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"WHAT IS THE FEDERAL RESERVE SYSTEM?"

The Federal Reserve System, as its name implies, is organized under federal law and is national in its scope. It has three main parts. One of these comprises about 6,400 local banks in all parts of the country that are members of the Federal Reserve System. The next comprises the twelve Federal Reserve Banks situated in twelve different centers and serving the twelve Federal Reserve districts into which the country is divided. The third is the Board of Governors of the Federal Reserve System - a governmental body in Washington, D. C., consisting of seven members appointed by the President, with the approval of the Senate.

Not all banks are members of the System by any means; out of some 16,000 banks, only 6,400 or so, as I said, are members. The members include most of the larger banks of the country however. The capital stock of the twelve Federal Reserve Banks is owned by the 6,400 member banks, each member bank owning stock in proportion to its own capital and surplus. But although the Federal Reserve Banks may therefore be said to be privately owned, they are not subject to control by their owners as privately operated corporations are. Their stockholders, the member banks, do not vote their stock, they receive dividends limited to 6 percent, and the surplus in the event of liquidation belongs to the government. The member banks elect six of the nine directors, but only three of these six are bankers; the other three must be actively engaged in commerce, agriculture, or some other industrial pursuit. The remaining three directors are appointed by the Board of Governors in Washington. The powers of the Federal Reserve Banks are limited by the law and their operations are subject to regulation by the Board of Governors.

The basic purpose of the Federal Reserve System has to do with the reserves of banks. The word reserves might be taken to refer to funds which banks keep locked up some where and only use when emergencies arise; but in fact the reserves of banks are constantly and actively used. In the course of business as transacted by the American people, thousands and thousands of bank checks are written every day, and these checks for the most part are never cashed but transfer credit on the books of banks from one customer to another. For example, your tuition here at the college is paid mainly by check, I imagine, and the checks are in reality orders on the authority of which credit is transferred from the bank account of your parents to the bank account of the college. Reserve accounts are the medium through which these transfers of credit from bank to bank are made. The bank in which your family keeps its checking account and the bank in which the college keeps its account may both maintain reserves with the Federal Reserve Bank, and the checks given in payment of your tuition, when they are cleared, effect a transfer from the reserve account of your parents' bank to the reserve account of the bank the college deals with. Because checks are constantly being used, banks are as a result constantly losing and gaining reserves. The process is like that by which water may constantly be flowing into and out of a reservoir and maintaining its level with but little change. On the other hand, it is quite possible that a bank may either lose substantial reserves or gain them, depending on whether its customers, at any given time, are checking out more than they are depositing or depositing more than they are checking out.

In order to avoid a serious loss of reserves, a bank has various courses of action open to it, one of the most important of which is to stop making new loans and to collect on those it has made. A bank may not always find this the best course, though; it may be better for it to sell some of the securities it owns or to borrow, especially if by doing so it can avoid hardship to its customers. It is therefore extremely important not only that bankers have a place to keep their reserve accounts, but also that they have means of replenishing those accounts when necessary.

Prior to the establishment of the twelve Federal Reserve Banks in 1914 an outstanding weakness of our banking system was the lack of satisfactory facilities for reserves. The panic of 1907 - which played a large part in bringing about the establishment of the Federal Reserve Banks - was largely due to this condition. At that time each country national bank was required to keep part of its reserves as cash on hand and part on deposit in correspondent banks in larger centers.

Under this arrangement, the reserve needs of banks all over the country converged on a relatively few large banks in the money centers, but these banks were not always prepared to meet the full responsibilities of such a situation. They were not primarily reserve banks, but banks serving their own communities and operated for profit. It was not to be expected, even if it had been legal, that they would abandon the purposes for which they were organized and voluntarily play the role which the Federal Reserve Banks now play. As things stood, therefore, banks in general had no certain means of augmenting their reserves except when conditions were easy. The Federal Reserve Banks, however, not being organized or operated for profit, having no local interests other than those of their member banks and of the public, and having been legally endowed with specific powers for the purpose, are under no such limitation. They are expected to do what the large privately operated banks could not be expected to do, that is, maintain themselves in readiness at all times to furnish funds with which member banks may replenish their reserves.

These funds for the replenishment of reserves may be furnished either by lending to member banks or by purchasing securities. Ordinarily bankers are very reluctant to borrow and when they need funds they prefer to raise them by selling some of their investment securities rather than by borrowing.

The reserve accounts maintained by member banks with the Reserve Banks are actively used, as already explained, for the clearance of checks written by bank customers in one part of the country and received by bank customers in another part. They are also the means by which most money goes into circulation, for when banks need more currency and coin in order to meet the requests of their customers for cash, they draw what they need from the Federal Reserve Bank and have it charged to their reserve accounts. On the other hand, when they accumulate more cash than they need, they deposit the surplus in the Federal Reserve Banks and have it credited to their accounts. Through the facilities offered by the twelve Federal Reserve Banks, therefore, the amount of money in circulation automatically expands and contracts in response to the collective needs of the people. Before the establishment of the Federal Reserve Banks, there were times when the demand for currency could not be met promptly and adequately and severe disturbances to business resulted. Such shortages of currency do not occur now.

It is important to remember, however, that bank checks are used for a much larger volume of payments than currency is. The ordinary, incidental payments which we make in currency and coin amount to only about a tenth of the total payments made, while about nine tenths are made by check. One of the important means by which the use of checks is facilitated is the Interdistrict Settlement Fund, operated by the Board in Washington. Through this fund sums running into millions of dollars are transferred daily by wire between the Federal Reserve Banks, for their own account, for the account of the United States Treasury, and for the account of local banks. It is doubtful if any country in the world has a more efficient and comprehensive means of settling country-wide payments. In facilitating the use of checks, as in furnishing currency, the Federal Reserve Banks perform a function of the utmost importance and benefit even to the great mass of people who never enter or see a Federal Reserve Bank.

Another important thing is that the Federal Reserve Banks act as fiscal agents of the United States. The duties which the Federal Reserve Banks perform as fiscal agents always have been extremely important to the government, and in recent years they have come to absorb a larger and larger part of the attention and time of the Federal Reserve Bank personnel. In addition to servicing the public debt, providing currency, and acting as depositary of the United States Treasury, the Federal Reserve Banks perform a large amount of work for various government agencies, such as the Reconstruction Finance Corporation, the Federal Home Loan Banks, the Federal Home Owners' Loan Corporation, the Farm Credit Administration, the Public Works Administration, the War Department, Veterans Administration and an additional number of government agencies and bureaus. In the year 1936 the Federal Reserve Banks handled about 60,000,000 Treasury checks and over 87,000,000 work relief checks. This was an average of about 20,000 government checks a day at each of the twelve Federal Reserve Banks.

The transactions involved in servicing government securities are of great importance; they comprise receiving applications for new issues, delivery of securities to subscribers, exchanging securities of different denominations, meeting maturities, and paying interest. During the year 1936 the Federal Reserve Banks delivered to subscribers almost 900,000 bonds, notes, certificates and bills sold by the Treasury, or other government agencies and redeemed over 800,000 different government obligations. They exchanged almost 2,000,000 obligations for the convenience of their holders and paid almost 19,000,000 interest coupons. Last year they prepared and mailed over 25,000,000 bonus bonds to veterans, or practically the entire issue.

In addition to the services I have described, namely, holding the reserves of the United States banking system, making loans to member banks, furnishing an elastic currency which automatically increases or decreases according to the public demand, facilitating the clearance of checks and the inter-regional transfer of funds, acting as fiscal agents of the government in connection with the issue and retirement of government securities, the Federal Reserve System makes it possible to influence national credit conditions. This can be done through discounts, through open market operations, through direct action, through changes in reserve requirements, and through margin requirements.

Discounts

Rates of discount, under the terms of the Federal Reserve Act, must be established from time to time by each Federal Reserve Bank, subject to review and determination by the Board of Governors of the Federal Reserve System. The Banking Act of 1935 added the requirement that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board." This does not require that such rates must be changed every time, but they must be regularly and frequently reviewed.

At the time of the passage of the Federal Reserve Act it was the expectation that banks would borrow at the Federal Reserve Banks as a regular thing, since the rate they could charge their customers would be higher than the rate they would have to pay. Assuming that bankers were willing to borrow, the rate of discount would of course influence them very positively; they would be encouraged to borrow by low rates and deterred from borrowing by high rates. But bankers are reluctant to borrow under any circumstances and as a rule will do so only when they must in order to maintain their reserves. The fact that the rate is high or low is not sufficient of itself to determine what they will do; and for this reason the rate of discount is an effective means of influencing credit only under certain conditions.

Open Market Operations

Open market operations consist of the purchase and sale by the Reserve Banks of certain classes of securities, mainly government obligations, for the purpose of increasing or decreasing the supply of credit available in the money market as a whole. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available. The reason for this is that in the process of paying for the securities that are sold the reserves of member banks become diminished, because every payment means a debit sooner or later to some member bank's reserve account. And as a member bank's reserves decline toward the legal minimum it is less able to make extensions of credit.

On the other hand, by purchasing securities the Reserve Banks place funds in the market and more credit becomes available; because the funds which are released in payment flow directly or indirectly into the reserve accounts of the member banks and enlarge them. And as their reserves expand, they are in a position to extend more and more credit.

In principle, therefore, the Reserve Banks can increase or decrease the funds available for lending by local banks, accordingly as they buy or sell securities. Of course, there are in practice many limitations on the effectiveness of open market operations, but their tendency is to enable the Federal Reserve Banks to take corrective action with respect to abnormal credit conditions on their own initiative.

The powers of the Reserve banks to buy and sell securities in the open market were granted in general terms in the original Federal Reserve Act, and at the time were not generally considered to be of very great importance. The first operations were carried on by the Federal Reserve Banks independently of one another, but it was soon found that action would have to be coordinated; otherwise the banks would be buying or selling in competition with one another and following different, and perhaps conflicting, policies. To avoid this, a committee was formed for the purpose of directing the operations. About the same time the purpose of the operations was clarified. For some time purchases had been made with the idea of providing income to meet expenses, but it was eventually realized that such an objective was in conflict with that of moderating a given condition of the money market, and must, therefore, be subordinated or even abandoned.

The Banking Act of 1933 gave specific recognition to open market operations as a System matter and established a Federal Open Market Committee of twelve members, one representing each Federal Reserve Bank, to take the place of the former non-statutory committee. At the same time the law adopted substantially the statement of purpose which had already governed open market operations. This was to the effect that they be conducted "with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made a further change by providing that the Federal Open Market Committee should comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen by the twelve Federal Reserve Banks. The law also makes the decisions of this committee obligatory upon the Federal Reserve Banks and provides that the record of the Committee's actions shall be included in the annual report of the Board submitted to Congress. Thus an activity which was barely recognized in the original Federal Reserve Act, and which was gradually developed in the process of administration of the System, has come to be emphasized in the law as one of the System's most important functions.

Direct Action

I also mentioned direct action as a means of credit control. Direct action means efforts by the Federal Reserve Banks or the Board to discourage credit policies of given member banks in given circumstances. Opportunity for it occurs on various occasions, but particularly when a member bank is being examined, and when it is seeking to rediscount some of its paper. In this sense, direct action is aimed at the correction of specific conditions in particular banks. It may also be resorted to, however, with reference to general conditions and for the purpose of enforcing general credit policy.

Power to Change Reserve Requirements

Recent legislation has also established two other new forms of general credit control which previously did not exist. The first of these is the power given the Board to change reserve requirements. This power was first given the Board in 1933, under limitations which were later removed by the Banking Act of 1935. The Board is now authorized to change the reserve requirements "in order to prevent injurious credit expansion or contraction", but it is not permitted to lower them below the original requirements nor increase them to more than twice those requirements. Under this authority the Board has now taken action twice to increase the requirements, the first increase being effective August 15, last, and the second being effective in part the first of March and in part the first of May of this year. On the basis of the excess reserves that had accumulated, almost entirely as a result of the enormous imports of gold into the United States, the possibility existed for an expansion of credit which was quite beyond the present or prospective needs of commerce, industry, and agriculture, and which might be extremely injurious. The Board by its action in reducing the amount of excess has diminished the possibility of such an injurious credit expansion.

Under the law, the Board may reduce reserve requirements from their present level to the original legal requirements - and not below - but it cannot increase them beyond the requirements which are to go into effect on May 1 of this year.

Margin Requirements

The second new form of general credit control recently authorized pertains to margin accounts and loans made for the purpose of purchasing or carrying securities. Its object is to restrict the use of credit for speculative purposes.

Pursuant to these provisions the Board has issued twin Regulations, T and U. Regulation T, following Sections 7 and 8(a) of the Securities Exchange Act of 1934, governs the extension and maintenance of credit by brokers and dealers in securities for the purpose of purchasing or carrying securities. Regulation U, following Section 7(d) of the Act, governs loans made by banks for the purpose of purchasing or carrying stocks registered on exchanges.

One of the conditions at which the original provisions of the Federal Reserve Act were aimed was the use of bank funds to finance stock market speculation. It has always been clear that the Act sought to make credit ample for commercial, industrial, and agricultural purposes without encouraging its speculative use; but the difficulty has been to make measures of control work in one field without producing corresponding but undesired results in the other. A discount rate that was advantageous to agriculture was advantageous to speculation, and a rate that was disadvantageous to speculation was disadvantageous to agriculture. This difficulty in the way of discriminating between the possible uses to which credit might be put was characteristic of attempts to reach the objective by control from the angle of supply. It appears to be obviated in the new provisions, which, as I have said, attempt to reach the objective from the angle of demand.

This power which has been given the Board to impose and relax restraints upon the demand for credit for speculative purposes is definitely selective. It is aimed at a particular use of credit and at the specific channels through which demand becomes effective. For this purpose, the powers of the Board are extended outside the Federal Reserve System to reach directly also brokers and even non-member banks. The new powers differ from those of discount, because while the latter may be exercised to discriminate against paper directly involved in speculative uses, they cannot prevent the speculative use of funds procured by the discount of paper not directly involved in speculation. The new powers also differ in effect from the power to conduct open market operations, which influence the total amount of funds but not the uses to which they can be put. The same thing is true of the power to alter reserve requirements. The power to take direct action can be used to discriminate against the speculative use of credit, but only in individual cases. The new powers with respect to margin requirements, however, are under no such limitations.

Conclusion - Limitation on Means of Credit Control

Although the five means I have discussed by which credit control may be exercised - discounts, open market operations, direct action, reserve requirements, and margin requirements - appear to be very comprehensive and powerful, it would be a mistake to convey the impression that a perfect control of credit can be effected through them. In the first place, their application cannot be mechanical nor governed by simple unvarying rules. Credit and economic relationships are extremely intricate, and the circumstances under which the need for action arises are always to some extent different and special. Let me mention a few things that complicate the task of credit control.

For one thing, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. It does not now. The majority of banks in the United States are outside the System, although it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country.

For another thing, United States Treasury activities must be taken into account. These have to do in part with the operations of the Exchange Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve large sums and intimately affect the banking and credit situation.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold from abroad - a movement that in the last three years has added four billion dollars to the reserves of member banks.

These factors, among others, necessarily limit and modify the exercise of credit control.

The Board in Washington is constantly in touch, through the Federal Reserve Banks, with the general credit conditions of the country. The Board has data supplied to it by the Federal Reserve Banks' statistical departments, and it has its own research and statistical department in Washington, which presents facts and figures constantly, so that it may know what is going on. The Board compiles and publishes information bearing on banking and credit conditions, here and abroad, and includes data on production, employment, trade, and prices. No other central banking organization in the world makes available such comprehensive information on domestic banking and business developments.

The purpose of all the services of the Federal Reserve System is to improve the business of banking. I say "improve" not because I think the business of banking is handled badly, but because in our complex, world-wide business life there are changes going on which are beyond our control and which are constantly making improvement necessary. The banking business must constantly be adapting itself to these changes, and this it cannot do without knowledge and understanding of the facts.