The Federal Reserve System

As established by the Federal Reserve Act, the Federal Reserve System comprises five parts. These parts are:

- The Federal Reserve Banks
- The Board of Governors
- The Federal Open Market Committee
- The Member Banks
- The Federal Advisory Council

The twelve Federal Reserve Banks are institutions set up under authority of Congress for the performance of monetary functions. While they have a corporate form of organization, their functions are of a governmental nature, and they are not operated for profit but in the public interest. Each has a board of nine directors, three of whom are bankers, three of whom are actively engaged in commerce, agriculture, or some other commercial pursuit, and three of whom, selected by the Board of Governors in Washington, are representative of the public interest.

The stock of each Federal Reserve Bank is owned by the member banks of its district. Dividends limited to six per cent per annum cumulative are paid thereon. The income of the Federal Reserve Banks is derived from their loans and their holdings of securities and other investment obligations, the amount of which is determined by public policy and other considerations apart from profits. At present the total assets of the twelve Federal Reserve Banks amount to about twenty-one billion dollars, of which only about two and a half billion are earning assets, the balance consisting chiefly of cash and gold certificate reserves. Earning assets are only about 12 per cent of the total. At times in the past the Federal Reserve Banks have had a much higher percentage of earning assets, but in recent years the situation has been more nearly what it is at present. The income of the Federal Reserve Banks is ordinarily sufficient to cover their expenses, meet their dividend requirements, and provide additions to surplus. The surplus in the event of liquidation belongs to the United States Government.

The Federal Reserve Banks perform most of their services as regional institutions, particularly in providing currency for circulation and in facilitating the clearance and collection of checks. They also act as fiscal agents of the United States Government. They carry the checking accounts of the United States Government and do the servicing of the public debt. This includes handling subscriptions for issues of Government securities, paying interest, redeeming matured issues, and making conversions.

The primary function of the Federal Reserve Banks, however, is to hold bank reserves and to make additional reserve funds available, when necessary, by the extension of Federal Reserve Bank credit. I shall speak of this later.
The activities of the twelve Federal Reserve Banks are coordinated by the Board of Governors of the Federal Reserve System. The Board consists of seven members appointed by the President of the United States and approved by the Senate. It has important regulatory powers as the administrative head of the whole System. It is a governmental body, but its expenses are met by assessment upon the twelve Federal Reserve Banks.

The Federal Open Market Committee comprises the members of the Board and five representatives chosen by the Federal Reserve Banks as follows: one by Boston and New York, one by Philadelphia and Cleveland, one by Chicago and St. Louis, one by Richmond, Atlanta, and Dallas, and one by Minneapolis, Kansas City and San Francisco. Its function is to direct the purchases and sales of investment securities and other obligations made by the Federal Reserve Banks for the purpose of enlarging or reducing, as the case may be, the volume of member bank reserve funds.

The member banks of the Federal Reserve System supply the capital stock of the Federal Reserve Banks and elect six of the nine directors of each Federal Reserve Bank. Member banks are now about 6,400 in number. About 5,200 are National banks and about 1,200 are State banks. Member banks, although less than half the total number of banks in the country, do from 80 to 85 per cent of the banking business.

The Federal Advisory Council consists of twelve members, one chosen by each Federal Reserve Bank. It consults with the Board of Governors and submits recommendations to the Board from time to time on current banking and monetary problems.

So far what I have said tells what parts the System is made up of—it describes its structure—but gives little idea of the System's purpose or how it functions. The primary purpose of the System is to exercise a directive influence, so far as it is possible, over the cost and availability of money in a manner that will promote economic stability.

I use the word money in a broad sense to include whatever serves for the purpose of effecting monetary payments. In this broad sense there are two kinds of money. The first is paper currency and coin. The second is bank deposits.

From the standpoint of the individual these two kinds of money are practically interchangeable. If a person has currency, he can take it to his bank and receive deposit credit in exchange for it. If he had deposit credit he can write a check and get currency. This process of interchanging the two kinds of money makes up a substantial part of the routine activity of a bank.

Our monetary system is so flexible that people who deal with banks are wholly free to determine for themselves whether they want to make a given payment or purchase with currency or with a check. If they are paying a bill by mail, or if they want a record of the payment, or if the amount is relatively large, they will usually choose to write a check. But for small miscellaneous purchases, they will use currency and coin.

The function of supplying currency and coin did not always work as smoothly, automatically and dependably as it does now. Before
establishment of the Federal Reserve System there were times when the
demands of the public for currency overtaxed the ability of the banking
system to supply it. There were no provisions for prompt and elastic
expansion of the supply of currency when needed nor for its retirement
when not needed. In other words, there was no lender of last resort to
which bankers might go in order to turn some of their earning assets
into cash assets. Today, however, a member bank with sound assets can
convert them into currency or reserves as promptly as any conceivable
demand from its customers makes necessary. It makes no difference
whether the demand originates in alarm or whether it originates in
sound business activity, the Federal Reserve notes and other money in
circulation can readily expand until the demand is met.

The task of supplying this kind of money represented by currency
and coin no longer offers any great problems therefore. But when we
turn to the other kind of money—namely, that represented by bank de-
posits—we find a very different situation in almost every respect.

At the present time there are about 15,000 banks in the United
States. Suppose that tomorrow morning every one of these banks receives
an application from some one of its customers for a loan of $10,000.
That means 15,000 times $10,000 or $150,000,000. Suppose every applica-
tion is granted and every borrower takes deposit credit for his loan.
That means an increase of $150,000,000 in bank deposits that morning,
assuming no corresponding reduction. This additional amount would imme-
diately be available for making payments and purchases by check.

This enlargement of the supply of the means of payment would have
occurred as the result of 15,000 separate decisions: 15,000 bankers
would separately and simultaneously have said "yes"; none of the 15,000
would have had any idea of what the others were doing. Yet acting in-
dependently, individually, and on the basis of separate and distinct
transactions, the banks and their customers would have increased by
$150,000,000 the aggregate amount of deposit credit transferable by
check.

As a matter of fact a loan of $10,000 is too large for many banks
and is small for others. Yet in reality bank loans and consequently
bank deposits might increase by much more than $150,000,000 in a given
day.

A collective movement in the opposite direction would also be con-
ceivable. Suppose the reserves of banks were in general low and that
all 15,000 banks said "no" instead of "yes". The result would be that
15,000 bank customers throughout the country would simultaneously fail
to get in the aggregate the $150,000,000 they wanted.

I use these figures merely because I wish to indicate emphatically
the collective force potential in the independent action of thousands
of bankers each acting on his own initiative. Each transaction at each
bank seems of importance only to those immediately concerned. Col-
lectively, however, the effects may be very great, especially because
there are times when prevailing conditions impel all bankers to take
the same general attitude simultaneously.

The Federal Reserve System brings a regulative and compensating
force into this situation. It sets up twelve Federal Reserve Banks whose operations are in a way reciprocal to those of the member banks. It brings member banks and Federal Reserve Banks together into a system whose collective powers are much greater and more effective than the powers of member banks standing alone.

Before the establishment of the Federal Reserve System there were no institutions performing the essential functions of the Federal Reserve Banks. City correspondents performed some of them for their country correspondents, but they were themselves privately managed institutions like other banks—operated for profit, and necessarily bound by the interests of their stockholders and their local customers. They were influenced by the same kind of considerations as their country correspondents, and could not be expected to change their objective and operate—the way the Federal Reserve Banks do—as central banking organizations. It is true that from the standpoint of individual member banks, the Federal Reserve Banks may be considered as filling much the same place as city correspondents. But beyond the field of direct relations in which the services of Federal Reserve Banks and city correspondents are similar, is a broad field in which the Federal Reserve Banks are unique.

The basic fact in the relation between the individual member bank and the Federal Reserve Bank is that the member bank is required by law to maintain its legal reserves with it. The member bank uses this account as a means of procuring currency and clearing and collecting checks, but the real importance of the account lies in the fact that it determines the ability of the member bank to extend credit. When the member banker makes loans or purchases investments, the tendency is for his reserves to be reduced thereby. Consequently he can make extensions of credit only so long as his reserves are up to the required minimum. If he is gaining in his clearings with other banks, or collecting loans, or selling investments, or letting them run off as they mature, his reserves may be maintained while he continues new extensions of credit. But if he cannot maintain adequate reserves by these means, then there is always the Federal Reserve Bank from which he may borrow.

I emphasize the word "always". Under Section 13 of the Federal Reserve Act, a Federal Reserve Bank may discount commercial, agricultural and industrial paper for a member bank or lend to a member bank on the security of such paper or on the security of Government obligations. But extensions of credit by the Federal Reserve Bank are not limited to this class of "eligible paper", so-called; for under Section 10(b) of the Federal Reserve Act, the Federal Reserve Bank may also lend to a member bank on any satisfactory security. These terms mean that a member bank can always borrow from the Federal Reserve Bank, provided only it has good assets to offer as security.

The real importance of the Federal Reserve System lies in the power which its discounts and its open market operations give it over the volume of member bank reserves. The volume of these reserves determines the ability of member banks to extend credit. This volume of reserves is itself subject to the open market policy of the Federal Reserve System. Discounts and loans, as I have indicated, are transactions initiated by individual banks for the replenishment of their reserves. Open market operations are transactions initiated by the Federal Reserve System for
the purpose of influencing member bank reserves in general—sometimes increasing them, sometimes decreasing them. When the Federal Reserve Banks buy bills and securities, the transaction has the effect of augmenting the reserves of member banks, for the funds with which the securities are purchased find their way into the member banks' reserve accounts. When the Federal Reserve Banks sell bills and securities, the transaction has the effect of decreasing member bank reserves, for the funds paid to the Reserve Banks for the securities come out of the member banks' reserve accounts.

Since purchases and sales are made in the open market, their effect is general. Some banks will feel a given transaction less directly than other banks, but the effect in any event is to make reserves in the aggregate either more abundant or less abundant. Their effect is general, and they tend to counter-balance those conditions when banks as a whole have insufficient reserves to enable them to meet the requirements of their customers, or when their reserves are large and a tendency to speculative demand for credit develops.

Under the Federal Reserve System, banking is drawn into one inter-related organization in which measures can be taken for banking as a whole. The System gives nation-wide unity to the banking and monetary function. It makes possible the application of broad, regulatory, and corrective measures. In doing this the Federal Reserve System has not diminished the importance of the individual bank's position nor of individual relationships. On the contrary, the position of the individual bank has been improved, for as I have said, the Federal Reserve Bank is always ready and able to meet the individual banker's needs. That is its business. But aside from this improvement in individual relationships, there has come the addition of a general over-all inter-relationship which knits individual banks for certain essential purposes into one unified system.

I have given you an account of the Federal Reserve System based upon general experience in the past. In many respects that past is essentially unlike the present and unlike what the future may be. As a result, some of the powers of the Federal Reserve System, which in the past have been of utmost importance, have not in recent years had the same opportunity to be exercised. Moreover, the conditions which now exist and which are so different from those obtaining in the past show no signs of changing in the near future. As students, you must find this a stumbling block of considerable importance in your study of the Federal Reserve System. You have to study the System as it has worked in the past but you have to consider it in the light of a future which no one can foretell. The present condition of outstanding importance is that member banks of the Federal Reserve System have such large reserves that the powers of the Federal Reserve authorities have not the occasion to be exercised as was originally intended. The member banks of the Federal Reserve System have excessive reserves of practically 7 billion dollars. This condition is the result of the enormous flow of gold to this country in recent years. What its eventual effects may be I cannot tell you, but I can assure you that we who are working in the System are deeply aware of these conditions and are constantly studying to adapt the System to the needs of the country's future.