Business Conditions

1964 November

FEDERAL RESERVE BANK OF CHICAGO

The Federal Reserve Bank of Chicago opened for business November 16, 1914. This issue of *Business Conditions* describes briefly the role played by the Bank and its 11 sister institutions in the nation's financial life during a half century of economic change.

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FEDERAL RESERVE BANK OF CHICAGO

OFFICE OF THE PRESIDENT

To the readers of BUSINESS CONDITIONS:

You will note that the appearance and content of this issue of BUSINESS CONDITIONS differ somewhat from previous ones. The reason--since this is the 50th anniversary month of the opening of the Federal Reserve Bank of Chicago, we have taken the liberty, this once, to talk about ourselves.

In the preparation of this issue we have had in mind the employes of the Federal Reserve Bank of Chicago and the Detroit Branch and their families, relatives and friends as well as the regular subscribers of BUSINESS CONDITIONS. I hope all of you will find this brief description of some of the activities of the Bank as well as the historical review to be of interest.

Charles J. Scanlon
President

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Fifty years of the Chicago "Fed"

Conceived in distress, born of controversy and battered incessantly by crosscurrents of economic tides and political winds, the Federal Reserve System in 1964 marks completion of its first 50 years of service. One of a dozen new regional "central" banks, the Federal Reserve Bank of Chicago opened for business on November 16, 1914, in rented quarters in Chicago's financial district.

The region to be served by the Chicago "Fed," known as the Seventh Federal Reserve District, included the state of Iowa and the major portions of Illinois, Indiana and Michigan and the southern portion of Wisconsin. This region was later extended to include the central part of Wisconsin as well.

A branch of the Federal Reserve Bank of Chicago was established in Detroit in 1918. The Branch territory now includes the entire lower peninsula of Michigan.

What is a Federal Reserve Bank?

It is impractical, in limited space, to describe fully all the jobs performed at the Federal Reserve Bank of Chicago. Nevertheless, a general impression of the size of the Bank and its major activities can be provided.

The volume of work performed by the Bank, of course, has grown through the years as the population and economic activities in the District it serves have increased. In addition, the functions of the Bank have been broadened. From a total of 36 employes on opening day, the Bank's staff, including Detroit, reached a wartime peak of about 3,900 at the end of 1943. In recent years, employment has remained fairly stable with about 2,400 at the head office in Chicago and about 500 at the Detroit Branch.

The big jobs

Measured in number of employes, the Bank's three largest departments today, as in past years, are those engaged in the processing and collection of checks, the distribution of currency and coins, and the issue, servicing and redemption of Government securities.

One of the first tasks undertaken by the Federal Reserve System was the improvement of the cumbersome and expensive methods for *clearing and collecting checks* in use at the time the System was created. Checks are at the heart of the payments system in the United States, probably accounting for as much as 90 per cent of total dollar volume. Efficient conduct of business, therefore, requires that there be an accurate and rapid means of clearing and collecting checks.

The volume of checks handled at the Federal Reserve Bank of Chicago has been rising steadily during recent years. In 1963 more than 600 million checks drawn on commercial banks and nearly 100 million checks and money orders drawn on the Government were processed. "Keeping the checks moving" requires the efforts of about 1,200 workers, more than 40 per cent of the Bank's employes, working on a round-the-clock basis. Improved machinery and operating proce-

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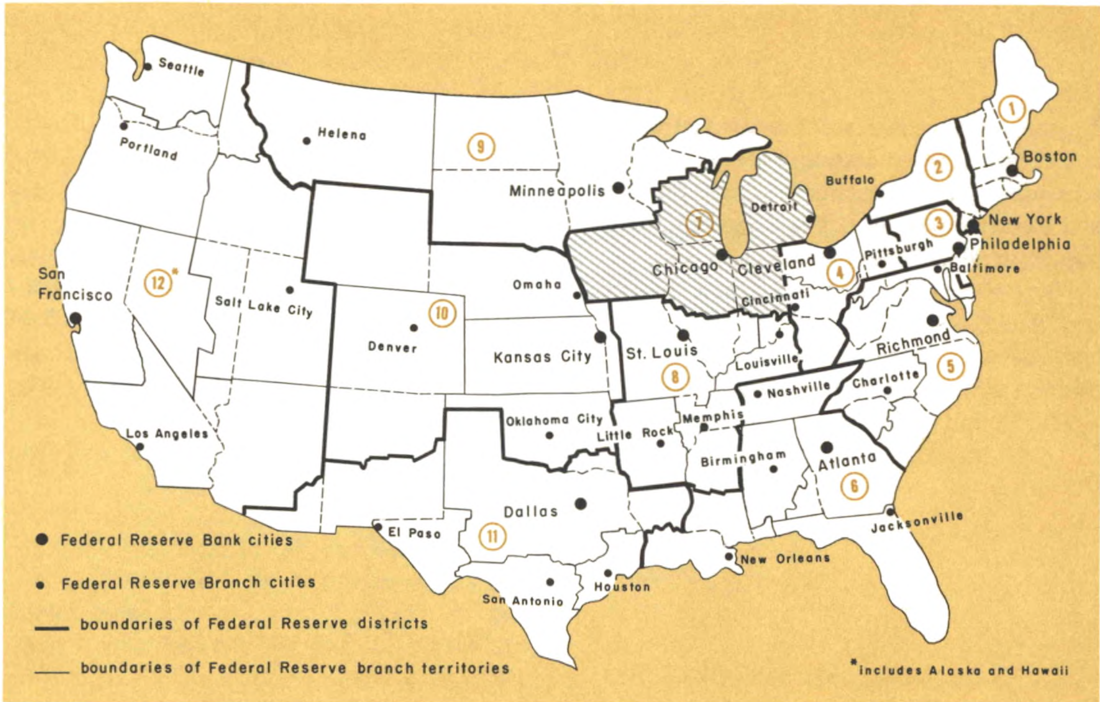
Federal Reserve Districts



dures have enabled a staff of roughly constant size to continue to handle the rising volume in recent years. Currently, about 60 per cent of the checks are processed on complex high-speed equipment.

Funds are moved readily among commercial banks within each Federal Reserve District, through transfers of deposits kept with the Reserve Banks. A rapid and efficient means of transferring funds between banks located in different districts also is necessary.

Through the Interdistrict Settlement Fund in Washington, money can be transferred by telegraphic order from the account of one Reserve Bank to that of another. Last year, more than a half million interdistrict transfers totaling nearly 500 billion dollars were made by the Federal Reserve Bank of Chicago. These were largely settlements for checks collected, transfers of balances for the account of member banks and their customers and transfers for the U. S. Treasury.

Although most payments in the United States are made by check, a large number of transactions involve the use of coins and currency. The Federal Reserve Banks handle the *distribution of coins and currency* to the commercial banks, although these are produced by the Government. The Chicago "Fed" distributed about 1.7 billion coins valued at 190 million dollars in 1963.

In addition to coins, more than 900 million pieces of paper currency with a value of over 5.7 billion dollars were paid out to member

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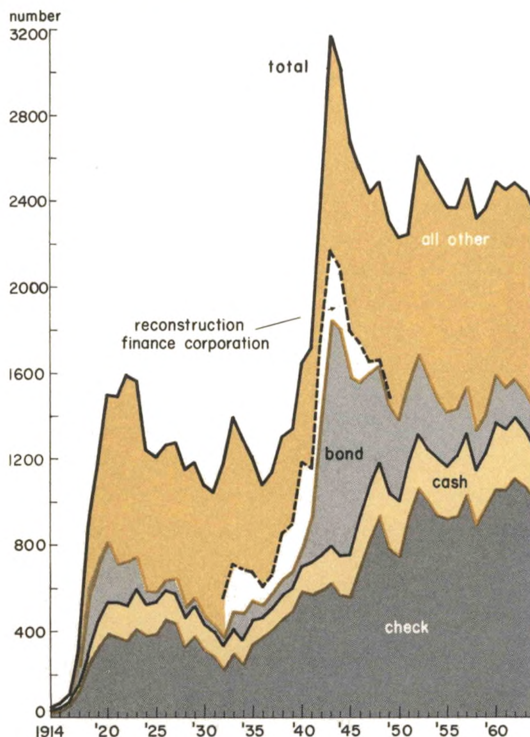
banks in 1963. Unfit Federal Reserve notes in the amount of almost 900 million dollars were withdrawn from circulation and shipped to Washington for destruction and 200 million dollars of unfit silver certificates and United States notes were destroyed at the Bank. On a typical day upwards of 3.3 million pieces of currency are processed. Coin and currency processing account for about one-tenth of the Bank's employes.

The cost of processing and collecting checks and of supplying currency and coin is a major part of Federal Reserve Bank expenses. These services are provided free to the commercial banks and the public to help assure an efficient and effective payments system in which money will circulate at par in all regions of the country. This was not the case prior to organization of the Federal Reserve System.

Employment at Chicago "Fed" rose sharply during wars and depression



Many of the *fiscal duties* of the U. S. Treasury and other Government bodies are performed by the Federal Reserve Banks. Last year more than 8 billion dollars of Federal tax receipts were processed at the Chicago Reserve Bank. The bulk of taxes paid are first deposited in "tax and loan" accounts at commercial banks. These funds, eventually, are transferred to the Treasury's checking accounts that are maintained at the Reserve Banks. Nearly 17 billion dollars of Government checks and postal money orders were processed at the Chicago Bank in 1963.

For the convenience of the Treasury and the investors in Government securities, Federal Reserve Banks have facilities in various parts of the country to handle public debt transactions. When the Treasury offers a new issue of Government securities, the Reserve Banks receive the applications from financial institutions, dealers and others who wish to buy; the Reserve Banks also make allotments of securities in accordance with instructions from the Treasury, deliver them to purchasers and credit the proceeds to Treasury accounts.

At the Chicago Bank about 16 billion dollars of marketable Treasury securities were issued in 1963 and 20 billion dollars were redeemed. Over 1.5 billion dollars of the nonmarketable savings bonds were issued and redemptions totaled nearly 1 billion dollars. In addition, interest coupons were paid and large numbers of securities were reissued or replaced.

Federal Reserve Banks also perform fiscal agency services for Government agencies

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other than the Treasury. Altogether, these services for the Government require about one-tenth of the Bank's employes, but during World Wars I and II the proportion was much greater.

Other vital services

There are many other important functions of the Reserve Banks that individually do not require large numbers of employes. Among these is the *supervision and examination of commercial banks.*

The preamble of the Federal Reserve Act stated that the System was "to establish a more effective supervision of banking in the United States." If an efficient payments system is to be maintained, depositors must have confidence that their funds will be available when needed. There have been very few bank failures in the past 30 years, in large part because of measures taken to avoid the conditions that had led to widespread failures in the Twenties and early Thirties. Detecting weaknesses in commercial bank practices and suggesting corrective action are important objectives of the bank examination staff.

Another important aspect of supervision has been the continuing evaluation of changes in the structure of banking, including mergers of existing banks and the formation of new banks and branches. Although basic policy on these matters is determined by the Board of Governors of the Federal Reserve System, the examination staff provides a thorough analysis and specific recommendations on each proposed change involving a member bank in the Seventh District.

Member banks also are privileged to borrow, when necessary, at the Reserve Banks' *discount window.* During 1963, 192 banks borrowed a total of nearly 6.7 billion dollars from the Chicago Fed. Because these loans were for short periods, the amount outstanding averaged less than 50 million dollars daily.

The Reserve Banks also aid members in the *management of security portfolios.* In some 16,000 transactions the Chicago Bank purchased or sold nearly 2 billion dollars of securities for the accounts of member banks in 1963. A substantial portion of these securities were held in safekeeping by the Reserve Bank.

At the end of last year, over 1.4 million securities valued at 8.3 billion dollars were held in *safekeeping and collateral custody* for member banks. During the year approximately 16 billion dollars of securities were received and a similar amount was released. Coupons maturing on securities in safekeeping were detached, collected and credited to the owners.

Regulating money and credit

A wide consensus exists that the Federal Reserve System has done a good job of handling the functions described thus far. The System also is charged with providing an adequate, but not over-ample, supply of money and credit to meet the needs of commerce, industry and agriculture. In this area of "monetary policy," standards of performance are not clear-cut and substantial differences of opinion exist, both in and out of the System. Monetary policy, therefore, has received the major attention of those interested in central banking, particularly in recent years.

Views on monetary policy vary widely, largely as a result of different interpretations and appraisals of historical trends and events. To understand these controversies, a knowledge of the conception and development of the Federal Reserve System is required.

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Organizing the System

Conceived in distress

Business fluctuations have occurred since the beginning of recorded history. As financial arrangements grew increasingly complicated, it became common to associate periods of inflation or declining business activity with imperfections or mismanagement of the banking system.

Money, of course, is tied closely to credit which includes the processes of borrowing and lending money and the delivery of goods and services on the basis of a promise to pay in the future. In times of economic uncertainty, money and credit may become hard to get, possibly because the supply is restricted, but more importantly because borrowers and lenders and buyers and sellers become reluctant to enter into new commitments as their confidence in the future lessens.

Prior to the establishment of the Federal Reserve System in 1914, there were periods of credit stringency, often associated with seasonal demands for funds in the autumn when crops were being moved and production of manufactured goods was rising to accommodate Christmas trade. Occasionally, as in 1907, there were serious financial panics followed by business recessions. The causes of this Panic of 1907 were varied and complicated, but defects in the nation's banking structure were at least partly responsible. The following year Congress appointed a National Monetary Commission to study these problems and report recommendations for change. The commission's report emphasized the need for the creation of a central bank, similar to those already operating in Europe, which could provide a sufficient quantity of currency and act as "a lender of last resort" to banks in temporary need of funds.

Born amidst controversy

Opposition existed to the proposed Federal Reserve System. First, there was a long-standing prejudice against any form of centralized "money power." Many farmers and small businessmen feared that less credit would be available than before and that interest rates would be higher. Also, there was a controversy whether the System should be owned and controlled by the Government or by the commercial banks.

To help placate fears and to reconcile divergent views, the Federal Reserve Act, signed by President Woodrow Wilson on December 23, 1913, provided for a system of 12 regional banks instead of one central bank. The Banks were authorized to issue their own notes to supplement the relatively fixed supply of national bank notes and Treasury currency. In addition, the Reserve Banks were empowered to lend to member banks and purchase securities on the open market, thereby influencing the availability of money and credit.

The selection of the cities in which Reserve Banks would be located and the determination of the territories to be served was left to an Organization Committee that made its decisions on the basis of existing flows of trade and financial payments, and polls of bank preferences. The fact that subsequent alterations of the boundaries of the various districts were minor indicates that the Organization Committee did its work well.

Ownership of the Reserve Banks also involved a compromise. Elements of both private and public control were provided, with the latter predominant.

Member banks are required to hold stock

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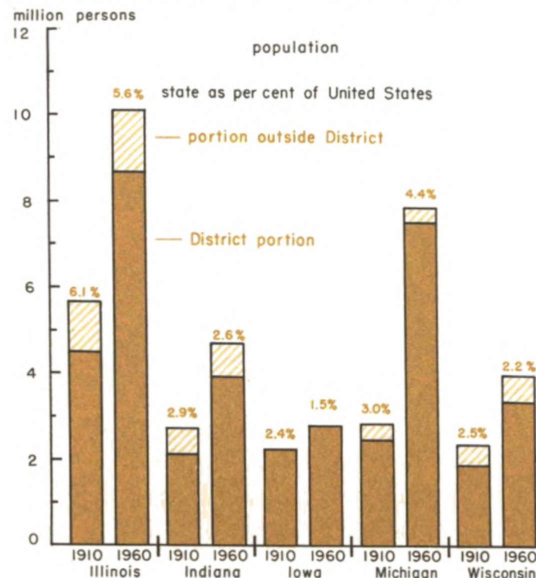
equal to 3 per cent of their capital and surplus, regardless of size, but they have only one vote in the election of directors of the Reserve Bank. A 6 per cent cumulative dividend is paid on the stock. Any additional profits of the Reserve Banks, after additions to surplus, are turned over to the Treasury. The stock can neither be sold nor offered as security on a loan. Clearly, this "stock" has very little in common with other equities.

Six of the nine members of the Board of Directors of the Federal Reserve Banks are elected by the member banks. Of these, three may be bankers. The other three directors, including the chairman and deputy chairman, are appointed by the Board of Governors of the Federal Reserve System. The chief executive officer of a Reserve Bank is the president, elected by the Bank's directors with the approval of the Board of Governors.

Population in District states, except Michigan, has grown less rapidly than in the nation



Activities of the Federal Reserve System are coordinated by the Board of Governors, constituted of seven members appointed by the President of the United States and confirmed by the Senate. The Board of Governors, located in Washington, D.C., has a variety of powers including the ability to veto the discount rates proposed biweekly by the boards of directors of the Reserve Banks, the determination (within legislated limits) of the proportion of deposits that member banks must keep as reserves and the maximum rates that they may pay on time and savings accounts, the establishment of margins that must be maintained on loans made for the purpose of purchasing or carrying listed securities and the approval or disapproval of proposed bank mergers and holding company acquisitions.

The Seventh Federal Reserve District in 1914 contained more than 5,000 banks including state and national banks and a few hundred "private banks," now practically extinct, that were not incorporated and operated without charters. The large number of individual banks in the United States was one of the reasons for a regional central banking system. It was feared that a single central bank would be unable to provide adequate service to the thousands of commercial banks located far from the seat of authority.

In June 1915 the Federal Reserve Board announced regulations for the admission of state banks to membership in the System. At the end of the year only eight Seventh District state banks had joined. In subsequent years the number of state banks that found it advantageous to become members of the System rose sharply. By the end of 1920, 358 of the 1,421 member banks in the Seventh District were state banks. Most large state banks found that the services of the Reserve Bank were essential to efficient conduct of their

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business. The great majority of smaller state-chartered banks used System facilities through their correspondent banks.

At present there are 1,012 members of the Federal Reserve Bank of Chicago. Of these, 624 are nationally chartered and are required to be members of the System. The remaining 388 members are state banks that applied voluntarily for membership and were accepted after an evaluation of their condition and management. Member banks currently account for 40 per cent of the number of commercial banks in the Seventh District but hold 80 per cent of deposits.

Battered by economic tides

World War I

Until 1917 there was relatively little implementation of the two main Reserve Bank functions—rediscounting of loans and the issuance of currency. During 1917, when the United States entered World War I, however, the volume of loans made by the Chicago Bank to member banks rose from 4 million dollars at the beginning of the year to 105 million at year-end, and currency issued by the Bank rose from 5 million to 181 million dollars. Increases in these amounts continued until, at the end of 1920, borrowing totaled 476 million dollars and currency outstanding reached 545 million.

Because Congress did not levy taxes sufficient to pay for the vast increase in war expenditures, it was necessary for the Government to borrow heavily. As a result the Federal debt rose from 1.2 billion dollars at the end of 1916 to 25.5 billion at the end of 1919.

The bulk of the World War I financing consisted of bonds issued in five "Liberty Loans": two in 1917, two in 1918 and a fifth "Victory Loan" in 1919, which together totaled 21.4 billion dollars. The Reserve Banks issued the bonds and handled the publicity and promotion of bond sales. Using normal channels and techniques the market could not have absorbed this volume of securities. Nevertheless, the offerings were oversubscribed.

Expansion of Federal Reserve credit provided the funds that many subscribers borrowed to finance bond purchases. Total Federal Reserve Bank credit—including discounts, bills purchased in the open market and holdings of Government securities—rose from 220 million dollars at the end of 1916 to 3.2 billion dollars at the end of 1919. At the Chicago Bank the increase was from 15 million dollars to 330 million with the great bulk accounted for by advances to member banks secured by Government obligations for which a preferentially low discount rate had been established.

But this was not all. The increase in Federai Reserve credit tended to raise member bank deposits at the Reserve Banks by a similar amount. Increases in these reserves enabled the commercial banks to expand their loans and investments. Between 1916 and the end of 1919, loans of Seventh District member banks doubled, while their investments, principally in Government securities, quintupled.

Boom and bust—1919-20

World War I had brought the first major crisis for the Federal Reserve Banks. After the war there was a brief period of reconver-

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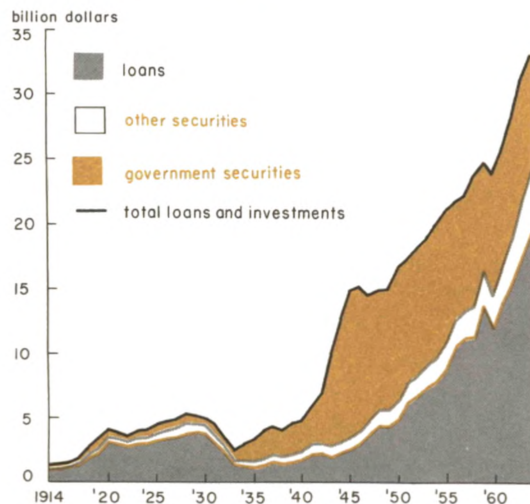
sion from war production and unemployment rose sharply as 4 million men were demobilized. Soon consumers turned to spending their higher incomes and savings accumulated during the war.

Prices had risen and shortages had developed during 1917 and 1918, but these were generally accepted because "there was a war on." As prices continued to rise rapidly in 1919, complaints about the "high cost of living" became bitter and widespread. From the end of 1916 to mid-1920, the consumer price index rose more than 80 per cent, and for many families income did not advance proportionately.

In part, the "shortages" of 1919 and early 1920 were the result of hoarding or advance buying by consumers and business firms who were speculating that prices would advance still further. This was apparent in the spring of 1920 when buying was sharply curtailed. Surplus stocks were thrown on the market and prices fell precipitously.

Assets of District member banks reflect economic tides



Speculation was also prevalent on the farms, mainly in the purchase of land. Some properties changed hands several times in the space of a few months and there was active trading in real estate options. Prices of farmland doubled from the time the war began in Europe to the spring of 1920. In 1919 the Chicago Reserve Bank's monthly review reminded its readers that prices of farmland had fallen by half in the aftermath of war-induced inflations in the past. This proved to be an understatement of what was to come. In Iowa, for example, prices of farmland fell more than two-thirds between 1920 and 1933.

In retrospect it appeared that the boom after World War I hit its peak early in 1920. The Federal Reserve Board's index of manufacturing output reached a high in the first quarter of 1920; a year later it had declined 33 per cent. (In the recessions since World War II, declines in manufacturing have not exceeded 15 per cent.) Average wholesale prices continued to rise in 1920 for several months after business activity began to recede, then dropped more than 40 per cent in a few months. The collapse of the commodity markets was worldwide.

Ever since, the 1919-21 development has served as a classic example of a speculative boom and bust. In its aftermath there was a wave of failures of business firms and banks and widespread unemployment untempered by a nationwide program of unemployment compensation. The experience showed that an over-ample supply of money and easy credit coupled with a widespread desire to gain through rising prices is likely to end in disaster.

In postmortems on the 1920-21 recession, the Reserve Banks have been accused of deepening the decline unnecessarily by restricting the availability of credit. This does

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not square with the fact that Federal Reserve credit and commercial bank loans continued to rise throughout most of 1920, reaching a high in October of that year. By the end of 1919 the situation had already deteriorated to the point that a business recession was about to begin. Perhaps a more valid criticism would focus on the rapid expansion of Reserve Bank credit throughout 1919 when it appears that the economy was already overly liquid. There was a desire to keep credit readily available while the Treasury floated the Victory Loan and while these securities were being "digested" by the market.

The prosperous Twenties

The decade of the Twenties was regarded at the time and in retrospect as a period of rapid growth and widespread prosperity. During 1928 and 1929, prior to the stock market crash in October of the latter year, many observers spoke confidently of a "new era" of stable prices, continuous high levels of profits, low unemployment and the probable elimination of serious business fluctuations. Nevertheless, the period ended in the most severe and prolonged depression in the nation's history.

Long before the end of the decade, there were many signs that all was not well. The 1920-21 recession had been followed by a rather sharp decline in activity in 1923-24 and a much milder drop in 1926-27. Moreover, agriculture was in a relatively depressed state throughout the period as were certain industries including coal mining, tanning, textiles and, after the peak of the construction boom in 1926, building materials.

Every year throughout the Twenties, hundreds of commercial banks suspended payments and had to be liquidated, reorganized or "taken over" by stronger institutions. In the generally prosperous year 1926, 182 banks—52 were member banks—suspended payments in the Seventh Federal Reserve District. Almost three-fourths of the suspending banks in the District were located in Iowa where declines in prices of farm products and farmland had led to numerous bankruptcies. Primarily, the problem was that banks held assets that could not be turned into cash readily when depositors demanded their money. The Reserve Banks' ability to help was limited by legal restrictions that allowed them to rediscount only short-term "self-liquidating" paper.

For most families the Twenties was a period of rising standards of living. Incomes were increasing and after 1925 prices—both wholesale and consumer — were drifting downward slightly. Income tax rates were reduced as the Treasury was running surpluses large enough to permit both tax cuts and reductions in the public debt.

Inventories were believed to be relatively low as evidenced by talk of "hand-to-mouth" buying, and most industries had moderate margins of unused capacity. Also, confidence had developed in the Federal Reserve System's ability to dampen business fluctuations by easing or tightening the availability of credit.

Various theories have been advanced to explain the bursting of the 1929 boom; some are critical of the actions of the Federal Reserve System. In general, these criticisms have centered upon measures taken to stem credit expansion in 1928 and 1929 and supposedly inadequate steps to maintain liquidity after the business decline began.

As noted earlier, the Federal Reserve System had largely achieved the tasks set out for it in 1913: it had provided an elastic currency and a means of discounting commercial paper when seasonal stringencies developed. The Reserve Banks' day-to-day func-

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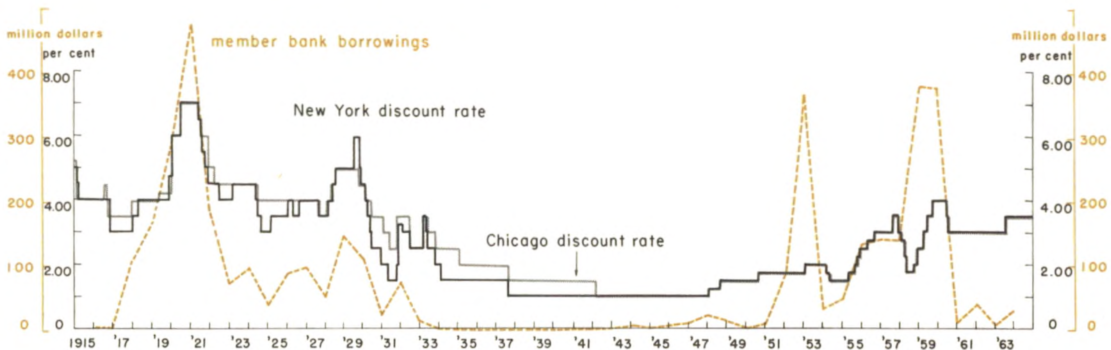
Discount rates and member bank borrowing



tions—acting as fiscal agents for the Treasury, clearing of checks and handling of currency and coin—had been adequately performed. In addition, the Banks had learned to cooperate with one another in shifting reserves from one District to another when regional stringencies developed and in conducting open market operations in a manner that implemented discount policy and offset the arbitrary impact of international gold movements. Finally, the System, mainly through the Federal Reserve Bank of New York, had established cooperative relations with the central banks of Europe.

Clearly these arrangements were not adequate to deal with the 1929-33 collapse. As in 1907, the causes of the decline were many and varied. One development that the System was ill-equipped to handle was the roaring stock market of 1928-29. Rising stock prices were based in large part on credit buying of securities, often on margins of no more than 10 to 20 per cent. The Federal Reserve System attempted to restrict excessive use of credit in the security markets in 1928 and 1929, but its capacity to do so was limited to actions that affected the availability of credit to other borrowers as well.

When stock prices began to decline, blocks of shares were thrown on the market if borrowers could not put up additional margin. In addition, there were many other practices, some of them now illegal, that made the market vulnerable to any downward adjustment. From the high in September 1929 to the low in June 1932, average common stock prices dropped an incredible 85 per cent.

Once the business decline began, the Federal Reserve System moved to ease credit availability. The discount rate of the Chicago Bank was reduced in November 1929. Member bank borrowing, nevertheless, was reduced substantially in 1930. Many commercial banks had surplus funds available because customers' loans were being repaid as prices and the volume of trade declined, and working capital needs were reduced. Often these bankers were extremely cautious in granting new credits in the face of growing economic chaos. In many cases where banks required assistance, supplies of commercial paper eligible for discount at the Reserve Banks—short-term credits incurred to finance transactions in goods—were limited.

The decline in discounts also reflected the attempts of the Reserve Banks to maintain

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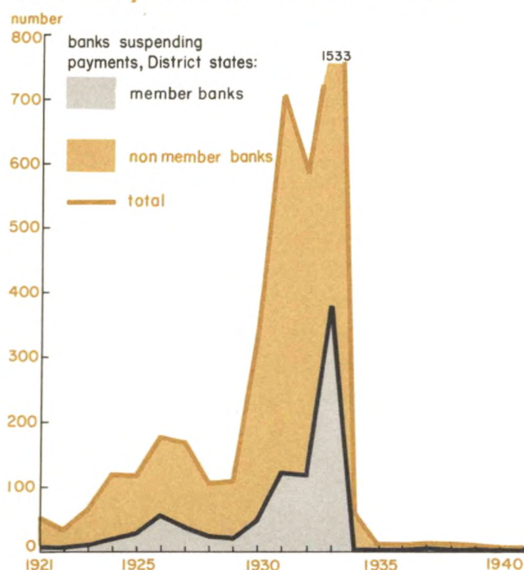
bank reserves by purchasing Government securities on the open market. Holdings of the Chicago Bank rose from 70 million dollars at the end of 1929 to more than 400 million in 1933.

Once the panic was on, confidence in the banking structure was undermined, even for banks in a basically sound position. Many individuals converted bank deposits to currency. To accommodate these demands the note issue of the Chicago Bank expanded from 300 million dollars in 1929 to 800 million in 1933. This currency was readily available from the Reserve Banks but to obtain it commercial banks were forced to sell or borrow upon the security of their most liquid assets and to restrict new loans.

Bank suspensions in the nation rose sharply in the early Thirties, reaching 4,000 in 1933. One-third were member banks. About 30 per cent of the suspensions were in the hard hit Seventh Federal Reserve District.

Bank failures have been at a very low level since 1934



From 1929 to 1932 total manufacturing output dropped almost 50 per cent, and output of durable goods declined almost 70 per cent. Industries that are important in the Seventh District were drastically affected. Production of motor vehicles in 1929 was 5.4 million and in 1932 only 1.4 million. During the same period output of steel ingots declined from 89 per cent of capacity to less than 20 per cent. Production of agricultural commodities was well maintained but prices declined sharply. Average prices received by farmers dropped more than 50 per cent between 1929 and 1933. Unemployment, in the depths of the Depression, was estimated to be as high as 25 per cent for the nation and was appreciably higher in some areas of the District.

Reconstruction

Shortly after taking office in early 1933, President Franklin D. Roosevelt declared a national "bank holiday." Governors of various states already had taken such action: Governor Comstock had closed the Michigan banks a month before. Banks were permitted to reopen after their condition had been investigated and a license granted by the Secretary of the Treasury. Many were recapitalized or were merged into other institutions. The Reconstruction Finance Corporation and the Federal Reserve Banks were active in this work.

Widespread recognition of the need for banking reform resulted in the enactment of the Emergency Banking Act of 1933. Its major provisions were confirmed and amplified in the Banking Act of 1935, which took its place as the most far-reaching piece of banking legislation in United States history. Many of its sections pertained to the Federal Reserve System.

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The Banking Act of 1935 provided for a permanent system of deposit insurance. It changed the name of the Federal Reserve Board to the Board of Governors of the Federal Reserve System, to consist of seven members appointed by the President. Formerly the Board had included the Secretary of the Treasury and the Comptroller of the Currency as ex officio members. The new Board was given permanent authority—in the Securities Exchange Act of 1934—to impose margin requirements on stock purchases and to change reserve requirements of member banks to as much as twice the ratios provided in the 1917 legislation, or any level within these limits. The Federal Reserve Banks were given the power to lend to member banks "on any sound asset" at a rate ½ per cent higher than the discount rate.

The act also created the Federal Open Market Committee, superseding the informal arrangement previously used to coordinate System purchases of Government securities and banker's acceptances. The Committee consists of the seven members of the Board of Governors and five of the presidents of the Reserve Banks. The New York Bank president serves continuously and the other presidents serve in rotation. The Chicago Bank president serves on the Committee every other year.

Banking legislation in the Thirties was intended to deal with the problems that developed in the late Twenties and early Thirties. Success was achieved in large measure. After 1934 bank failures were reduced to negligible proportions. Since 1941 only one member bank has failed in the Seventh District. Deposit insurance has played a vital role in preventing "runs" on banks—panic-inspired withdrawals of deposits—which had weakened many sound banks in the days prior to 1934.

Other amendments to the Federal Reserve Act have been made in the past 30 years. Most important perhaps was the reduction in gold reserve requirements of the Federal Reserve Banks in 1945 from 40 per cent of Federal Reserve notes and 35 per cent of deposits to 25 per cent of note and deposit liabilities. Also, if need arises, the law provides for the suspension of the gold reserve requirements. Other changes include the counting of cash held in the vaults of member banks as reserves, the permission granted the Reserve Banks to pay out notes of other Reserve Banks and, most recently, the authority to issue one dollar Federal Reserve notes to replace silver certificates.

From depression to war

Until World War II the recovery from the Great Depression was slow and incomplete. Moreover, there was a short but severe recession in the 1937-38 period that dashed hopes that the nation was on the road to full employment.

The discount rate was reduced in 1937 to 1.5 per cent in the Chicago District. Member banks were in an extremely liquid condition, however, and had no need to borrow. Reserves expanded substantially as gold flowed in from abroad, mainly because of unsettled conditions in Europe, but loan demand was weak and many banks were cautious in granting new credits.

After doubling bank reserve requirements in 1937, the Board of Governors permitted continuing gold inflows to increase reserves of member banks. In 1941, member bank reserves in excess of requirements totaled almost 7 billion dollars. Prior to 1942 there were relatively few short-term Government securities and only a scanty supply of other money market instruments in which banks could invest these excess reserves in the ab-

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sence of demand for loans from credit-worthy borrowers. Following the unfavorable experience of the early Thirties, long-term securities and mortgages were not viewed with favor by most bankers.

A vast defense program was initiated by the Government after the fall of France in 1940, and the rise in military spending accelerated after the United States entered World War II in December 1941. Taxes were increased substantially but only enough to pay for about half of the war effort. As a result, the Federal debt rose from 48 billion dollars in 1939 to 279 billion after the end of hostilities in 1945. The great bulk of the Federal debt that remains outstanding today was created in those years.

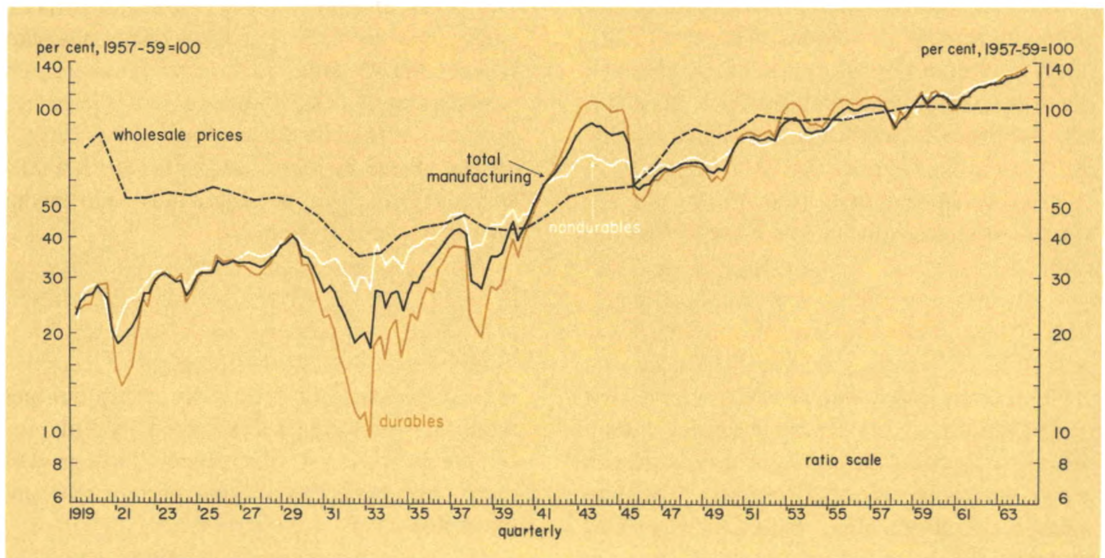
The credit base was expanded in World War I by a vast increase in discounts at the Reserve Banks. In World War II commercial bank reserves were increased as the Reserve Banks purchased three-month Treasury bills at a price fixed to yield ⅜ per cent and nine-month Treasury certificates to yield ⅞ per cent. Reserve Bank holdings of Government securities rose from 2.5 billion dollars in 1939 to 24 billion in 1945. Meanwhile, holdings of Governments by member banks rose from 14 billion dollars to 73 billion.

During World War II the bond department of the Federal Reserve Bank of Chicago expanded sharply from less than 100 employes to over 1,000. Even more than in World War I, an attempt was made to place small denomination savings bonds, and even savings stamps, with millions of individuals. The mechanics of these issues again were handled by the Federal Reserve Banks.

Seventh District manufacturers of durable goods, particularly the automotive, steel and machinery producers, converted almost entirely to war work in the months after Pearl Harbor. Largely to help finance these activities, member bank loans rose 60 per cent.

Once again the Reserve Banks performed many other functions in the war effort.

Manufacturing output has reflected changes in total economic activity



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Among these were the investigation and service of V-loans made by commercial banks to manufacturers and guaranteed by the armed services, and the administration of controls that restricted down payments and maturities on consumer instalment loans.

The postwar era

Liquidity injected into the economy during World War II in the form of currency, bank deposits, savings bonds and other near money assets together with the pent-up demands for consumer goods, business capital equipment and private and public construction produced an inflationary upsurge in total demand during the demobilization process in 1945 and 1946. The extent of the excessive demand became fully apparent only after price controls were eliminated in the autumn of 1946. Prices continued to rise until late in 1948 when the first postwar recession began.

In retrospect the price inflation and its reaction after the second world war was less severe than after the first. In part, this was because Federal Reserve credit and the money supply were not increased in the 1946-48 period, in contrast with the record of 1919. Nevertheless, even more effective policy would have been possible were it not for the implied commitment on the part of the System to support the market prices of long-term Government bonds at par or above. After the start of the Korean War, in early 1951, an agreement was reached between the Federal Reserve Board and the Treasury. Under this "Accord," bond prices and yields were gradually allowed to seek their own level as dictated by overall credit requirements.

The Korean War reproduced many of the features of World War II but on a smaller scale. The V-loan program and controls over prices, materials and consumer credit again were activated. Because the scope of the conflict was confined, it was possible to remove or moderate most controls before hostilities ended in June 1953.

Since 1949 there have been three recessions, beginning in 1953, 1957 and 1960, each of moderate amplitude. The first was associated with the defense cutbacks that started in the spring of 1953 and the second with the ending of the capital goods boom of the mid-Fifties. The 1960 recession, shortest and mildest of the three, is not as readily explained but it probably was related to the reaction to the long steel strike of 1959 and the balance of payments crisis of 1960.

The economy has been expanding continuously since early 1961. The long upswing has tended to quiet fears, widely expressed early in the decade, that the nation's capacity for economic growth had weakened. Nevertheless, there is increasing concern that unemployment remains undesirably high in the face of general prosperity.

Learning from experience

Fifty years ago it was believed widely that the provision of an elastic currency and a means of discounting short-term commercial paper would permit the banking system to operate automatically. Experience proved that these facilities did not eliminate the need for judgment and flexibility in providing monetary conditions conducive to full employment, price stability, economic growth and the strength of the dollar in international exchange.

From the beginning, officials of the Fed-

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eral Reserve System recognized a need to improve their knowledge and understanding of the economy that they were expected to influence. To this end economic research departments were established by the Board and each Federal Reserve Bank. The latter were charged primarily with responsibility for studying and interpreting developments in their respective districts. Information on finance, industry, trade and agriculture are tabulated and analyzed by research staffs.

Economic intelligence also requires constant contact with businessmen, bankers, economists and others outside the System. The regional nature of the System provides a group of observation posts scattered throughout the nation that are often in a position to spot trends that begin, or first become prevalent, in certain sections of the nation. Boards of directors of the Reserve Banks, representing diverse business and financial interests, aid this process, as do the bank examination departments.

Although experience has shown the need to coordinate or centralize the monetary policy activities of the Federal Reserve System, the Reserve Banks continue to carry a substantial responsibility in the formulation of such policy. The boards of directors set the discount rate subject to "review and determination" by the Board of Governors; each Reserve Bank administers its "discount window" in accordance with general standards used throughout the System, and Reserve Bank presidents serve as members of the Open Market Committee.

Reaching decisions on methods of achieving the various objectives of monetary policy can be expected to be as difficult in the future as it has been in the past. Proposals to change the structure and practices of the Federal Reserve System will continue to be discussed. Some of these proposals reflect the view that existing System objectives could be pursued more effectively. Others envisage a modification of these objectives.

President Wilson's words of 1913 often have been quoted as a comment on the Federal Reserve System: "We shall deal with our economic system as it is and as it may be modified . . . and step by step we shall make it what it should be." More than a half century later these words still apply and it is quite possible that the same view still will be pertinent after another 50 years.

In the past half century the structure of the Federal Reserve System, the organization of the Federal Reserve Banks and methods of implementing policies and operations have been modified in response to changing economic conditions and knowledge gained through experience. While "the future is not ours to see," the experience gained thus far does indicate the desirability of maintaining a high degree of flexibility to meet new conditions and to avoid rigid doctrines that almost certainly would be found wanting at a later date.

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