SUPPLEMENT

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THE FED'S FIRST 50...

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THE FED'S FIRST *50*...*

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EVEN in this era of computers that work in milliseconds, special significance continues to be attached to the century and its halfway mark, the midcentury, the golden anniversary. For both the individual man and the whole range of human institutions, the 50th birthday seems a particularly appropriate moment for a philosophic stocktaking. It is a moment for examining the present as the outgrowth of the past, for measuring achievement against original goals, and perhaps even of studying the changing nature of the goals themselves, because time changes goals just as it changes everything else.

We are now in the midst of the Reserve System's golden anniversary. The Federal Reserve Act was signed by President Wilson 50 years ago last December. The 12 Reserve Banks were incorporated the following May; the Federal Reserve Board, as the Board of Governors was then called, set up shop in the Treasury Building in Washington half a century ago this summer, and the 12 Reserve banks simultaneously opened their doors for business on November 16, 1914.

The Beginning

Reflect for a moment on the circumstances surrounding that opening period. World War I was three-and-a-half months old. The German plan for the lightning defeat of France had failed and the conflict had bogged down into the bloody and futile trench warfare that was to prevail for several years. It was on that same November 16 that Prime Minister Asquith told the House of Commons the War was costing England $5 million a day — and the House responded by voting an extraordinary credit of a billion dollars and permission to put one million more men in uniform.

Here in the United States every stock exchange was closed, in fact had been closed since the initial firing of "the guns of August," and for a most obvious reason — the Nation's net debt to other countries was estimated at a minimum of $3.5 billion. The outbreak of the War had provoked a near-panic, which was followed by a business recession marked by sharply falling prices and widespread unemployment. U. S. exports of gold were extremely heavy between June and November in 1914. During midsummer the price of the pound sterling soared briefly to a phenomenal $7 from its spring normal of $4.86.

In the midst of all this the Federal personal income tax law was finishing up its first full year of operation, and according to the newspapers, the Treasury was "weaving a nationwide net to catch income tax dodgers." American industrial management was still struggling with the applecart which Henry Ford had overturned by his decision to pay a minimum wage of five dollars a day as against a general level of about two. Despite price declines the high cost of living was nationally deplored: in Boston a seven-course dinner, with wine, cost one dollar, and Filene's was selling men's "fancy

* Speech delivered at the annual convention of the Connecticut Bankers Association at Equinox House, Manchester, Vermont on June 5, 1964.

suits" for $13.30. Good rye whiskey was 75 cents a quart, four for $3 "express paid to all parts of New England."

What with the dubious domestic and deteriorating European situations, it was a far from propitious moment for launching a new "grand design" in American banking.

Nevertheless, hopes were high. On the morning the Reserve banks opened the Nation's press carried a statement by Secretary of the Treasury McAdoo which said in part:

> The opening of these banks marks a new era in the history of business and finance in this country. It is believed that they will put an end to the annual anxiety from which the country has suffered for the past generation about insufficient money and credit . . . and will give such stability to the banking business as to destroy entirely extreme fluctuations in interest rates and available credits . . . The supply of credit will be absolutely responsive to the demand, and thus business will be freed from the restrictions, limitations and injuries from which it has suffered in the past.

Well, that was the world that was.

In the 50 years which have elapsed since the creation of the Federal Reserve System, science and technology have wrought greater changes in the physical circumstances of human living than occurred in all previous centuries. Two world wars and a continuing series of ideological battles have saddled the United States with a free-world leadership which perhaps it didn't want, but from which it certainly cannot withdraw. Both of these wars ignited inflationary fires. For 20 years between these wars the riptides of the business cycle played havoc with the country's economy — a boom, a crash, an unparalleled depression, a period of slow and painful recovery.

All of these things taught the Nation bitter lessons. All of them significantly altered the Nation's social and economic goals and brought about new laws, rules, and regulations designed to help achieve these goals. And many of them, of course, deeply affected, and in turn were affected by, the Federal Reserve System.

The vehicle of our democratic, competitive, free enterprise system is money. Throughout its 50-year existence the Federal Reserve, as trustee of the Nation's money, has been confronted with crises of kinds and magnitudes not dreamed of by its Congressional creators. In the beginning, by virtue of their newness, the Reserve System's managers were inexperienced and unsophisticated in matters of central banking. In retrospect it also appears that they were inadequately equipped with the tools of their trade. And to complicate matters still further they were united in a shotgun marriage with thousands of commercial banks whose attitudes toward them ranged from resigned tolerance to active hostility. As decade succeeded decade, each bringing with it differing problems and needs, the System vastly expanded its understanding of the theory and practice of central banking. New policy concepts were developed, new policy instruments were devised, new skills and techniques acquired. As circumstances forced the readjustment of the Nation's social and economic goals, the System readjusted its own policies and operations to assist in attaining these goals.

Let me briefly review a few of the major changes which have taken place during "The Fed's First 50." I can do this only by painting with a broad brush and by committing serious sins of omission and compression. Every statement I shall make is subject to assorted qualifications and a series of footnotes. But in your interest let me proceed without them.

The Goals

The Federal Reserve was designed to help meet the critical monetary needs of a society which, from its very beginnings, has held steadfastly to two fundamental precepts — preservation and extension of both the democratic process and the free enterprise system. The Reserve Act itself tacitly recognized and undertook to sustain and improve the privately-owned, profit-oriented, highly-competitive character of American commercial banking. At the same time it recognized that banking is deeply involved with the public interest, as the severe, chronic money panics of the 19th and early 20th centuries had all too unhappily demonstrated. The Act was the Nation's attempt, by means of the democratic process, to reconcile and weld into a viable system these two vital but essentially divergent concerns.

The broad structure of the Federal Reserve, still largely unchanged since 1913, was the product of comparison, selection, and compromise. Instead of the one central bank common to most European countries, 12 Reserve banks were established — each with substantial autonomy — in order to allay rural fears of dominance by the "money trust." A special form of stock ownership of the Reserve banks by the member banks of their respective districts, and the right of the member banks to elect 6 of each Reserve bank's 9 directors, were designed further to quiet these fears and to enlist the active cooperation of district banking interests. And creation of the Federal Reserve Board, to be appointed by the President and given supervision of the Reserve banks, was designed to indicate and guard the public interest in the quality, quantity, and behavior of the Nation's money. In my own opinion much of the current controversy over the Federal Reserve reflects ignorance of the fact that the System was deliberately devised as an instrument of cooperation between Government and private enterprise — with dual, and therefore unique, responsibilities.

The System's first operational objectives were to pool required reserves within each Reserve district in the interests of liquidity and mobility; to furnish an elastic currency; and to afford means of rediscounting commercial paper. These, together with improved bank supervision, were aimed at preventing money panics, at accommodating "legitimate" credit needs, and reducing costs of credit to business.

In effect, the System was to provide funds to member banks which needed additional resources to meet the currency demands of their depositors or to pay balances due other banks. The funds could be obtained by a member banker through a simple process: he had only to go through the notes owed him, select those deemed "eligible," and present them to his Federal Reserve bank for discount. If banks had enough eligible paper they would always be able to get funds from the System and thus prevent panic among customers.

The System was also to meet the "legitimate" credit needs of a growing economy at the discount window — for the Reserve Act authorized the Reserve banks to discount for member banks:

> notes, drafts and bills of exchange issued or drawn for agricultural, industrial or commercial purposes . . .

In other words, the Fed would provide new credit to banks, but only on the basis of their short-term loans made to finance current production — goods in process. Each new grant of credit by the Fed would thus match the needs of the production process. If production grew, credit grew. If production contracted, credit would contract. The credit machine would thus be practically self-regulating.

In relation to other countries, gold flows and discount rate administration were to provide measures and safeguards for this newly established credit machine. If credit became excessive on the home front, prices would rise, interest rates fall, and gold would flow abroad. A gold outflow called for Reserve System discount rate increases which would discourage member bank borrowing, help limit the volume of available credit, and increase its cost. Under these squeezes, domestic prices and interest rates would eventually again become competitive with those abroad and thus the desirable international equilibrium would be restored.

All this was internationally accepted theory of central banking 50 years ago — so naturally it was incorporated into the framework of the Federal Reserve System. Careful administration of the discount window and the discount rate were expected practically automatically to do away with money crises, promote economic stability, and foster the orderly growth of our free enterprise system. As it turned out, events so whipsawed the System that things didn't work out as expected. True, money panics were averted, a national market for credit was developed, and the cost of credit to business was reduced. But expectations as to the automatic regulation of total credit flows had eventually to be abandoned.

From its opening in 1914 until this country entered the War in 1917 the Fed was largely concerned with its own organizational matters and the establishment of its services to banks. There were few pressing national credit or monetary policy issues. War production for both belligerent groups erased unemployment and the real gross national product increased by almost 20 percent in only three years. But with this country's declaration of war the Treasury confronted the System with its first great problem and first great opportunity — financing the war effort. To all intents and purposes the Fed became the strong right arm of the Treasury. It provided liberal discounts for member banks and preferential treatment for government securities. Commercial banks were enabled not only to make substantial loans on "governments" but also to accumulate large inventories of their own. Carter Glass later expressed the opinion that:

> the World War could not have been financed but for the Federal Reserve Act.

After World War I

It was the aftermath of the War which first tried the souls of the System's men. By the spring of 1919, four months after the Armistice, the almost inevitable price and credit inflation was underway. Compounded of pent-up domestic demand and the needs of a long frustrated Europe, it was described by System officials of the time as:

> characterized by an unprecedented orgy of extravagance, a mania for speculation, overextended business in nearly all lines and in every section of the country, and general demoralization of the agencies of production and distribution.

As another put it:

> The war was financed in large measure by creating money, and the money came home to roost.

Until the end of 1919, some nine months after the uprush began, the Fed made no significant moves to try to control the boom. It was under pressure from the Treasury to keep credit readily available and interest rates down in order to assist in a large postwar Victory loan and in handling the huge war debt. It was not until May of 1920 that the System embarked on a policy of vigorous restraint. Ironically, this was the month the boom collapsed and the Nation went whistling down one of the sharpest price declines in history and into a severe business depression. Within 14 months wholesale commodity prices plunged 40 percent and unemployment rose to 4.7 million.

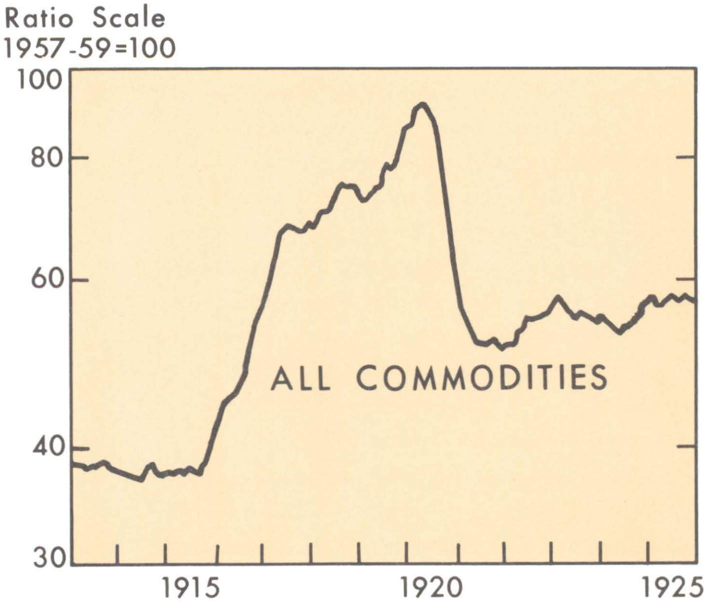
Explanation of the Fed's actions in the face of this catastrophe remains a matter of controversy. The reasons cited include: political pressure from the administration, particularly the Treasury (incidentally, the Secretary of the Treasury had from the very beginning been a member of the Reserve Board, was indeed, its chairman); second, lack of experience — this was the System's first encounter with a fiery cycle of boom and bust; third, reliance by the System on the quality rather than the quantity of commercial paper discounted; fourth, disagreements among the still generally autonomous Reserve banks and between the banks and the Board as to when and how to act; and fifth, confusion or disregard as to the interacting effects of debt management and monetary policy.

However one may apportion responsibilities, the fact remains that the Reserve System drew a public reprimand. In a report submitted late in 1921, after extensive hearings and study drawing heavily on hindsight, a Congressional Joint Commission said:

> The Commission believes that a policy of sharp advances in discount rates should have been inaugurated in the first six months of 1919 and cannot excuse the action of the Federal Reserve Board and the Federal Reserve banks in this period in failing to take measures to restrict the expansion, inflation, speculation, and extravagance, which characterized this period.

In retrospect there is every reason to doubt that early and sharp advances in the discount rate could by themselves have braked the runaway economy. But there was no doubt whatever in System minds about the general ineffectiveness, in fact, the breakdown of the earlier concept of the self-regulating credit machine. The continuous discounting of eligible paper would certainly insure ample credit, but who could foresee how the credit was to be used? Furthermore, once there was an excess

WHOLESALE PRICES



in the money supply how could it be removed? The Reserve Board put it this way in its annual report for 1923:

> There are no automatic devices or detectors for determining when credit is granted by a Federal Reserve bank in response to a rediscount demand, whether the occasion of the rediscount was an extension of credit by the member bank for nonproductive use. Paper offered by a member bank . . . may disclose the purpose for which the loan . . . was made, but it does not disclose what use is to be made of the proceeds of the rediscount. A farmer's note may be offered for rediscount . . . when in fact the need for rediscounting has arisen because of extensions of credit by a member bank for speculative use.

In short, funds from rediscounts of entirely satisfactory "productive" paper could easily be diverted to financing stock market speculation. If this occurred money might grow faster than production. And the Reserve Board continued:

> In its ultimate analysis credit administration is not a matter of mechanical rules but is and must be a matter of judgment — of judgment concerning each specific credit situation at the particular moment of time when it has arisen or is developing.

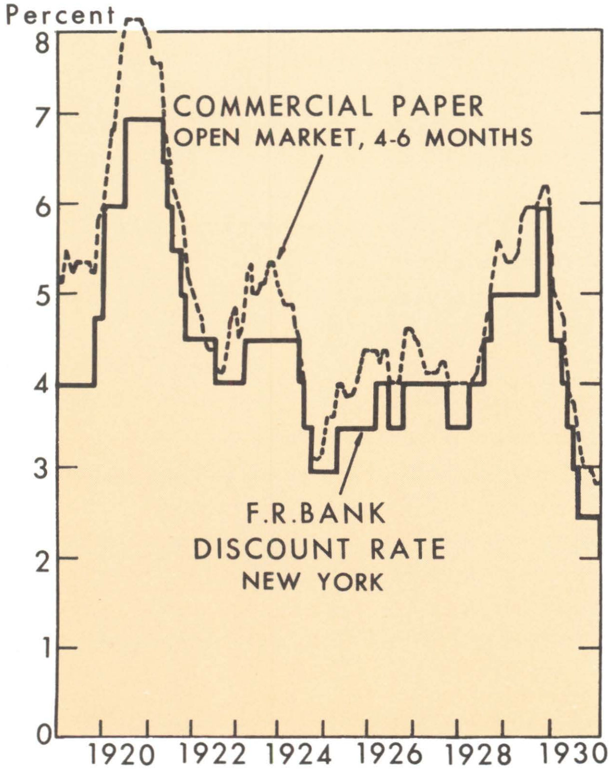
Concomitant problems facing the Fed in the early 1920's were to determine whether the volume of credit provided by the Reserve System, under any given circumstances, was adequate, excessive, or deficient — and if excessive, how was it to cut back? The answers to both these problems were at hand, at least in embryo. The first need was for more extensive, more detailed economic, and especially financial, information to facilitate evaluation judgments. The second called for the development and adroit use of a recently discovered tool of monetary policy, a tool of active intervention, called open market operations.

New Tools

Early in the decade the Fed found that by means of buying or selling government securities in the open market it could inject or withdraw funds from the economy at will. Under the older, essentially passive theory of discounting, the Reserve banks had to wait for member banks to come in and borrow — and they had also to wait for the banks to react to changes in the discount rate. By using the new tool of open market operations the initiative was transferred to the Federal Reserve — it could directly affect the volume of funds available for loans and investments at its own discretion instead of at the judgment of the banking system. Moreover, the open market operations tool had the added advantage of flexibility. It could be used much more frequently — in either direction, of course — than the discount rate change. Its final advantage was that it could be used quietly, without the publicity that attended rate changes which instantly alerted the banking community to System thinking.

Later, Federal Reserve officials learned to coordinate the tools of discount policy and open market operations to achieve greater effectiveness in executing monetary policy. For example, if the Fed wished to restrict credit, it could begin the operation by selling its governments, which could force member banks into debt at the Reserve banks. This alone would lead the banks to lend less liberally and market interest rates would tend to rise. The Reserve banks could then, if they chose, increase the restrictive pressure by raising discount rates. As the System discovered and developed the relationships between these two tools of monetary policy, it was able to use its control instruments with much greater precision and effectiveness.

SHORT-TERM INTEREST RATES



The System's new philosophy of initiative and positive action did not, of course, spring forth fully grown out of any single head or at any given time. Like almost everything else about the Federal Reserve, it was evolved — frequently slowly, sometimes painfully. When the inflation-deflation cycle of 1919 to 1921 proved the ineffectiveness of the Fed's automatic credit-governing machinery, and even more important, the Fed's inability to tighten the reins on a booming economy by draining off its excess credit, it took time and a lot of soul-searching to develop new concepts. And it took still more time to develop new machinery for credit control and then to learn its skillful use.

The Nation's wartime goal of "making the world safe for democracy" was succeeded by a widespread desire for a return to what President Harding called "normalcy." Coolidge declared that "the business of America is business," and the Fed's prime job through the balance of the 1920's became that of discretionary money management in the interest of business stability and progress. It was increasingly troubled, however, by the rising incidence of bank failures, a very high percentage of which were those of small country banks ineligible for System membership and therefore well beyond System reach. And as early as 1925 the Board began to take notice of the steadily rising volume of stock market speculation. Despite admonitions to member banks about using the resources of Reserve banks for credit extensions for speculation — this was the era of moral suasion — brokers' loans continued to mount and stock prices soared. Eventually the System was trapped in a dilemma beyond its powers to solve — the need for encouraging "sound" business enterprise on the one hand, and on the other, the need for sharply retarding speculation. And it received no support whatever from an administration which consistently denied the existence of any serious problems.

What happened was a national tragedy of a magnitude now almost beyond belief. The history of the crash and the great depression which followed has been voluminously recorded and microscopically analyzed. Its details need not concern us here. What does concern us is the further evolution of the banking system and especially the Reserve System — its developing philosophy, its broadened objectives, its new policy instruments, the increasing breadth and precision of its operations.

New Legislation

New legislation was urgently needed to assist both the commercial banking system and the Federal Reserve in meeting the crisis of the 1930's. In 1932 the Glass-Steagall Act permitted the Reserve banks to use government securities as partial collateral for their currency issues. In the following eight months Reserve bank holdings of governments increased by more than $1 billion and currency based on these securities was pumped into the Nation's banking system. Another provision of the Act enabled the Reserve banks to make advances to member banks on any security they considered satisfactory, and in unusual circumstances they could even make loans to nonbank borrowers.

The Banking Act of 1933 authorized the System to refuse credit to a member bank engaging in undue use of:

> bank credit for the speculative carrying of or trading in securities, real estate or commodities or for any other purpose inconsistent with the maintenance of sound credit conditions.

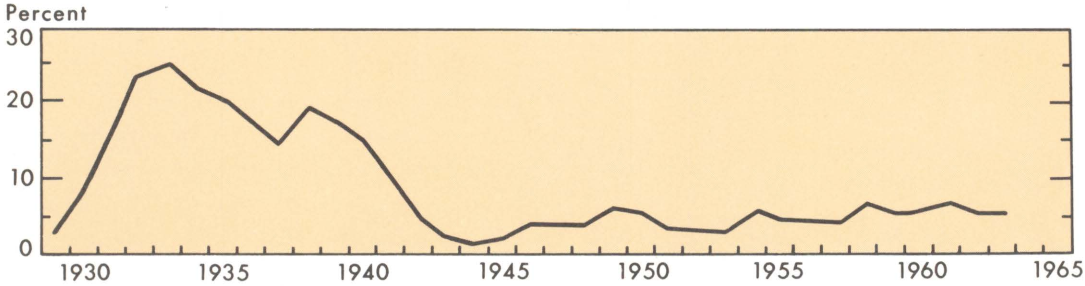
The 1933 Act also created the Federal Deposit Insurance Corporation with the Reserve banks providing nearly half of the capital required to put it in business.

The Securities Exchange Act, which came the following year, handed the System its first "selective" tool — the Board was given the power to prescribe minimum margin requirements for purchasing or carrying securities or selling them short.

All this vigorous legislation was supplemented by the Banking Act of 1935 which gave the System still another important new tool. The Board was empowered to change reserve requirements within specified limits and thus increase or decrease the volume of deposits which a given volume of reserves would support. The Act also reconstituted the System's Open Market Committee into the form in which we know it today; that is, the Board plus representatives of five Reserve banks — with the New York Fed serving permanently and the other 11 banks in rotation. The Open Market Committee was given full control over open market operations and its decisions were made binding on all Reserve banks in contrast to the optional participation which had hitherto prevailed. Since World War II the Open Market Committee has developed into the System's most important policy-making body. Finally, the Act of 1935 revamped the Federal Reserve Board into the Board of Governors, cut its membership from 8 to 7, dismissed from membership both the Secretary of the Treasury and the Comptroller of the Currency, and increased the Governors' terms of office from 12 to 14 years.

Thus reorganized and equipped with new powers, the Reserve System directed its energies toward support of the new national goal of a full and lasting recovery from the great depression. Even with the many especially devised governmental programs, progress was slow, difficult, painful. Still there was progress. The incredible unemployment figure of nearly 13 million in 1933 — 25 percent of the labor force — was gradually whittled down to eight

UNEMPLOYMENT RATE



by 1939, though there remained a vast amount of unused plant capacity and a huge reservoir of idle capital funds. This was the situation when war again engulfed Western Europe — this time in the midst of the Fed's silver anniversary.

I have devoted virtually all this time to describing the first 25 years of the Fed's first 50 — because these were the years in which the Fed acquired the stature, the structure, the tools of monetary policy, the operating philosophy with which you are generally familiar. These were "the years in which the Fed learned to swim." Because I suspect that most of you have been in banking during the Fed's second 25 years, let me polish off that period with a few capsule reminders.

During World War II the money and credit-creating powers of the Reserve System were once again placed at the disposal of the Treasury. While an important objective of war finance was to see that as much borrowing as possible should tap savings, it was equally important that no government bond should go unbought for lack of funds. The Fed and the Treasury agreed in March of 1942 — three months after the devastation of Pearl Harbor — that the then existing pattern of interest rates on government securities should be maintained. In pegging bond prices the Fed lost effective control over the money supply.

In five years the Federal Government raised $383 billion, a very substantial part of it coming from commercial banks and the Federal Reserve System. From 1939 to 1945 the money supply almost tripled, soaring from $36 billion to $103 billion. At the War's end, when price controls and rationing were relaxed, this flood of purchasing power swept over the Nation. The Fed took what anti-inflation measures it could — but once again, as after World War I, the problems of managing a huge Federal debt induced the Reserve System to subordinate other objectives to that of facilitating Treasury financing. Meanwhile, consumer prices jumped over 25 percent between 1945 and 1949.

During this period the fears of postwar unemployment and social conflict brought about the Employment Act of 1946 which declared:

> It is the continuing policy and responsibility of the Federal Government to use all practical means . . . to promote maximum employment, production, and purchasing power.

If "maximum purchasing power" is equated with stable prices, then the Reserve System was placed in the impossible predicament of striving to stop inflation — a move which the Fed had long since believed vitally necessary — while yet continuing to support the Treasury's securities market. The situation deteriorated steadily. Finally it reached a point where, as Marriner Eccles saw it:

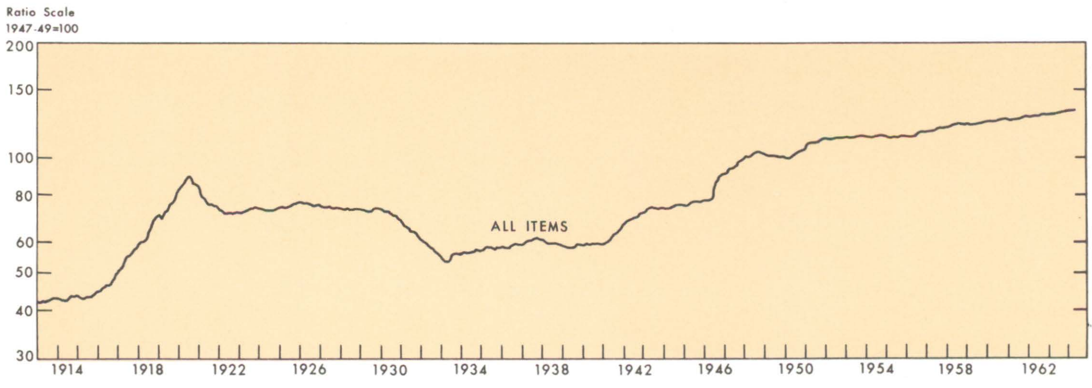
> if swift action was not taken the Federal Reserve would no longer have a voice in deciding monetary and credit policy. It would lose the independent status Congress meant it to have, and in its most important function of open market operations it would be reduced to the level of a Treasury bureau.

The issue thus joined was not resolved until the Treasury-Federal Reserve accord of 1951, "now considered a landmark in American monetary history." Nine long years after it agreed to peg the prices of Treasury obligations as a concomitant to financing the war effort, the Fed regained much of its freedom to follow flexible policies in creation of bank reserves and restricting credit when necessary to prevent inflation. I might add that in recent years the System and the Treasury have worked together with steadily increasing harmony on the difficult, interlocking problems of monetary policy and debt management. Such harmony is of incalculable importance in these days of persisting balance of payments problems, inter-central banking cooperation, and international liquidity issues — which is a whole book by itself and one with which I'm sure you are familiar.

In this year of its golden anniversary the Reserve System is once again under intensive critical examination by Congress. As you meditate the thousands of printed pages of testimony which the current Congressional hearings are producing, I hope you will remember the points I have stressed here.

The Federal Reserve System is the product of evolution over a long period of time. It has adjusted itself, and it has been adjusted by Congress, to meet the constantly changing needs and goals of a constantly growing Nation. It has had its failures as well as its successes. It has been tempered in the fires of adversity. Time and experience have increased its wisdom, demonstrated its capacities, honed to a fine edge the instruments with which it works. It is my conviction that it is doing ably, efficiently, and pre-eminently in the public interest the job which Congress originally laid out for it.

CONSUMER PRICES



BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM