The Federal Reserve System

Hon. Charles S. Hamlin
Governor, Federal Reserve Board

FEDERAL RESERVE BANK
OF PHILADELPHIA

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Address Before The
Philadelphia Chamber of Commerce
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Gentlemen:

When I first received the most cordial and kind invitation from my old friend, your Secretary, Mr. Kelly, I said to myself that it would not be possible for me to accept, but I have had many years' friendship with your Secretary, and when I saw that he had come to see me in person I knew it was simply a question of a very few moments when I would have to comply.

During a large part of my professional career as an attorney, before going into the public service, I had the honor of representing the great community of New England, and I had very many controversies over the old question of port differentials with your community and Baltimore, and I can truly say that my body is covered with scars it received at the hands of your Secretary and the other able men who represented you in these negotiations.

It is very pleasant for me to be here today to speak to you briefly about the Federal reserve system, which has passed now one year of its existence.

The Federal reserve banks have been organized and open for a year. You have had the opportunity to see the work they have done and the even greater work they can do in the future.

You have had the opportunity to observe the character of the men who represent you, the people, and you, the member banks, and, as well, the Government of the United States.

I can point out to you, with pardonable pride, some of your representatives in this great district. I am sure you join with me in the gratification we have in the successful work done by the Chairman of the Board of Directors of your Federal Reserve Bank,—my friend, Mr. Austin—and also in the accomplishments of Mr. Rhoads, the Governor of this great bank, and I speak also with much pleasure when I refer to my friend Mr. Rue and his influence in the Federal Advisory Council. I also see here several of the Board of Directors of this great bank, one of them being my friend Mr. Norris. I only wish I had time to detail to you the number of high offices which have been pressed upon him, only to be declined. He is one of the rare examples of men; fitted to adorn any position, and yet he prefers to live quietly, doing his good work and remaining in the quiet influences of his home. I also see Mr. Alba Johnson, one of your directors, and also ex-Governor Stuart, and I say, as a New England man, that I cannot come to this great city without feeling a pride in the character of the citizenship that you have offered as officers and representatives in this great Federal Reserve Bank of Philadelphia.

We have had a year of progress. During this year of progress many things have happened. If you study the commercial records of the country, you will notice that the crops of the country ordinarily move in such a manner as to cause a certain apprehension throughout the country; whereas, since the passage of the Federal Reserve Act, these crops have moved without a ripple of excitement. We have seen the discount rates of the Federal reserve banks getting down to a close approach to uniformity throughout the United States. So successful has our system been, that, although some of the Federal reserve banks in the recent past have not made their expenses, yet substantially all are doing that now; and the reason for earlier deficits is that there have been so much available funds in the country that the banks have been able to meet every demand and have had no occasion to call on the reserve banks for that assistance for which the Federal reserve banks were created.

What is the principal reason for that condition today? I take it that business and banking depend upon confidence, and when confidence is impaired disaster must follow. When confidence is restored normal business conditions are restored and the country is once more filled with prosperity. There was a feeling among our people that the Federal Reserve Act was a long-desired step in the right direction, and its passage gave us confidence. We realize that we have at last a sound financial and banking system on which this nation can build its future prosperity.

Let us go back, for a moment, to August, 1914. You remember the conditions of foreign exchange at that time, the exportation of gold and our current indebtedness abroad which had to be paid in gold or its equivalent, and which amounted to nearly five or six hundred millions of dollars.

We had plenty of gold in the United States, but the Federal reserve banks had not yet been opened; the bank reserves were not consolidated, and one of the first tasks of the Federal Reserve Board was to apply to the banks and bankers of the country for a fund of one hundred millions in gold.

We said, "We will demonstrate to the world that every obligation, payable in gold, will be promptly paid," and, with the patriotism that was to be expected, the banks and bankers of the country arose and almost with a common impulse there was quickly accumulated a fund of one hundred and ten million dollars. It was a great act of patriotism. Then, having secured that fund of one hundred and ten million dollars—Mr. Rue will correct me if I am wrong—we found it necessary to send abroad only about ten million dollars, but the confidence of the world in the United States was fixed by that act.

Then, to help move the cotton crop, the Federal Reserve Board got together a fund of one hundred and thirty-five million dollars, and of that one hundred and thirty-five million dollars I believe we made one loan on cotton to an amount of about twenty-eight thousand dollars. And yet, some claim that that loan was not a success! On the contrary, that loan created confidence. It did not have to be used, any more than did the gold fund of one hundred and ten millions, but it did its good work, and that, decisively.

You will also remember the conference that was held between the eminent English financiers who came over here to see how we were going to pay our foreign indebtedness in gold, and as we sat there debating how it should be done—we had the resources with which to do it, but it was simply a question of how and when we should do it—we began to realize that the tide was turning, and almost before that commission reached home the question had resolved itself, not as to how we were going to meet our liabilities to them, but as to how they were going to meet their liabilities to us.

In the middle of that crisis you will probably remember we had to have recourse to the Aldrich-Vreeland Currency Act, and we issued three hundred and eighty-eight millions of notes, of which about three hundred millions were used, and that was very effective in averting the crisis then imminent. This Act, you will remember, was made workable only by the Federal Reserve Act. Taking into consideration the Aldrich-Vreeland notes and the clearing house certificates issued, it is safe to say that about five hundred millions was all that was needed to stem the crisis. Yet today we could issue seven hundred millions of Federal reserve notes if any similar crisis were to occur. I believe firmly that without the assistance at that time of the Federal Reserve Act in amending the Aldrich-Vreeland Act and in restoring confidence, we should have had a panic with which the panic of 1907 would hardly have served as an understudy.

I think you will realize from what I have said that the Federal reserve system is able to respond to every need and cure every crisis that may arise.

Confidence has been restored. Business conditions are in excellent shape and continually improving. You no doubt know the enormous surplus reserves the banks in this country hold today. I suppose it is nine hundred millions, probably a billion dollars. You know what amount of credit that represents; but, in times of such prosperity we should not forget to act with conservatism and prudence, and, I am glad to say, that the banks of this country are exercising conservatism and prudence, for it is for them to determine what our future shall be.

We should also remember that some states have lowered the reserve requirements for their state banks and trust companies, following the lower reserves permitted by the Federal Reserve Act for member banks; but state banks are not necessarily a part of the Federal reserve system and do not have the benefit of the consolidation of the reserves that member banks in the Federal system have, and, therefore, I repeat, there is reason for caution, care and prudence.

It is often said that under the Federal Reserve Act we can never again have panics. That is one of those statements that is half true. I believe we never again can have a currency panic, or a general collapse of credit; but, my friends, in any financial system, it is impossible to prevent the joy-riding, so to speak, of individual banks; any bank can commit suicide, and there is no system devised that can prevent such action. So, I say again, that even though no general panic can prostrate us, it is still necessary to impress upon you the necessity of prudence and caution.

The state banks also have the right to join the Federal reserve system, and I think about thirty banks have now joined its membership. The strong banks appear to be the ones that are coming into the system. In my opinion, I believe it to be a good policy for all state banks doing a commercial banking business to join the Federal reserve system, and I believe it can be shown to them that it is for their best interests to join that system. I am sure they will sooner or later come to that conclusion, because the Federal Reserve Act is built on a firm foundation, and the state banks will recognize that they must have a consolidation of reserves of their own or else come into our system.

I have heard it said that some bankers would like to have a Federal Reserve Act, so to speak, for state banks; but, if they went to their legislatures about it, I think the first question to be put to them would be, "Why don't you join the Federal reserve system? Why do you want to go to the expense of establishing a system for yourselves?" I believe there is no need for that. Now is the time of all times for them, the state banks, to join, for, if they wait for some stringency to arise they may find their assets not in as liquid a condition as now, and thus find it not so easy of entrance into the Federal reserve system as it would be in the good condition in which they find themselves today. Our regulations governing the entrance of state banks into the Federal reserve system have been most liberal. They can come in and still continue to loan on real estate. All we ask is that their assets shall be reasonably liquid. They can come in with power to carry Federal reserve notes and National bank notes in their reserves, if permitted by their state laws, and after they come in, if they feel that it is not advisable for them to stay in, on a year's notice they can withdraw. You will see we have gone to the limit in the liberal treatment we have accorded them.

A banker once said to me: "What is the use of state banks joining the Federal system if, as you say, there is never going to be any more financial panics? Why should they put up their capital and reserve deposits and go to that cost and trouble when the National system is going to take care of the country?" Suppose the people of a city get together on the subject of putting in a system of water for the prevention of fire, and one member of the community got up in the conference and said, "I read in a national report the other day that fire protection is so complete in the United States that there couldn't be any universal conflagration in this country. Therefore, why is it necessary for us to put in any system at all?"

Now that argument is about as sensible as that of those who rely on the strength of the Federal reserve system and, therefore, do not enter it.

Under the old system we had seventy-five hundred national banks and a much greater number of state banks. They were all independent. They had their individual reserves, and, under the law governing national banks, although they had reserves they were forbidden by law to use them, for, if they went below the reserve required under the act, after thirty days' notice, a government officer, the Comptroller, might appoint a receiver to take charge of the bank.

The customers of the banks were like a man dying of starvation looking through a plate glass window behind which there was every delicacy in the way of food, and upon which is inscribed a sign, "This food is for your benefit, but under no circumstances can you touch it. The smell and the luscious fragrance are for you, but not a particle of it can you eat." That was the condition of our National banks before the passage of the Federal Reserve Act.

In times of stringency, instead of freely drawing upon their reserves, they piled up their reserves and left the poor customer to take care of himself as well as he could. The result was that in times of stringency when we saw banks conserving their reserves and hoarding their assets, naturally, the people followed these masters of finance and imitated them and began to hoard for themselves. I know nothing more gruesome than the hoarding of frightened banks at times when they should be paying the money out to customers and helping to conserve the spirit of confidence throughout the United States.

Banks, under the old system, discounted commercial paper; and such paper when it was discounted was a dead asset until maturity. The bank officers would take these pieces of paper and place them tenderly in their vaults as if they were funeral vaults, and the notes were indeed dead, not to rise again until maturity. If some bank president with ghoulish propensities should try to rob the grave and sell these notes, he would have had the finger of suspicion cast upon him and his directors.

Under the Federal Reserve Act, however, the banks can instantly turn their paper into reserves, because they have only to step into their Federal reserve bank and take cash credit, gold or notes for it as they desire.

Under the old system National bank notes were supposed to be issued to meet the expansion and contraction of business, and yet these notes were indissolubly bound to Government bonds. The Government bonds determined the amount of those notes and not business necessity. The fluctuation in value of Government bonds, not dependent on business needs, was a predominant factor in the issuance of that currency. Government bonds do not represent business increase or contraction in the slightest degree. Government bonds represent the necessities of the past generation. They represent destruction of property through war, and we have the incongruous spectacle of commercial paper issued for business needs, tied to Government bonds, which represent past destruction of property and business. We had the commercial needs of the 20th century, expressed by bank notes, tied to the commercial destruction of the 19th century, represented by bonds. There may have been some reason for this incongruous alliance during the last century, but there is surely none during this century, and it is to be hoped that the Federal Reserve Act will soon get these notes out of the way, substituting a truly elastic currency in the shape of Federal reserve notes which will rise and fall in response to the legitimate needs and requirements of business.

I said that we all agree that the Federal Reserve Act is a long step in the right direction. It was not a political act, although offered by a great political party. It came to the floor of Congress and the Senate and was discussed and debated by the ablest statesmen. Although many changes were made, when the Act was finally passed it represented the best thought of the Congress of the United States and of all political parties. My own Senator, Hon. John W. Weeks, voted for that Act. Some thought it did not go far enough. Some preferred an act on the order of the so-called Aldrich act, but the great difficulty in that act was that the central board of directors representing the banks did not in any satisfactory way represent the Government, who might be said to, in turn, represent the people. If that act had become a law, sooner or later there would be a sharp line drawn between the banks on the one hand and the people on the other. That was felt so keenly that the Aldrich act was never brought to a vote in the House of Representatives. The trouble with that act was that it did not represent the public interests, it being admitted by all that reasonable public control is wise and proper for the banks and people of the United States.

I believe you are familiar more or less with the Federal reserve system. Under the Federal Reserve Act we have the country divided into twelve districts, and in each district the National banks come together and make a new bank called the Federal Reserve Bank. There are twelve such banks over the United States. Each district, however, varies in area and population. For example, the Federal Reserve Bank of Chicago covers a district whose area takes in a population of twelve millions of people, I think, for that district.

People talk of one central bank in the United States, and they say, "Europe has central banks—why shouldn't we?" Just figure it out for yourselves. The Federal Reserve District of Chicago has, as I said, a population of about twelve millions of people, greater than that of Norway, Sweden and Switzerland combined. I think you will agree that that is quite a respectable-sized central bank.

On the other hand, let us consider the area of the Federal Reserve District of San Francisco. In that area you could put all of continental Great Britain, France, Italy and Germany, and then have an area left over larger than New England—excepting only Maine—and I think you will see from that that it is a bank of somewhat large potentialities. The Federal Reserve District of Dallas also is larger than the entire continental German Empire.

The stockholders of the Federal reserve banks are entitled to six per cent. cumulative dividend. They have ultimately to deposit about forty per cent. of their reserves in the Federal Reserve Bank. There you have the consolidation of reserves. You have this reservoir, and every man, no matter what he puts in, can take out what the directors think best for him. No matter what he puts in he has a claim to the consolidated fund as long as there is enough to go around, and, I think, experience has shown that the consolidation of reserves will be more than capable of taking care of any future contingencies which may arise.

Furthermore, every dollar of funds held by the Federal reserve banks—and they have today about three hundred million dollars in gold, and thirty-four to forty million dollars in commercial paper—is a trust fund made so by the act of Congress, for the agriculture, commerce and industry of the United States. Not a dollar can be loaned out on call loans or stock exchange collateral. You all know that up to the time this act was passed we looked on the "call loan" as the financial barometer of the country. It occupied the center ring, so to speak. Now, however, we regard the call loan and transactions in the stock market with somewhat languid interest; they are both relegated to a side tent.

The Federal Reserve Board, as you know, was created to have general supervising power over Federal reserve banks, but I want to impress upon you that these banks are autonomous banks. Their boards of directors govern them. Upon them is placed the responsibility for failure, and to them must be given credit for the success which they are bound to achieve. The Federal Reserve Board represents not only the member banks, but also the people of the United States, upon the assumption that banking is affected with a public interest. The Government directors also represent the public interest, as well as the interests of the stockholders of the Federal reserve banks.

The Federal Reserve Board has power, ultimately, to determine the rate of discount and re-discount between the banks. There are, no doubt, many here today who can give us useful information upon this important matter, and we are glad to receive suggestions at all times. Any information you have that you consider of benefit to us will be gladly welcomed and considered with the utmost care. We want to keep in the closest touch with member banks and their customers behind them.

You cannot maintain a banking system and achieve success unless you give your agents, the banks, the greatest power, and that is what the Federal Reserve Board desires to do. We shall exert our best effort to hold up their hands and offer them assistance in whatever way we can; and, when we enact regulations governing in any way their conduct, you will know that we do it in the firm belief that it will be for the best interests of the people of the United States.

The Federal Reserve Act, as I stated, cures the defects I have pointed out in the old system. It consolidates the reserves, it provides for re-discounts between banks, and thus the twelve Federal reserve districts and banks are connected together under that system. Some people said, "You are giving too great power to the Federal Reserve Board in permitting it to force one Federal reserve bank to discount for another." We can, as you know, only do that by five votes out of seven. The people, however, who feared that power, are not supported in that fear by what has taken place, for not a single bank has asked for a re-discount. Even the three southern banks have gone through the whole season and still have a surplus, and the "peak of the load" has already been reached. I think Mr. Rue will bear me out that some of the banks have even become impatient because they had no opportunity for affording re-discounts.

Under the Federal reserve system the paper held by the member banks has become liquid, for any bank can at any time take its paper and turn it into cash or a cash credit at the Federal Reserve Bank. Under the old law, re-discounting was a sin, but under this act re-discounting is righteousness and the foundation of the whole system.

The Federal Reserve Act also provides for the issue of Federal reserve notes. These notes have to have one hundred cents on the dollar behind them in the shape of commercial paper, or one hundred cents in gold for every dollar issued. There could be no possibility of inflating the currency through Federal reserve notes, because they respond automatically to the needs of business. Suppose business increases. These notes, tied to business transactions, will increase also, and when business decreases the notes themselves will decrease and will be redeemed. It is a sound, flexible currency, with a forty per cent. gold reserve as the minimum, and I believe it is going to be a currency that will respond instantly to the needs and demands of the business men of the United States.

Occasionally some bankers come in to see us and criticise the Federal Reserve Act. They say, "If we come in and put our money in the Federal Reserve Bank, we lose our two per cent. on deposits with our reserve agents." A little reflection, however, satisfies them that the lowered Federal reserve requirements will permit them to make more than they would lose. That is a mathematical proposition, and I do not think it can be denied.

Sometimes a banker comes in and says, "We have no paper that can be re-discounted." We ask him to sit down and go over his portfolio, and after awhile he realizes that much of his paper would be gladly re-discounted by his Federal Reserve Bank. Where we find no paper that can be re-discounted, we advise him to go home and call his directors together and bring his bank back to a proper commercial banking basis from which it has evidently wandered and strayed.

Some tell us that many of the banks are not making dividends and that some have not been able to make expenses. I think they all now are making expenses except one. I want to ask you as business men if you were founding a new business would you expect to make expenses and dividends the first year after your new business was founded. I want to ask the bankers here if they know of any banks that make expenses and dividends the first year of their existence. I think if a bank pays dividends at the end of the second, or even the third, year it would be doing well. And remember, also, the reason that the Federal reserve banks have done so little business is because member banks are so prosperous they haven't had to come for assistance to the Federal reserve banks; but, in times of stringency, when all banks have to come to the Federal reserve banks for re-discounts, they will then make money and dividends, and, let me add, all dividends over six per cent. and a reasonable surplus go to the United States Government in the form of a franchise tax.

I am reminded of a railroad that was once organized in Boston. It was called the Boston, Barré and Gardner Railroad. The peculiarity of that railroad was, that it did not begin in Boston, did not go through Barré and never reached Gardner. I feel in a condition somewhat akin to that railroad. I have omitted to mention, at the outset, many things I intended to say. I have forgotten to dwell on many important topics I hoped to go through, but the anxious look on your President's face convinces me that I have certainly reached my terminus—Gardner, and, thanking you for your attention, I will now take my seat.