The Federal Reserve System as Established and in Operation

An Address

By

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By Hon. Charles S. Hamlin.*

Governor of the Federal Reserve Board.

Now that the reserve banking system has become established, and the Federal Reserve Banks have opened their doors, it may be profitable to look back and consider what an advance has been made by the new system.

Under the old system, there were approximately 7500 National banks, each with its separate reserve and each independent of every other, the only interdependence being that arising from the deposit of reserves in other banks of the system—an interdependence of danger rather than of strength.

Under the old system, when a bank discounted commercial paper, it tied up its funds, the investment being to all intents and purposes as dead as if buried in the ground until it came to life again at the time of maturity. If any bank, pressed by necessity, should, metaphorically, take this note up from the grave and rediscount it before maturity, such an act, if done openly, would tend to raise suspicion of the solvency of the bank.

The result of the old system was that in times of unusual, even though normal, demand, the banks needing more credit to assist trade and commerce had to rely on their own credit unassisted by that of the business interests of the country, although the latter constituted the safest and broadest basis for credit in the world. The old system, in short, separated entirely the credit of the borrower from that of the bank.

So, also, under the old system, a bank, to keep possession of liquid assets which it could turn quickly into cash, was compelled to place its money on call loans, to be loaned on stock exchange security, as such loans could presumably

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be called in speedily. Even this practice, however, did not always bring the required amount of money into the banks, as in times of great stress, the loans could not be called; and as a result practically all the resources of the banks would be tied up in non-liquid securities, as we saw in the recent disturbances in our financial markets, growing out of the European War.

In other words, the liquidity of credit, under the old system, was the stock exchange loan; and as the legitimate trade and commerce of the country is infinitely greater than the speculative transactions upon the stock exchange, the result was an inverted pyramid, the apex of which was never stable. When money was idle, it rushed into the call loan market and was poured into the stock exchanges. When, on the other hand, there was need of expansion, it was at times difficult to withdraw this money from the speculative markets without affecting injuriously all our securities.

As a result, even the normal seasonal demands for cash and credit created acute strain, and at times when we were enjoying the benefits of splendid crops and great prosperity, we learned to our cost that the greater the prosperity, the greater the strain upon our banking system, resulting in high charges for the use of credit or money, thus injuring the whole trade and commerce of the United States.

Under the old system, still surviving for the time being, we had National bank notes as a basis for currency. These notes were chained to Government bonds. While this system of note issue permitted expansion, such expansion could only be accomplished by new issues of Government bonds generated from the necessities of the Government. In other words, under the old system, National bank notes, issued to help trade and commerce, were linked together with Government bonds, the evidence of the destruction of trade and commerce during the Civil War, the Spanish War and other necessitous periods of the Government. Thus the extension of the trade and commerce of the twentieth century was linked with the destruction of the trade and commerce of the nineteenth century. While there may have been some justification for this alliance in the nineteenth century, there is surely none in the twentieth century, and I earnestly hope the method provided in the Federal Reserve Act for retiring these National bank notes may prove efficacious.

The National bank note system, as I have said, is capable of expansion only but responds feebly to any necessity for contraction, even in times when contraction is absolutely needed for the protection of the legitimate trade and commerce of the country. Experience has shown that even when expansion was legitimate and necessary, the response has often been so sluggish that when the expansion of note circulation had fairly begun, the need of it had already passed.

Under the old system, there was no broad discount market. In original discounts, the note broker was an important factor and, as I have pointed out, once discounted, the note remained in the bank vaults.

Furthermore, all eyes were fixed on the rate for call loans; and while in foreign countries a very small increase in the rates would bring to a country capital from all over the world, yet in the United States a rate for call loans of 10, 20, 50 or 100 per cent. would have little effect on foreign investors, who well knew that such rates were but manifestations of a disturbed banking condition, rather than of legitimate demands for increased credit facilities.

Turning now to the Federal reserve system, it is easy to see what a change has been effected. In place of the scattered reserves, we have reserves mobilized in the Federal Reserve Banks. In place of bank notes issued by independent National banks, the Federal reserve system has provided notes based not upon Government bonds, but upon the trade and commerce of the United States. In place of fixed discount investments, we see the promissory note and accepted bill based upon commercial transactions leap into life; and what was a fixed investment has become an investment far more liquid than any loan upon stock exchange security. Furthermore, we see the resources of the reserve banks, including all deposits of Government funds, forever pledged to the use of trade and commerce.

And finally, after three years, we shall have a system under which all the reserves of the banks must be deposited either in their own vaults or mobilized in the Federal Reserve Banks, thus taking away from the member banks the dangerous privilege of pryamiding said reserves unduly.

In short, a new system has been established—a system based upon principles recognized over the world as sound—upon mobilized reserves, liquid assets and a note issue elastic and responsive to the needs of trade and commerce.

I have noticed some comment upon a remark of the Governor of one of our Federal Reserve Banks recently that the new system will relegate panics to obscurity. I believe this remark was intended to be applied only in a limited sense—that is, to financial as distinguished from commercial panics. If in the future business expands unduly under the spirit of speculation, the day of reckoning will surely come in the future as it has in the past. Undue expansion will correct itself just as the air bubble will ultimately burst. I believe, however, that the Federal reserve system will materially check undue expansion by making banks conservative as to their loans, because of the knowledge that any departure from strictly commercial transactions will take away their ability to liquidize such investments by rediscounts in the Federal Reserve Banks. It is a fact, however, that even under the Federal reserve system, or to speak more accurately, entirely outside the Federal reserve system, the banks still have it in their power to permit, if not to encourage, undue speculative activity; and if they do this, the inevitable result—commercial stringency—must follow. When, however, the State banks and trust companies of the United States join the Federal reserve system—I hope in the near future—even that possibility will be greatly minimized.

There is one form of panic, however, which I believe the Federal reserve system will relegate to its proper place, the museum of antiquities—and that is the panic generated by distrust in our banking system, leading to a struggle for self preservation between bank and bank and individual and individual and, to ultimate hoarding by the people. I say ultimate hoarding by the people, for to my mind such hoarding usually follows hoarding by the banks and does not precede it. It is safe to say that if hoarding by banks should cease, hoarding by individuals would never occur; and both, I believe, will be relegated to obscurity under the Federal reserve system.

No hoarding can be imagined more injurious than the hoarding by banks when they have engaged in this operation in the past. Each bank retreats into its own citadel at the sound of danger and at a time when it should be drawing upon its reserves to help the business man of the community, it stays aloof, piling up reserves upon reserves like Pelion upon Ossa, and the business men have to care for themselves as best they can. Witness the condition of some of our banks during the financial panic of 1907, with reserves of 60 and 70 per cent., although the legal requirement was 15 per cent. Similar conditions could be observed in our recent disturbance growing out of the European War. Many of these banks defended their action by pointing to our defective banking system, and there was some force in this argument; but whether the justification was complete or not, such a state of affairs will never occur again under the Federal reserve system. The mobilization of reserves and the turning of commercial paper into a liquid investment, will enable every bank to draw down its reserves with confidence that it can replace them at will if it has proper commercial paper at its disposal.

The Federal reserve system, as I have said, rests upon sound banking and financial principles. These principles are not new—they have been recognized for years abroad, and form the basis of the banking laws of many foreign countries. It is only the American people who have failed to recognize them and adopt them in the past; but this recognition has been accorded at last under the Federal Reserve Act.

Among these established principles are: the recognition of the fact that banking is not so much a cash as a credit problem; that the use of cash must be minimized and the use of credit extended; that a sound banking system cannot be predicated on cash alone, and that the more extensively credit is used, under proper safeguards, the sounder the banking system; that reserves should be mobilized so that the freest use can be made of them in times of unusual demand; that commercial paper must be turned from the non-liquid investment into a quick, liquid asset; that commercial paper based upon the trade and commerce of the people is the best self-liquidating asset that can be had; that, as has been so cogently pointed out by Mr. Warburg, my associate upon the Federal Reserve Board, the function of issuing money and the function of making money in banking should be kept separate and distinct in any sound system; that rediscounting institutions, such as the Federal Reserve Banks, should be conducted primarily for assistance to the commercial banks and not for profit, and that the latter should always be secondary to the former; that an open discount market is absolutely essential to any sound banking system.

All of these principles can be found in the Federal Reserve Act. We find there mobilization of reserves; the creation of a discount market; notes issued by the Government through the reserve banks, based upon adequate gold reserves and upon commercial paper; an elastic currency thereby created, which will contract as well as expand in accordance with legitimate demands of trade and commerce; Government influence in administration through the appointment of minority Government directors; Government examination, and Government taxation of surplus profits.

Furthermore, the Federal reserve system has taken for its foundation, not the call loan market, but the trade and commerce of the entire country. It has ear-marked as trust funds for the benefit of the trade of the country the resources of the Federal Reserve Banks, including all deposits of Government funds. Last, but not least, it has given to the Federal Reserve Board, a Government body, general control over the whole system, with power to fix discount rates of the reserve banks, and with power, in case of emergency, of permitting said banks, normally shut off from direct banking dealings with the public, to go into the open market and by purchase and sale of Government securities, and even also of bills of exchange, domestic and foreign, and bankers' acceptances, afford to the public engaged in trade or commerce such assistance as it deems necessary.

Such is the Federal reserve system established by the recent act. No man can say that amendments may not be desirable as to some features of the bill, but all will agree that it is a step, and a long step, in the right direction.

Much speculation exists as to the authorship of the Federal Reserve Act. It was finally presented to the country with the approval of a party caucus; in fact, it may be said to have been party but not partisan legislation. Republicans as well as Democrats voted for its provisions. Its underlying principles, as I have said, were not invented or newly created, but are the result of years of discussion and study. And let me add that your President, Honorable Seth Low, and the New York Chamber of Commerce, have powerfully assisted in establishing these principles. I can say this with confidence, however, that no selfish interests assisted at its birth. I can further state that, beyond those primarily responsible for its provisions—Mr. Glass and others of the House, Senator Owen and others of the Senate, and the Secretary of the Treasury, there looms up one figure more entitled to the credit for its provisions than any of the others, the man primarily responsible for this piece of wonderful constructive statesmanship—the President of the United States, Woodrow Wilson.