase in the reserve requirements reduces and a decrease increases the potential volume of member bank credit. Consequently the power to change reserve requirements gives the Board an important means of controlling the general volume of credit. This power was originally given the Federal Reserve Board in emergency legislation but the new act clarifies it. Under the old law changes could be made only in the event of an emergency arising out of credit expansion and then only with the approval of the President of the United States. Under the new act changes can be made to prevent injurious credit expansion or contraction, provided that reserve requirements may not be reduced below the present requirements specified in the law nor increased to more than twice the amount of these legal requirements.

Open-market operations

The third important means of control over the supply of credit are the so-called open-market operations, responsibility for which under the new banking act will be vested in a new Federal Open Market Committee. This committee will consist of the seven members of the Board of Governors and five representatives of the Reserve banks selected by the Reserve banks in different regions.

Open-market operations consist of the purchase and sale by Reserve banks of certain classes of securities, chiefly Government obligations. These operations have the effect of increasing or decreasing the supply of credit available in the market. By selling securities the Reserve banks withdraw funds from the market and there

is a decrease in the supply of credit. Through a purchase of securities a Reserve bank puts funds into the market, thus tending to ease credit conditions.

Purchases and sales of securities by the Reserve banks were unimportant in the early days of the System. It was not until 1922 that they were large enough to affect the money market. At that time it became necessary to take steps to coordinate purchases and sales so that credit conditions for the country as a whole would not be adversely affected. Gradually these purchases and sales have become one of the most important means whereby the System can take the initiative in influencing credit conditions.

The responsibility for determining what security transactions should be undertaken and the authority for enforcing a program were not clearly defined by law until the new banking act. At the time this act was passed an Open Market Committee consisting of representatives of the twelve Reserve banks was authorized to propose purchases and sales. Its proposals were then submitted to the Federal Reserve Board which had the authority to approve or disapprove but not to initiate a policy. Even after purchases or sales by the Reserve banks had been agreed upon by the committee and the Board, the boards of directors of the twelve Federal Reserve banks throughout the country could frustrate the policy by refusing to participate in its execution.

The new act clearly places responsibility for determining open-market transactions on the new Open Market Committee and directs the

Reserve banks to carry out the transactions determined by this committee. This is one of the most important changes in the Federal Reserve System which the new act introduces.

Other work of the Board

The Board of Governors has a variety of other duties which tie in with its general responsibility for supervision of the System. These include the examination of Reserve banks, passing on applications of State banks and trust companies for membership in the System, obtaining condition reports from State member banks, administration of those provisions of the Clayton Anti-trust act which relate to interlocking bank directorates, regulation of the maximum rate of interest to be paid by member banks on time and savings deposits, regulations under the Security and Exchange Act governing the margin requirements for loans on securities listed on the stock exchanges, and maintenance and operation of the Gold Settlement Fund.

In carrying out its responsibilities it is essential that the Board keep in touch with banking developments in different parts of the country. In the organization of the System provision was made for regular contacts between the Board and the various Federal Reserve districts. One of the class C directors at each Reserve bank, designated by law as the Federal Reserve agent, represents the Board at the bank and maintains an office of the Board at the bank. The Federal Advisory Council, also provided by law, is made up of representatives of each Federal Reserve district and meets at least four

times a year in Washington to confer with the Board and to make recommendations. The Board also has meetings in Washington with the chief executive officers of the Federal Reserve banks and with the Federal Reserve agents.

Information bearing on credit policy

It is also a part of the System's problem to watch indicators of credit trends and to develop a better general understanding of the facts bearing upon credit policy. The System has pursued a policy of collecting information bearing on banking conditions throughout the country and on production, employment, trade and prices. In a monthly publication, the Federal Reserve Bulletin, and in its Annual Report, the Board has undertaken to give to the public a comprehensive view of current banking and financial developments at home and abroad and also to furnish detailed information on conditions of banks throughout the country and on the business situation. Each of the Federal Reserve banks also publishes a monthly review of the business and banking conditions in its district.

There is no central bank in the world which makes available such exhaustive information on domestic banking and business developments and on the formulation of its credit policy as that which is published by the Federal Reserve System.

The new act will still further increase the publicity given to the System's operations. It provides that records shall be kept of

the actions of the Federal Open Market Committee and of the Board on all questions of policy. This information, together with the underlying reasons, is to be published in the Annual Reports of the Board. The public will thus be given an opportunity to study the reasons for the Board's decisions in greater detail and will be helped to cooperate with the System in pursuing a broad credit policy which meets the interests of the nation.

Loans to industrial and commercial businesses

I want to take a few minutes now to tell you about recent special work of the Federal Reserve banks. I refer to operations under an amendment to the Federal Reserve Act approved June 19, 1934 which authorizes the Federal Reserve banks to make direct loans to industry and to guarantee for banks certain types of loans to business men which the banks might not otherwise be willing to make. The purpose of these provisions is to give both bankers and business men some added assurance in making commitments during a difficult period when they tend to feel unduly conservative.

Anyone in an established industrial or commercial business who wants a loan for working capital purposes which is reasonable and sound and has a maturity of not more than five years should now be able to get such a loan from his local bank. This applies to both member and nonmember banks. Furthermore, if the local bank cannot accommodate the borrower, he may be able to borrow from the Reserve bank itself. No business man who has assets of value to offer as security need hesitate

because they do not conform to the types of collateral usually required by banks.

The local banks are given special assurance in making these loans through the privileged status which they enjoy at the Reserve banks. The loans are eligible as a basis for borrowing at the Reserve banks. More than that, if the bank wants to dispose of a loan it can procure a commitment from the Reserve bank to take it off its hands and the bank is guaranteed against loss up to 80 percent of the loan.

As of October 2, 1935 the Federal Reserve Bank of Chicago had given final approval to 73 loans aggregating \$4,826,000. This amount included \$2,582,000 loaned by the Reserve bank direct to industrial and commercial borrowers because local credit was not available on reasonable terms. There were also \$519,000 of loans for which commercial banks had secured a commitment by the Chicago Reserve Bank to take over all or part of the loan. These are loans to business which for the most part would not have been made without the special guarantee of the Reserve bank.

Finally, therefore, let me say that I feel that the Federal Reserve System as changed by the Banking Act of 1935 is in a position to be more useful than ever before because it can give more help to the local banks in meeting the credit needs of their communities. It must be recognized, however, that if the System is to achieve as much success as we all hope, it will need more than mere legal provisions.

It must depend upon the cooperation of business men, bankers, and the general public. I believe that this cooperation will depend much on the extent to which we in the System are able to encourage the public to know and understand the principles under which it operates. For that reason I appreciate the opportunity I have had today of making what contribution I can to such a general objective.