FRBSF WEEKLY LETTER

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Beginnings

The idea of a "central bank" in the United States arose from widespread concern over recurring financial crises and panics early in this century. Those crises and panics were caused by an "inelastic" supply of currency and credit and the absence of a central bank that could balance the amount of money and credit available with the American economy's ability to produce and consume goods and services. The form this central bank took is the subject of this *Letter.*

The authors of the Federal Reserve Act in 1913 conceived of a *decentralized* central banking system involving a combination of private and public interests. They created this structure to dispel widespread concern over a concentration of economic power—in this case, money and credit—in the hands of either the nation's banks (especially the large Eastern banks) or the nation's politicians.

At the time, the term central bank, with its connotations of centralized power and control, was so unpalatable to segments of the public that it did not appear anywhere in HR 7837, the Federal Reserve Act. In the intervening 70 years, we have come to accept the term as entirely appropriate given the dramatic expansion of the Federal Reserve System's functions in response to the demands of a rapidly changing and increasingly complex financial environment. This *Letter* discusses the principal provisions of the Federal Reserve Act to remind us that the decisionmaking structure of the System remains decentralized in a manner that is perhaps unique in American government.

Structure

An elated President Wilson signed the Federal Reserve Act into law on December 23, 1913. His desire for a *decentralized* reserve system with a "balanced" mix of public and private as well as regional elements, found accommodation in several key provisions of the Act. One was the stipulation that the number of Federal Reserve Districts be "not less than eight or more than twelve," delineated with "due regard to the convenience and customary course of business" and "not necessarily coterminous with state lines." Under an organizing committee headed by the Secretary of the Treasury, in consultation with representatives of banks, clearing houses, major industries and business associations, delineation of the resulting twelve Federal Reserve Districts occasioned considerable dispute in some sections of the country.

Concern for a proper balance of various interests was reflected in provisions affecting the structure and composition of both the Reserve Banks and the Federal Reserve Board. The "private" element was represented by the provisions for member bank stock subscriptions in, and election of, six of the nine directors of the proposed twelve regional Federal Reserve Banks. These directors were to include three bankers (Class A), one each to be elected by small, medium-sized and large banks, and three others (Class B) actively engaged in commerce, agriculture or some other industrial pursuit (in effect, potential borrowers) who could not be an officer, director or employee of any bank. The remaining three (Class C) directors, including the Chairman and Vice Chairman, were to be appointed by the Federal Reserve Board to represent the general public; they could not be a bank officer, director or employee, or own any bank stock. Thus, the majority of each Reserve Bank's board would consist of non-bank interests.

In 1977, the basis for selecting Class B and Class C directors was broadened substantially to include representatives of labor, consumers, and the service sector. Furthermore, the selection was to take place without discrimination as to race, color, sex or national origin. A bill recently passed by the House would add two Class C directors, at least one of whom must be representative of thrift institutions.

The directors also were empowered to appoint the Bank's officers and employees and "to dismiss them at pleasure." At the outset, the Banks began choosing a "Governor" as the chief executive officer. In 1935, Congress changed this position to "President" and subjected selection for this position to formal approval by the Board of Governors.

The Federal Reserve Act provided for stock subscriptions by member banks in part to obviate the need for government financing. In deference to the "dual" system of federal and state bank chartering, membership was made compulsory for national banks but voluntary for state banks, while stock holdings, which cannot be traded in the market, were (and still are) limited to a statutory dividend of 6 percent. The Act also stipulated that in the event that capital subscription by banks proved inadequate, stock in the Reserve Banks could be sold to the general public, and then to the Treasury as a last resort. As Congressman Glass, author of HR 7837, emphasized, the Reserve Banks would have "an essentially public character" and, except for purposes of the Federal Tort Claims Act, are "instrumentalities" of the government in the exercise of their major responsibilities.

Contrary to some assertions, ownership of Federal Reserve Bank stock does not vest control of the Reserve Banks (or the determination of System policies) in member banks. The Presidentially appointed Board of Governors must approve the appointment of Reserve Bank presidents (and may remove any Reserve Bank officer or director), must approve any change in discount rates, sets the rules under which a Reserve Bank may make advances to depository institutions, and must approve Reserve Bank budgets under guidelines and limits which it prescribes. Under guidelines set by the Congress, it also sets the prices which the Reserve Banks charge depository institutions for check clearing and other payments-related services.

The public nature of the Federal Reserve System is further evident in the fact that after operating expenses and payment of the small statutory dividend on stock subscriptions, all of the System's net earnings are paid to the Treasury. In 1983, these payments (mostly earnings from its open market portfolio and discount operations) amounted to $14.2 billion and represented about 90 percent of the System's gross income.

Wilson's "capstone"

In the words of Congressman Glass, the Federal Reserve Board would represent "the only factor of centralization in the new System." Specifically, he envisioned the Board as "an altruistic institution, a part of the government itself (but) a distinctly non-partisan organization whose functions are to be wholly divorced from politics." It would be an entity created solely for regulating relationships "between the Federal Reserve Banks and between them and the government itself."'

To this end, the Act provided for a seven-member Board, including, in addition to the Secretary of the Treasury and the Comptroller, five other members to be appointed by the President with the advice and consent of the Senate, with "due regard to a fair representation of the different commercial, industrial and geographical divisions of the country." At least two of the five were to be experienced in banking and finance but could not be officers or directors of a bank or hold any bank stock. However, President Wilson did agree to the establishment of a Federal Reserve Advisory Council consisting of one banker appointed by each Reserve Bank to meet at least quarterly with the Board to discuss business conditions in their respective Districts.

At the time, only one Board member was designated "Governor" and one "Vice-Governor" (the others, "members"). The Governor served as "active executive officer" notwithstanding the designation of Treasury Secretary as "Chairman." Initially, the Act did not fix the term of either the Governor or Vice-Governor as such, and until 1935, when the Board was renamed the "Board of Governors" and its powers and functions considerably expanded (at the expense of the Reserve Banks), the President generally appointed a member "Governor" for a year at a time, with frequent annual extensions.

The Act also empowered the President to remove board members "for cause." However, to help ensure that the Board and the new System's "banking processes" would, in the words of Congressman Glass, "be as far removed from all sinister influences as one pole is from another," the Act also provided for long and staggered terms for the five presidentially appointed members (ten years, after an initial phase-in; their terms were changed to 12 years in 1933 and then to 14 years in 1935), as well as exemption of the System from the Congressional appropriations process. The rationale behind a central bank enjoying a substantial degree of "independence" reflects a tacit recognition, underscored by historical experience, that it is not desirable to place direct control over the power to create money in the hands of those (the Congress and the Treasury) who develop spending programs and who pay the government's bills.

Functions

The principal duties of the Federal Reserve Board (which initially did not include the power to set or to vary reserve requirements inasmuch as these were set by the Act itself) were to "examine the accounts and affairs of each Federal Reserve Bank," to define the character or paper eligible for short-term (generally 90-day) discount (but not including notes drawn for carrying or trading in stocks and bonds other than U.S. government securities), to "review and determine" discount rates set by the Banks (the word "determine" was highly ambiguous and shortly led to intense intramural disputes), to appoint the three Class C Reserve Bank directors, to suspend or to remove any Reserve Bank officer or director for cause, to "set the rules" under which the Banks would conduct "open market operations," and to levy annual assessments on the Reserve Banks to cover the Board's expenses.

Reserve Bank officials simply did not then conceive of administering the discount window in such a way as to initiate credit and monetary expansion or contraction for the ultimate purpose of deliberately influencing the movement of aggregate income, output, prices and employment. These goals were expected to be achieved by adhering to the rules of the gold standard then in place. (That is, if the country lost gold, perhaps as a result of an adverse trade balance, credit would be restricted and interest rates raised to dampen economic activity and domestic prices, thereby making American exports more competitive. This, in turn, would lead to gold inflows, reduced interest rates, and so on.)

The same was true of "open market operations," including the purchase and sale by Reserve Banks of notes, bills, bankers' acceptances and drafts arising from commercial transactions plus government obligations. Initially, these operations were undertaken separately by individual Reserve Banks simply to provide themselves with a source of earnings from which to finance their expenses. They were not envisioned (or initially even recognized) as a powerful tool of monetary policy—a discovery not made until the early years of the "Roaring Twenties."

Reception

The Federal Reserve Act was not greeted with universal enthusiasm. Its passage had been marked by partisan opposition (from Republicans) and 28 abstentions or absences in the final Senate vote. At its convention in October, 1913, the American Bankers Association passed a series of resolutions denouncing the Act as socialistic, unAmerican, and (because of its provisions for requiring that reserves be held at the Reserve Banks) "confiscatory and unconstitutional."

New York investment banker Paul Warburg found some provisions "deeply alarming and distressing," and claimed they prompted the "determined opposition on the part of businessmen and bankers." These included Presidential appointment of members of the Federal Reserve Board (which he thought would make the Board "hopelessly political"), "excessive decentralization" that would result from twelve Reserve Banks, and the provision to make Federal Reserve notes obligations of the U.S. government as well as of the Reserve Banks—a "radical and revolutionary" step, according to former Senator Nelson Aldrich (R-RI), author of a rival "central bank" plan that would have centralized monetary control in private hands.

To many, the structure of the Federal Reserve System still seems unnecessarily complex and bewildering. But it is precisely its blend of regional and national interests that makes it representative of the various elements in American society. Its decentralized structure, under the "capstone" of the Board of Governors, also protects the Federal Reserve from the sometimes fierce short-term partisan political pressures to which both Congress and the Executive Branch are subject. This is exactly why Congress has endeavored to give the System a substantial degree of independence and insulation from political pressures in its day-to-day conduct of monetary policy. This independence takes place within government as the Federal Reserve is still accountable to Congress and must periodically report its plans and objectives for the monetary aggregates for a year ahead and how these relate to the short-term economic goals and projections of the President and Congress.

The Fed's structure, in short, reflects another practical application of the U.S. philosophy of federalism, one with its own built-in system of checks and balances.

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Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/10/84	Change from 10/3/84	Change from 12/28/83 Dollar	Percent Annualized
Loans, Leases and Investments[1,2]	183,757	342	7,732	5.5
Loans and Leases[1,6]	165,059	422	9,704	7.9
Commercial and Industrial	49,921	210	3,958	10.9
Real estate	60,966	64	2,067	4.4
Loans to Individuals	30,268	42	3,617	17.2
Leases	5,036	– 5	– 27	– 0.6
U.S. Treasury and Agency Securities[2]	11,630	– 85	– 877	– 8.8
Other Securities[2]	7,068	5	– 1,095	– 17.0
Total Deposits	192,909	739	1,912	1.2
Demand Deposits	46,684	464	– 2,553	– 6.5
Demand Deposits Adjusted[3]	30,901	1,292	– 430	– 1.7
Other Transaction Balances[4]	12,551	– 97	– 224	– 2.2
Total Non-Transaction Balances[6]	133,674	372	4,689	4.6
Money Market Deposit Accounts—Total	37,935	170	– 1,662	– 5.3
Time Deposits in Amounts of $100,000 or more	41,374	232	3,209	10.6
Other Liabilities for Borrowed Money[5]	19,822	– 508	– 3,185	– 17.5

Weekly Averages of Daily Figures	Period ended 10/8/84	Period ended 9/24/84
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	102	105
Borrowings	67	47
Net free reserves (+)/Net borrowed(–)	35	58

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately