FEDERAL RESERVE BOARD

WASHINGTON

X-3375

April 3, 1922.

SUBJECT: Abstract from Annual Report.

Dear Sir:

I enclose herewith, for your information, two copies of a slightly modified abstract of the last few pages of the annual report of the Federal Reserve Board. This article has been prepared for publication, about the middle of April, in a special edition of the Raleigh (N. C.) News and Observer.

Very truly yours,

Governor.

(Enclosure)

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THE FEDERAL RESERVE SYSTEM - WHAT IT IS AND WHAT IT HAS ACHIEVED.

In order that there may be a clearer understanding of the principles which govern the policies of the Federal Reserve Board and the operations of the Federal Reserve Banks, it seems desirable to review briefly some of the essential features of the Federal Reserve Act, to discuss the measure of authority conferred upon the Federal Reserve Board, the joint and separate powers exercised by the Federal Reserve Board and the Federal Reserve Banks, and to describe concisely the fundamental character and some of the distinctive functions of the Federal Reserve Banks.

No Central Bank

Attention should be called, first of all, to the fact that the Federal Reserve Act did not establish a central bank. On the contrary, it adopted the regional principle and authorized the establishment of not more than 12 banks, to be located in various sections of the country. Each of these banks is practically independent of the others, in operation as well as in local policies. From a legal standpoint these banks are private corporations organized under a special act of Congress, namely, the Federal Reserve Act. Their stockholders are their member banks, each of which is required to subscribe to the capital stock of the Federal Reserve Bank an amount equal to 6 per cent of its own capital and surplus, one-half of which amount is required to be paid in.

Disposition of Earnings

After all necessary expenses of a Federal Reserve Bank have been paid or provided for, the stockholders are entitled to receive an annual dividend of 6 per cent on the paid-in capital stock, which is cumulative. After the dividend claims have been fully met, the net earnings are paid to the United States as a franchise tax, except that the entire earnings are paid into a surplus fund until that fund amounts to 100 per cent of the subscribed capital stock of the Federal Reserve Bank. Thereafter 10 per cent of the net earnings are paid into the surplus fund and the remaining 90 per cent paid to the Government as franchise tax.

Organization

Each bank has nine directors, of which six are elected by the member banks and three are appointed by the Federal Reserve Board. Not more than three directors can be officers or directors of member banks and the three directors appointed by the Federal Reserve Board can not be officers, directors, or stockholders in any bank. Three directors elected by the member banks must be men who are actively engaged in their respective districts in agriculture, commerce, or some other industrial pursuit. As there are 12 Federal Reserve Banks, there are, therefore, 108 Federal Reserve Bank directors, of which only 36 are appointed by the Federal Reserve Board, while the remaining 72 directors are elected by the member banks of the country - nearly 10,000 in number.

Lending Powers.

The law does not contemplate direct competition by the Federal Reserve Banks for business with each other or with national banks, State banks, trust companies, and savings banks. Federal Reserve Banks are not allowed to receive deposits from the public and can accept deposits only from their member banks, from the United States Government, and, solely for the purposes of exchange or collection, from nonmember banks or trust companies. They are not allowed to make loans or advances direct to the public, but can lend only to the United States, to their member banks, and, subject to certain conditions, for periods not exceeding six months, in anticipation of the collection of taxes or the receipt of assured revenues, to States, counties, municipalities, and other political subdivisions in the United States.

The Federal Reserve Banks are not permitted by law to make loans direct to individuals, firms, and corporations, and while they can, under certain restrictions, purchase bills of exchange and bankers' acceptances in the open market, their dealings with the public in the matter of loans are limited to the discounting of notes, drafts, and bills of exchange for member banks, all such paper to be indorsed by the member bank offering it. In lending in this way to their member banks, the Federal Reserve Banks are not authorized by law to use the same discretion and freedom of action that are allowed national banks, State banks, and trust companies, but they must observe the limitations prescribed by law as to the character and maturity of the notes offered them by member banks for discount; except as to notes, drafts, and bills

drawn or issued for agricultural purposes or based on live stock, which a Federal Reserve Bank may discount for a member bank if the maturity does not exceed six months, a Federal Reserve Bank can not discount any paper for a member bank which has longer than 90 days to run, exclusive of days of grace.

The law puts a limitation also upon the character of advances against member banks' notes. A Federal Reserve Bank may make advances to its member banks on their promissory notes for a period not exceeding 15 days, provided such promissory notes are secured by the deposit or pledge of bonds or notes of the United States, or by notes, drafts, and bills of exchange or bankers' acceptances which are themselves eligible for rediscount or purchase by a Federal Reserve Bank. To be technically eligible for rediscount a note must be indorsed by a member bank, its maturity must be within the time limit prescribed by law, and it must have been issued or drawn for agricultural, industrial, or commercial purposes, and it must also be shown that the proceeds of the note have been used or are to be used for such purposes.

As Federal Reserve Banks are not permitted by law to rediscount any paper which does not bear the indorsement of a member bank, it is clear that in order for a Federal Reserve Bank to render financial assistance to those engaged in commerce and industry, in agriculture, or in the raising of live stock, the loans must first be negotiated with member banks. There are many loans, however, which member banks may legally and properly make which can not be rediscounted with Federal Reserve Banks for the reason that the law does not admit of the classification of such paper as eligible. A Federal Reserve Bank, therefore,

can not discount any paper, however good it may be, which is not technically eligible under the terms of the Federal Reserve Act; and, on the other hand, it is entirely within its right in declining to discount notes which, even though technically eligible, are not satisfactory from a credit standpoint.

Federal Reserve Banks are forbidden by law from discounting notes, drafts, or bills covering merely investments, or issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States.

Reserves

The Federal Reserve Act, as amended, has changed both the amount and character of the reserves which all national banks and State member banks must carry against their deposit liabilities. For a long period of years it has been the practice of American banks to carry as a reserve in cash and on deposit with other banks a certain proportion of their deposits. Before the passage of the Federal Reserve Act the national banks in the three central reserve cities were required to keep in their own vaults as reserve in gold or lawful money an amount equal to 25 per cent of their net deposits, and in other cities and towns they were required to keep a part of their required reserves in cash in their own vaults, while a part might be kept on deposit with other banks. The laws regarding the reserves of State banks varied in the different states. Under the Federal Reserve Act the percentage of reserve required has been substantially reduced, and, as amended, no national bank and no State member bank is required to keep any definite

amount of cash in its own vaults, and whatever amount of cash is kept on hand by the member banks, as deemed necessary by the judgment and experience of their officers, does not count as part of the banks' lawful reserve.

The entire legal reserves of all member banks must be kept on deposit with the Federal Reserve Banks. As a consequence, the cash resources of the Federal Reserve Banks are necessarily very large and their holdings of gold, in particular, constitute a very large proportion of all the gold in the country. The gold held by the Federal Reserve Banks is equal to all the gold that would have been in circulation or held by all the banks throughout the country if there had been no Federal Reserve Banks established.

As the Federal Reserve Banks were made the sole custodians of the legal reserves of all member banks, the object of Congress in throwing safeguards and limitations around their loan transactions is evident. It is necessary that Federal Reserve Banks should keep themselves in a "liquid" position; that is, their bills discounted must be of short maturity and should be readily collectible. The strength of the entire banking system of the United States is directly related to the strength of the Federal Reserve Banks. If the Federal Reserve Banks should allow themselves to get into a weak, over-extended, and unsafe position, all member and non-member banks would be seriously affected.

General Powers and Limitations.

While Congress has placed upon the Federal Reserve Board the responsibility of defining eligible paper, within the meaning of the Federal

Reserve Act, it has intrusted the management of the Federal Reserve Banks, under the general supervision of the Federal Reserve Board, to their own directors. Each Federal Reserve Bank has power to appoint, by its board of directors, such officers and employees as are not otherwise provided for in the Federal Reserve Act and to define their duties, to prescribe by-laws, not inconsistent with the law, regulating the manner in which its general business may be conducted, and to exercise, by its board of directors, or duly authorized officers or agents, all powers specifically granted by law and such incidental powers as may be necessary to carry on the business of banking within the limitations prescribed by law.

Each Federal Reserve Bank is conducted under the supervision and control of its board of directors, who are charged by law to perform the duties usually appertaining to the office of directors of banking associations and to administer the affairs of the bank fairly and impartially and without discrimination in favor of or against any member bank or banks and, subject to the provisions of law and the orders of the Federal Reserve Board, to extend to each member bank such discounts, advancements, and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks.

The Federal Reserve Board is not authorized by law to pass upon the paper which is offered for discount to Federal Reserve Banks. This is a function which must be exercised by the directors of the Federal Reserve Bank or by their duly authorized officers or agents. While the law does not prescribe any fixed limit as to the amount of loans that a Federal Reserve Bank may make to a member bank, it does require that due

regard must be given to the claims and demands of other member banks; that is, to their possible needs for credit accommodation. It also provides that a Federal Reserve Bank must extend to each member bank such discounts and accommodations as may be "safely and reasonably" made. This means that the directors of a Federal Reserve Bank and the officers appointed by them must exercise their best judgment in granting discount accommodations. They must assure themselves that the discounts are such as can be safely made, and reasonably made, with due regard to the possible requirements of other member banks which may ask for accommodation later on.

The lending power is not vested in the Federal Reserve Board and the reason for this is probably twofold. First, The Federal Reserve System is not a central bank. It is a regional system comprising twelve banks. Congress did not intend that there should be a centralized control of credits. Second, In a country embracing so vast an area as the United States, it would be a very difficult task, if not an impossibility, for a central board to pass intelligently upon the security of the paper offered for discount, which must necessarily come from all sections of the country.

No Control Over Member Bank Loans.

While the Federal Reserve Act was intended to strengthen the banking system of the United States and to provide ready means of rediscounting certain classes of paper, it is also the evident intention of the act to disturb as little as possible the business of the member and non-member banks, or their dealings with their customers. There is nothing in the Federal Reserve Act which gives either the Federal Reserve Board or a Federal Reserve Bank any control over the loan policy of any member bank. A Federal Reserve Bank can not compel a member bank to make a loan which it does not desire to make, nor restrain it from making a loan which it wishes to make even though it is forbidden by law.

A Federal Reserve Bank can not lend directly to the customers of a member bank, nor does it, in fact, take the initiative in making loans to a member bank for the purpose of enabling the member bank to distribute the funds so advanced to its customers. The Federal Reserve Bank lends to the member bank against transactions already made, for the purpose of enabling the member bank to restore its reserve to the legal requirement, after the reserve has been impaired or is about to be impaired because of increased loans and deposits.

There is a very general popular misconception regarding this, and it may be that some of the member banks are responsible for this misunderstanding without being actuated, however, by sinister motives. Banks, as a rule, do not like to admit to customers that they are short of loanable funds nor do they wish to arouse enmity in declining to make loans or in asking for a reduction of a loan already made.

There are doubtless some bank officers who are able frankly to decline an application for a loan in a way which leaves no sting, but not all bank officers have such tact. Some are frank enough, but their bluntness hurts the feelings of the would-be borrower. It is not unusual, therefore, for some bank officers in declining loans to seek to evade direct responsibility. Formerly, the board of directors was made useful in this capacity. In recent years, however, bank officers have found in the Federal Reserve Board or the Federal Reserve Bank a much more satisfactory buffer than a local board of directors. In many cases, in small towns particularly, banks have found it convenient to pass the responsibility on to the Federal Reserve Bank or the Federal Reserve Board, and have stated to a borrower or would-be borrower that they would like to grant the extension asked for or make the loan desired, but the Federal Reserve would not permit it. Such a procedure has a tendency to relieve the situation as far as the local bank is concerned, but it is certainly unfair to the Federal Reserve System. This evasion of responsibility has subjected the Federal Reserve Banks to a great amount of unjust criticism and has given the public a wrong impression of the authority and attitude of the Federal Reserve Banks and the Federal Reserve Board.

It is entirely true that a Federal Reserve Bank, mindful of its responsibility under the law and acting in accordance with the dictates of ordinary banking prudence, may have had occasion to call the attention of some of its larger borrowing banks to their large discount lines, which have run in some cases over a period of years without being reduced, and have called the attention of the borrowing banks to the necessity of working themselves into a stronger position. But in no case within the

knowledge of the Federal Reserve Board has any Federal Reserve Bank undertaken to say to a member bank what particular loans it should call or ask to have reduced.

Federal Reserve Note Issues.

There is perhaps as much confusion in the public mind regarding the issue of Federal Reserve notes as there is regarding the rediscounting functions of the Federal Reserve Banks. There are some who appear to have an impression that the Federal Reserve Board has power to expand or contract the currency of the country at will and that it has exercised this power in a reckless and arbitrary manner. While the law prescribes that the Federal Reserve Board shall have the right, acting through the Federal Reserve Agent, to grant in whole or in part or to reject entirely the application of any Federal Reserve Bank for Federal Reserve notes, it has never exercised this right. On the contrary, it has always approved promptly every application which has been made for the issue of Federal Reserve notes. One of the purposes of the Federal Reserve Act, as stated in its caption, is to furnish an elastic currency, but there are some whose idea of elasticity is continuous stretching.

Currency to be really elastic must be susceptible of expansion or the reverse, as the needs of industry and commerce may require. Many believe that there was a preordained contraction of the currency during the year 1920, determined upon in order to reduce prices. The expansion of nearly $600,000,000 in Federal Reserve note circulation which actually took place during that year shows that the impression is absolutely unwarranted.

An increase or decrease in the volume of Federal Reserve notes outstanding is not the result of any preordained policy or premeditated design, for the volume of Federal Reserve notes in circulation depends entirely upon the activity of business or upon the kind of activity which calls for currency rather than book credits.

Federal Reserve notes can be issued only against collateral in an amount equal to the sum of the Federal Reserve notes applied for, which collateral security must be notes and bills discounted or acquired by the banks or gold or gold certificates. The law requires each Federal Reserve Bank to maintain a reserve of 40 per cent in gold against its Federal Reserve notes in actual circulation.

During the year 1921 the loans of the Federal Reserve Banks to their member banks decreased by about $1,500,000,000; and as the notes discounted with Federal Reserve Banks have been paid off, Federal Reserve note currency has come back to the banks and, in the absence of a demand for it, has not been reissued. Upon payment of commercial paper which has been deposited to secure Federal Reserve notes, there necessarily results either an immediate return of an equivalent amount of notes to the bank or an automatic increase in the percentage of gold reserve available for their redemption. Federal Reserve notes are not legal tender, nor do they count as reserve money for member banks. They are issued only as a need for them develops, and as they become redundant in any locality they are returned for credit or for redemption to the Federal Reserve Banks or to the Treasury at Washington. Thus, there can not be at any time more Federal Reserve notes in circulation than the needs of the country at the prevailing level of prices and wages require, and as the demand abates

the volume of notes outstanding will be correspondingly reduced through redemption. The increased volume of Federal Reserve notes in circulation from 1917 to the end of the year 1920 was, in so far as it was not the result of direct exchanges for gold and gold certificates, the effect of advancing wages and prices and not their cause, just as the reduction which has taken place during the past year is the result of lower prices and smaller volume of business, rather than their cause.

Under the Federal Reserve System, as business expands, as labor is more fully employed, and as production increases and distribution becomes more active, there follows a demand for greater discount accommodations and a need for more currency, and the increased volume of discounts furnishes a means of providing the increased volume of currency required.

Aid for Agriculture Through Rediscounting.

Some of the Federal Reserve Banks have much larger resources and consequently greater lending power than others. In ordinary times the Federal Reserve Banks in agricultural sections have very heavy seasonal demands made upon them for accommodation and in the fall of 1920 these demands were abnormally large because of the difficulty experienced in marketing agricultural products. As the Federal Reserve Banks are required by law to maintain certain specified reserves, both against their deposits and their note issues, and are required to advance their discount rates whenever their reserves fall below the legal requirements, it is evident that they must have some way of supplementing their resources in order to continue to accommodate their member banks and through them the public.

During the war every interest was subordinated to the single idea of winning the war, and restrictions were imposed upon many kinds of ordinary commercial and financial activities. The Government, in order to carry on the war, was obliged to borrow large sums and had outstanding when the war ended about $25,000,000,000 of bonds and short-time notes or certificates. The flotation of this vast amount of securities, without any impairment of the standard of value, was made possible by the Federal Reserve System.

The Federal Reserve Banks issued Federal Reserve notes up to the capacity of their respective communities to absorb them and maintained their lending power by rediscounting with other Federal Reserve Banks. After the war ended the various restrictions upon commerce and industry, which had been imposed during the war, were removed and for several months there was extraordinary activity in all lines, which continued until the late spring of the year 1920.

Then came a violent reaction, accompanied by a drastic fall in prices and by conditions which without the aid of the Federal Reserve System would have resulted in a financial panic of unprecedented proportions.

The Federal Reserve Board is empowered by law to permit or require one Federal Reserve Bank to rediscount for another and to approve applications of a Federal Reserve Bank for Federal Reserve notes, to decline them in part or to refuse them altogether. In every instance the Board arranged promptly all applications made by Federal Reserve Banks for rediscounts, and provided for the immediate issue of all Federal Reserve notes applied for.

In this way the Federal Reserve Banks in agricultural sections were able to tide their member banks over a most dangerous and embarrassing situation by making advances in amounts far beyond their normal lending power.

What Happened in Two Typical Agricultural States.

The reports of the Comptroller of the Currency show that on August 22, 1907, just before the panic of that year, the rediscounts and bills payable of all national banks in the entire United States amounted to $59,177,000. At one time during the fall of 1920 the borrowings of member banks in North Carolina alone from the Federal Reserve Bank of Richmond amounted to $28,758,889.53. At about the same time the borrowings of Iowa member banks from the Federal Reserve Bank of Chicago amounted to $98,636,000.

The Value of the Federal Reserve System.

Perhaps it might be indelicate for me to express an opinion as to the value of the Federal Reserve System to the country during the disastrous year 1920, but there is no impropriety in quoting a few passages from the report of the Comptroller of the Currency for that year, which was transmitted to Congress on February 7, 1921. In this report the Comptroller said:

"The story of Japan's industrial and financial experience is largely similar to the experience of South American and European countries - some of them our allies, and others neutral. Some of these countries are now going through a business cataclysm similar to that through which Japan has so recently passed. In our own country we have been thus far

fortunate enough - thanks largely to the splendid efficiency and stabilizing influence of the Federal Reserve System - to avoid the financial crises and complete disorganization which have made havoc elsewhere. We have passed with comparative safety through exceedingly troubled and nerve-racking times; but difficult and dangerous problems remain to be solved, the solution of which will demand clear heads and steady nerves." . . . . . .

"The deflation which at that time (1919) was obviously inevitable has come, and the country is now in many respects on a sounder basis, economically, than it has been for years." . . . . . .

"Largely through the aid and excellent functioning of the Federal Reserve System, the business and banking interests of the country have passed successfully through the perils of inflation and the strain and losses of deflation without panic and without the demoralization which has been produced in the past at various times from far less serious and racking causes. Those banking and other interests which at the outset so vigorously opposed the Federal Reserve System are now among its warmest advocates." . . . . . .

"The past seven years have been, in numbers of persons and extent of interests involved, the most momentous and critical in the history of this Republic. We have had to face and solve gigantic and unprecedented problems, and the banking and financial machinery of the country has been subjected to a test and strain unparalleled. It has been the duty of our country very largely to finance the world, and in carrying out the program which fate imposed upon us we have overcome successfully difficulties that at times seemed almost insurmountable

and we have met every righteous demand made upon us. Our Federal Reserve financial and banking system, inaugurated in 1914, has been of inestimable value; and without its aid, tasks which we have so successfully accomplished would have been impossible."

The present Comptroller of the Currency, in his report to Congress for the year 1921, has this to say:

"The year has been one of the most trying through which banking institutions have passed in a long period. Following an experience of inflation which, considering its world-wide extent, was perhaps without parallel, the banks in the past year have been under the necessity of facing the reaction in the form of progressive deflation. To an extent that a few years ago would have been beyond our utmost imaginings, the necessity has been imposed upon the American banking system to provide, as it were, a pneumatic cushion to ease down the economic structure of the world. The strain has been a heavy and difficult one, and the results have been such as to justify, beyond all our expectations, the confidence that has been reposed in our Federal reserve system.

"It is occasion of much satisfaction to be able to report that the national banks have demonstrated throughout this difficult experience a most impressive stability, strength, and soundness of management. That they have stood the test so well is largely due to the high courage and excellent management of their officers. It would be an egregious injustice to omit acknowledgment of this service to the public, and of the fine cooperation which the banks have extended to the supervisory authority of the Government." . . . . . .

"It must be borne in mind that the inauguration of the Federal reserve system was practically simultaneous with the outbreak of the Great War,

which, though it did not involve the United States directly for a long time, nevertheless had its instant reactions upon our financial and economic concerns. These reactions were so extensive and intensive that there is hardly possibility, in view of our experience of the last seven years, of questioning that but for the timely establishment of the Federal reserve system, our country, and indeed the rest of the world, would have suffered much greater difficulties in financing the war, than were actually experienced. It may well be doubted whether the extraordinary demands that were made upon American industry, agriculture, and finance could possibly have been met if this instrumentality of credit consolidation and elasticity had not been in existence. We will arrive at the most adequate appreciation of what the Federal reserve system has meant to us during these trying years, if we will undertake to visualize the conditions that would have existed had we been compelled to operate through the financial mechanism that was in existence prior to the creation of the Federal reserve system." . . . . . .

"It was inevitable that the period of deflation which followed the war's expansion of credits should be intense and difficult in proportion to the extent of the inflation. While it is true that no banking system could have created assets and industrial capacity where these did not exist in substantial forms, yet it is also true that none save a highly efficient and smoothly functioning system, could have made possible the contributions of our country during the world's crisis. It is a further testimony in favor of our system that since the armistice we have been able to proceed farther, and with less discomfort, on the way to normal conditions, than any other of the great powers."