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THE ROLE OF THE FEDERAL RESERVE SYSTEM
IN FINANCING A WAR

If we were engaged in war it would not bring about a change in the nature of the Federal Reserve functions so much as in the conditions to which those functions apply.

As fiscal agents of the United States Treasury, the Federal Reserve banks would, of course, have to assist with the very great burden of war financing. They receive subscriptions to Government issues, allocate the issues to the subscribers, deliver the issues and receive payment. They pay interest coupons and maturing obligations and effect exchanges of issues. In time of war, when, presumably, efforts would be made to secure as wide spread a subscription to Government issues as possible, the volume of work involved would be enormous.

In connection with Government financing but not as an activity of the fiscal agency function, the Federal Reserve banks would also have to assist in the financing of the public's purchase of Government obligations.

The function of issuing currency and coin would presumably not be greatly changed by war conditions. Any increase in the volume of money in circulation would be readily effected through the utilization of existing machinery. However, since the greater part of the increased demand for means of payment in time of war would be met by the use of bank deposits transferable by check, it is not to be supposed that any very great increase in the volume of money in circulation would occur.

The services of the Federal Reserve banks in facilitating the clearance and collection of checks and the transfer of funds in general would presumably be called on to a greater degree during war time than at present. The increased volume of business incidental to war would entail an increased volume and velocity of payments, but the machinery of the Federal Reserve System is adequate to meet without strain any conceivable increase in the volume of items to be handled.

In the field of credit control also the Federal Reserve banks would presumably exercise their normal central banking functions, though possibly more actively than they have been called upon to do in recent years. With our present enormous supply of gold, with banks holding vast excess reserves, and with the ready possibility of increasing through central banking action the volume of those reserves, there is no prospect of any difficulty in providing adequate credit for war-time industrial activity. The System has available, as you know, the power to decrease reserve requirements and thereby enlarge very greatly the basis for the extension of credit. It has the power through the purchase of securities in the open market to increase that reserve base still more. It also has the power through discount to enlarge and replenish the reserves of individual banks to the full extent of any conceivable demand.

The exact conditions under which the System would be called on to exercise these powers would depend, of course, upon the nature and extent of the war in which we were engaged and upon our relations with our allies. I think that I cannot do better than describe to you informally the present structure and functions of the Federal Reserve System and then indicate very briefly the use to which they would be put in war time.

The Federal Reserve System was originally organized for the purpose of decentralizing the currency and credit supply of the country. This being a very large country, we deviated somewhat from the central bank idea in Europe. European countries have in most cases one central bank with branches, but here, because of the area we have to cover and because of the variety of economic conditions in the various sections of our country - agricultural, industrial, commercial, financial - we have 12 autonomous Federal Reserve Banks located in 12 different districts. The districts, as you will remember, are Boston, New York, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, St. Louis, Minneapolis, Kansas City, Dallas, and San Francisco. If the area is large there are branches in that area. For example, in the San Francisco district, which covers a number of states, there are 5 branches. On the other hand, in the Philadelphia district, which has a small area, there is no branch. New York has a branch in Buffalo. Chicago has a branch in Detroit. Altogether there are 25 branches. The branches enable the banks to serve all parts of their districts promptly. Then, to meet special currency demands, 2 agencies were organized, one in Savannah and the other in Havana, Cuba. Altogether, therefore, we have 12 Federal Reserve Banks, 25 branches, and 2 agencies.

The Federal Reserve Act provided that there should be a board, known at that time as the Federal Reserve Board, to be appointed by the President of the United States, with the advice and the consent of the United States Senate. This board was to have supervisory and coordinating power over the activities of the 12 Federal Reserve Banks, the 25 branches, and the 2 agencies. In process of time the Federal Reserve Board was given additional power in the field of monetary control.

With the Banking Act of 1935 greater power to influence credit conditions was given to the Board in Washington, whose name was then changed to "Board of Governors of the Federal Reserve System". On that board are 7 members, appointed for a period of 14 years, to give them independence of thought and action. The Federal Reserve Banks are not owned by the Government. They are owned by the 6300 banks, approximately, which are members of the Federal Reserve System. There are altogether about 16,000 banks in the country. Less than half, therefore, are members of the System. Yet the 6300 which are members hold about three-fourths of the total assets of all the banks in the country. In other words, the member banks include nearly all the larger banks of the country. Membership in the Federal Reserve System is obligatory on all national banks. Each such bank purchases stock in the Federal Reserve Bank of its district, equal to 3% of its own capital and surplus. There are also about 1,000 state member banks that have applied for membership and been admitted to the System.

They too have to purchase stock of the Federal Reserve Bank of their district equal to 3% of their capital and surplus. Each member bank subscribes for 6%, but only 3% has been called for. The other 3% could be called for if necessary. The member banks receive dividends of 6% per annum cumulative on this stock.

Now there are, as I told you, about 6,300 member banks, about 5,300 of which are national banks and required to be members. State banks which become members obtain their charters from the state authorities. In each state we have a state bank supervisor, so that makes 48 banking systems, one in each state. Then we have the Comptroller of the Currency, supervising the national banking system; that's 49. There is also the Federal Deposit Insurance Corporation, which came into existence not so long ago. It insures the deposits of its member banks. Membership in the Federal Deposit Insurance Corporation is not to be confused with membership in the Federal Reserve System. Every bank that is a member of the Federal Reserve System ipso facto becomes a member of the Federal Deposit Insurance Corporation. But there are a great many state banks which are not members of the Federal Reserve System but are members of the Federal Deposit Insurance Corporation. Then there is also the bank supervisory authority of the Federal Reserve System, which supervises national banks in addition to the supervision they receive from the Comptroller of the Currency, and supervises state member banks in addition to their supervision by state authority. The Federal Deposit Insurance Corporation supervises also those state banks whose deposits are insured.

In addition, there is the Reconstruction Finance Corporation. It is not primarily supervisory, but is an organization that lends to banks. It owns preferred stock in many banks and it has power to examine those banks that it has stock in.

There, briefly sketched, is your banking picture - over 16,000 banks scattered all over the country, some national banks and some state banks; some mutual savings banks, others commercial, others trust companies. Then we have, in addition to that, all of these supervising agencies, the states, the Comptroller, the Federal Deposit Insurance Corporation, the Federal Reserve System, and the Reconstruction Finance Corporation. You can see that that is a difficult situation. It has just grown up like "Topsy". It will take some while to reconstruct it because it isn't as though you had a clean sheet of paper to write on and say "This is the way it ought to be." You just can't do that.

Even though we have the Federal Reserve System, banks continue to have correspondent relations with other banks as well. That means, for example, a bank in Milwaukee will keep part of its reserves with a bank in Chicago. A bank in Chicago will deposit part of its reserves with a bank in New York.

The reason for the correspondent relationship is that the smaller banks get certain services from the larger banks. For example, they get advice on their portfolio of securities, or the New York bank may invest some of their funds for them.

There is still another factor that came into the picture recently, the Securities and Exchange Commission. We are discussing with them the possibility of their modifying their regulations somewhat, and they have already done so to an extent. We are also suggesting to the Comptroller of the Currency that he modify certain of his regulations. Of course it is always presumptuous to suggest something like that to the other fellow, because he can turn around and say, "You have enough to do in your own backyard without coming over here and telling us what to do." We are suggesting that the Comptroller modify his regulations in respect to the kind of securities that can be purchased by member banks. When he says only certain securities can be purchased for the portfolio of the national bank that at once becomes our regulation and applies also to State member banks. If we can we would like to modify those regulations somewhat so as to provide a larger base upon which the banker can choose the kind of securities that he wishes to purchase for his portfolio. It seems to us that this would make capital more easily available. Today if you float an issue you have difficulty getting it on the market. It may be a very sound issue, but the bank can't buy it because it is not marketable, it hasn't the volume, it is not registered, and it is not in the manual. Therefore, the banks are obstructed from investing as they otherwise might and that makes it difficult for the smaller fellow to get his capital needs.

We are also discussing adoption of a uniform examination policy. You may have read something of that in the newspapers this morning. The idea is to get all of the supervising agencies to adopt a more uniform policy of examination. Each of these agencies I have mentioned has power to examine banks, though in practice only one authority goes in to examine a bank. The Comptroller examines the national banks and that is all. We receive a copy of his examination report and pay him for it. In theory we too can go into the national bank to examine it but we don't do it. The state member banks are examined by us and the state banks that are not members of the Federal Reserve System but are members of the Federal Deposit Insurance Corporation are examined by the Federal Deposit Insurance Corporation. Whenever one agency goes in to examine, the other agencies stay out, and they merely get a copy of the examination report. Therefore, there isn't the duplication of examination that might be supposed, but there may be differences in the policy of examination. What we are trying to do now is to get all of these, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the Federal Reserve System, and eventually the bank supervisory agencies of the forty-eight states, to agree upon a more uniform policy of examination, particularly on the question of securities and also on the question of a classification of some of the assets under the column headed "slow". Many loans are made for a longer period than 30, 60, or 90 days, which is the average commercial loan. Many loans are made for 2, 3, 4, or 5 years, and the moment you classify them under the "slow" heading of course it looks like criticism, when, as a matter of fact, the loans may be sound. In order to have a real expansion in industry, commerce, or agriculture one must obtain money for a longer period of time than 30, 60, or 90 days. These loans ought to stand upon their own merits of soundness rather than upon the time element.

With that in mind, the Banking Act of 1935 provided that any sound assets, regardless of maturity or classification, might be discounted by a member bank at its Federal Reserve Bank.

This provided a broader base upon which the Federal Reserve Banks can extend credit to the member banks of the country, so that today, in place of being limited to what was originally designated as eligible paper for discounting purposes, a member bank can borrow on any kind of sound paper with 30, 60, or 90 day maturities or 1 year or 5 or 10 year maturities. Such borrowings must be for 4 months or less and bear a rate of interest one-half of 1% higher than the discount rate of that district. You get a loan, for example, from a bank and the bank needs cash and so it takes your paper over to the Federal Reserve bank, if it is for industrial, commercial or agricultural purposes and it discounts that paper at from 1% to 2%. In other words, if it had 4% or 5% interest, it pays 1% to 2%; it collects the 4% or 5% but it pays part to the Federal Reserve bank. The Federal Reserve bank holds that paper for that bank and gives credit to that bank on the account. The Federal Reserve Banks are lenders of last resort. Their lending powers are practically inexhaustible.

However, banks as a usual thing don't like to borrow from the Federal Reserve bank or anybody else because they don't like to show in their statement that they owe any money to anybody. Therefore, there is very little occasion for the Federal Reserve banks to use their discount powers. When the Federal Reserve bank came into existence in 1914 this was considered to be not only an important power but one to be most frequently exercised. It was presumed that the banks would borrow from the Federal Reserve and we could either supply them with credit or refuse. As a matter of fact, even though that was one of the principal purposes, to discount and lend to banks, the banks have refrained from coming to the Federal Reserve banks except in times of emergency. It would be desirable if we could get bankers to take the point of view that borrowing from the Federal Reserve Bank is a normal and proper procedure when it enables them to meet the legitimate requirements of their customers, but I don't know how we can. They seem to feel that borrowing is always objectionable.

For reserve purposes, there are three different classifications of banks. First are the central reserve city banks. The banks in New York and Chicago are called central reserve city banks, and their rate of requirement of reserves is higher than is the rate for the banks in reserve cities. There are about sixty reserve cities, excluding New York and Chicago. Then banks in all other places are called "country" banks, even though they may be in relatively large cities. The rates of required reserves are different for the banks of those three different classifications, the central reserve city banks, the reserve banks, and the country banks. That is, the rate on demand deposits is different. The rate on time deposits is the same in all three classifications.

The requirements as stated in the Federal Reserve Act are 13% for central reserve cities on demand deposits; 10% for reserve cities; 7% for country banks; and 3% on time deposits. The Board was given power to double those requirements or raise them to any figure in between. While the Board could double the original requirements, it can't go below the 13, 10 and 7. It could go up to twice the amount and then come back to this amount but it couldn't go below that.

The present reserve requirements on demand deposits are for the central reserve city banks 22-3/4%; for reserve city banks, 17-1/2%; for country banks, 12%; and on all time deposits for all classes of banks, 5%. I will also give you the figure for excess reserves. They enter into this picture very definitely; they are the reserves that the member banks have in the Federal Reserve bank in excess of what they are required to have by law. The required reserve is frozen and can't be taken out. The excess reserve is the base upon which we can extend credit in this country. It is lying in the Federal Reserve banks idly without paying a penny of interest to the member banks, but when the member banks begin to lend, they lend on it.

Now in war time, as I said at the outset, the regular services of the Federal Reserve banks will be employed, but I find it difficult to say how they will be employed without knowing what the war is. There are certain to be, however, two main lines of credit required: one for the Government and one for industry.

With respect to Government financing, the Federal Reserve banks would have a double role to play: first, as fiscal agents of the Treasury in handling subscriptions to securities, receipt of payment therefor, and delivery; and second, as a central banking organization, assisting the banks of the country in financing flotations.

With respect to the financing of business, the task of providing ample credit, if conditions were anything like those at present, would not be difficult. The banks of the country have abundant excess reserves. Those reserves could be replenished by purchases of securities in the open market on the part of the Federal Reserve banks. They could be further replenished by rediscount of paper by member banks. They could still further be replenished by a reduction of reserve requirements. The difficulty would not be to supply sufficient credit, but to avoid supplying too much. The least of our worries, it seems to me, if we were engaged in war, would be the adequacy of our credit facilities.