X-6055

The attached article on "The Federal Reserve System" is by A. C. Miller, Member of the Federal Reserve Board. It has been prepared for publication in the June 30th or Jubilee Number of the London Statist commemorating the Fiftieth Anniversary of the founding of that paper.

It is issued with a release date for American papers not earlier than evening papers of June 30th. Suitable acknowledgment of its preparation for the London Statist should be made by the American papers using the article.

THE FEDERAL RESERVE SYSTEM.

The fundamentals of central-note-issue and reserve-banking are few and simple. And they are pretty widely recognized. Sometimes dignified by the name of "Principles" they are in fact little more than rules of administrative expediency and working practices developed out of experience in dealing with conditions. As the Bank of England is the prototype of central and reserve banking, the practice developed by it in the course of its long history has naturally supplied the general pattern after which other central and reserve banking institutions have been modeled with greater or less fidelity. Whatever their differences in structure, function and technique, they are merely variants of the mother type. In the last analysis all central and reserve banks are offspring of the Old Lady of Threadneedle Street.

It is nevertheless true that in a survey of central banking institutions it is the variations from type and the differences among them that constitute the chief matter of interest. The problems that present themselves to the management of these institutions may be one in the application of principles but unless the principles are tempered in their application by considerations of latitude and longitude, in brief by the exercise of a sound discretion in dealing with the particular conditions that surround them, the results do not usually prove satisfactory. Central banking is not - certainly not yet - an exact science and the wise practice of the art of central banking calls for larger qualities of mind than the habit of imitation. That this is appreciated is shown in differences to be found in the laws under which these institutions are organized in different countries, and these laws differ as do the institutions largely in the nature of the limitations, restrictions, safeguards and guarantees of one kind and another to insure the exercise of judgment in ways that are safe and prudent. There are some that allow great latitude for the play of discretion in many directions, others that allow much in certain directions and little in others, and others still that limit it narrowly in most ways.

The Federal Reserve System is a conspicuous example of an institution permitted the exercise of wide discretion in the handling of its problems and this accounts in large measure for the great flexibility it displays whether in the field of operation or of policy. Young in years it has nevertheless had a large experience. It has already attained something of a distinctive quality or personality. Its characteristic trait is expressive of the genius of American institutions. That genius, above all in the sphere of economic relationships is <u>flexibility</u> and this flexibility has reported itself in the Federal Reserve as flexibility of mind and operation and has given rise to a distinct flexibility of credit-control technique.

Closely associated with this outstanding quality of flexibility is the weighting of the operation of the System at every turn with an active and broad sense of public interest. This result has been achieved partly because of the clear expectation of the law but also and largely because of a self-imposed obligation on the part of those responsible for its operation and administration.

Looking at some of the variations of the Federal reserve banks from the mother type in the process of adapting its ways to the genius of the American people, it is noteworthy that alone among the central note-issuing and reserve-holding institutions of the leading countries the Federal reserve is not a central bank. The Federal Reserve System consists of twelve banks to each of which is assigned a definite area of territory known as a Federal Reserve District. Each of the twelve banks is autonomous within its province and each is independent of the others. This framework represents an adaptation of the structure of reserve banking to the analogies of the political, social and economic organization of the United States. That organization, as is well known to students of America, has much of a distinctly regional character - more especially on the economic, financial and social sides.

The problem of reserve banking even in a country as large as the United States with different sections of it in different stages of economic and financial development, however, requires attention to more than regional conditions. Ample provision was, therefore, made in the Federal Reserve Act for giving effect to the indispensable viewpoint of the national economic interest and its paramountcy at times in deciding the course of policy and operations of the Federal reserve banks.

In order to give adequate expression to the national viewpoint and to provide a means of coordinating at times the activities of the Federal reserve banks toward the attainment of objectives of national interest an agency, governmental in character and designated The Federal Reserve Board, was set up. Through this means it was sought not only to weight the administration of the Reserve System with a sense of national interest but also to give to the attitude of the Federal Reserve System and its larger determinations the aspect and quality of public policy.

It may be claimed for the institution of the Federal Reserve Board that it constitutes a distinctive element in reserve banking. Certainly no understanding and appraisement of the Federal Reserve System can be undertaken without an appreciation of the position, responsibilities, powers, functions and viewpoint of the Board. Standing at the apex of the System it is clothed with general power of supervision of the Federal reserve banks. Their actions are subject to its review and revision; it has the final say in the determination of discount rates; it has a voice in their open market operations and in matters affecting their international relations - to mention only some of the more important matters affecting the current operation of these banks. The Board also has ultimate authority in the matter of Federal reserve note issues; it has the power within limits to change the reserve requirements of its member banks; it has authority to suspend on occasion the legislatively-prescribed minimum reserve requirements both of the Federal reserve banks and of the member banks of the Federal Reserve System. It is, in brief, without carrying the specifications further, the repository of broad and varied discretionary authority such as the framers of the Federal Reserve System believed to be essential to the effective practice of reserve banking in the United States.

It is this vast grant of authority, exercised under the control of a governmentally constituted Board representative of the public interest and responsible to the nation, that makes the Federal reserve banks unique among the great banks of the world for flexibility of operation.

The Federal Reserve Board is, however, more than an agency of supervision and administration. It is a symbol - a symbol of the broad public interest and responsibility with which the reserve banks from the American point of view are invested. The dependence of economic well-being upon the manner in which institutions of the central banking type are operated is probably nowhere more keenly appreciated than in the United States; nowhere is more demanded or expected. The institution of the Federal Reserve Board may, therefore, be regarded as the method by which the American legislator at the time the Federal Reserve Act was drawn undertook to surround the operation of the Federal reserve banks with a constant atmosphere of broad public interest and to give to the administration of credit under the auspices of these banks a wider outlook and a truer sense of direction than might have been expected if their management had been more distinctly and exclusively of a "business" type. It is doubtless for this reason that the allegation of selfishness has seldom been made against Federal reserve banks; and, considering how sensitive the American temperament is in matters touching currency and banking, it is also no doubt because of the existence of such an institution as the Federal Reserve Board that hostile criticism of the System has had so little effect.

In consonance with the position of public responsibility thus emphasized by the creation of the Federal Reserve Board the System has from the beginning of its organization pursued to an unusual degree a policy of publicity with regard to its affairs. The Board in its Annual Report and even more currently through its monthly publication, the Federal Reserve Bulletin, and the banks through their current Monthly Letters have undertaken to give to the public not only a comprehensive view of current banking and financial developments but also detailed data in scientifically organized form of important movements in the fields of production, trade, agriculture, employment, prices, together with other relevant factors bearing upon the interpretation of the regional and national problems of credit conditions and needs. Through a Division of Research and Statistics the Board has done pioneer work in the organization and development of fact-finding surveys and economic analysis of a highly scientific and interpretive character. Taken in the aggregate this work supplies the basis of the economic rationale of Federal Reserve policy and is largely to be credited with whatever merit may be attributed to it.

In thus preparing and educating itself for the work of credit administration the Federal Reserve has also done much to educate the public. Indeed, its activities in the field of economic research have given impulse to similar undertakings by private agencies and by organized research in some of the leading universities of the United States. Supplemented by the prodigiously expanding work of the United States Department of Commerce in this same general field, the American business and banking public today is probably the most fully informed of any in the world regarding the changing condition of the national economy and its various elements. It would be hard in any estimate of the good working of the Federal Reserve System in recent years to exaggerate the contribution made by the business public through its cooperation based upon knowledge and intelligence with regard to the functioning of the System and the underlying conditions affecting its good operation.

Because of all this the policies of the System, particularly in the domain of credit policy, have been more consciously public in character, more widely conceived from the point of view of national economic interest and, on occasion at least, more nearly raised to the level of economic statesmanship. They have also been more confident in character and go far to explain the flexibility which the credit-control technique of the System discloses. It seems doubtful for instance whether the economic potentialities of open market policy would have been as quickly discovered and a technique developed for making it an effective instrument and a leading reliance in credit administration without the fullness of information and understanding requisite in the application of a type of policy requiring such positiveness and definiteness of attitude as does the open market operation on a broad scale. For open market operation is an instrument of initiative in credit administration and can not be undertaken in an atmosphere of doubt or hesitation. To be competent it must be based upon conviction as to its economic justification and its acceptance by at least the intelligent public.

In the post-war history of the Federal Reserve technique no single item is of greater interest than the development of its open market procedure. Such prominence as the open market operation has in recent years attained was probably not anticipated at the time the Federal Reserve System was organized. The Federal reserve banks were then conceived of as banks of discount to which member banks would turn as they needed additional supplies of currency or reserve credit - in brief, as institutions in which the initiative in creating new credit would rest with the borrowing member bank, the Federal reserve bank playing its part in the process mainly through the establishment of discount rates designed either to encourage or to discourage the use of its facilities as the situation might seem to require.

Following the disastrous revulsion of 1920 and the depression of 1921 rediscounting with Federal reserve banks fell into some disfavor. The public at least in certain sections of the country showed some misgiving with regard to member banks heavily or continuously in debt to their Reserve banks. In consequence member banks showed reluctance to borrow except under the pressure and justification of seasonal or other transitory requirements. In these circumstances it appeared advisable to the Federal Reserve in order that the recovery of trade might be facilitated and later in order continuously to maintain a favorable economic situation to take the initiative at times in supplying the country with an enlarged basis of credit. Thus was begun in 1922 an open market policy. It was organized and further developed in 1923 as a System matter and in the last five years has been perhaps the most decisive factor in the credit-control technique of the Federal Reserve System.

By an open market operation is, of course, meant the purchase or sale by Federal reserve banks of securities in the open money market of the country. The purchase of securities has the effect of enlarging the credit base; the sale of securities of contracting it. The effect so far as the public is aware is very similar to that of an inflow or outflow of gold. Indeed, as open market policy has been operated in the United States, for example in the autumn of 1927 when an outflow of gold was in process the Federal Reserve has sometimes intervened to prevent the firming effects on money rates that might normally be expected from such outflow by making offsetting purchases of securities, thus releasing money to the market. Similarly in the reverse case on one or two occasions sales of securities have been made to offset the effects of gold influx where easing of money conditions to be expected from such influx did not seem at the moment to be desirable.

In reviewing the course of money rates in the United States in recent years, at any rate so far as influenced by Federal Reserve policy, the foremost influence must be assigned to open market operations. While the discount rates of the Federal reserve banks have undergone change from time to time, such changes more frequently than not have been made either in recognition of a credit situation brought about by antecedent open market operations or to accompany and reenforce a change of attitude assumed by the Federal Reserve through its open market policy toward the trend of business and credit conditions and needs.

As revealing the flexibility of the Federal Reserve the history of its open market policy in the last five years constitutes the most interesting chapter of its post-war development. The manner in which this instrument has been used, the general procedure with reference to credit administration of which it constitutes the heart, and the degree of reliance placed in it make of it if not exactly a new expedient in the technique of reserve banking at least one of new and enlarged potentialities in situations calling for an authoritative attitude and active initiative toward the money market, such as have obtained more or less constantly during the past five years. The acute transitions and readjustments incident to the economic movement during this period called for a credit-control device less leisurely in character and less openly deliberate than that of the discount rate and gave impetus to the extraordinary development which the open market operation attained.

Whether open market policy will continue to hold its present place of importance in the credit procedure of the Federal Reserve seems doubtful. There have been some indications that it was losing its hold on the esteem of a considerable section of the business and banking public. Its quality of arbitrariness has exposed it to the criticism of being un-American. It seems not improbable, therefore, that with the return of the United States to a more settled economic basis and with the world in general well advanced to complete recovery and the gold standard as an international stabilizing mechanism pretty nearly restored to its old-time efficacy, the primary reliance in the credit-control technique of the Federal Reserve in the future will be the discount rate rather than the open market operation. Not that the open market operation will be discarded but that it will cease to be an habitual expedient and take its place as an occasional expedient in the credit mechanism of the Federal Reserve - an expedient to be resorted to in situations of acuteness where prompt intervention is necessary to effective handling. With the probability that such situations will be of less frequent recurrence in the future than in the recent past however the more orderly and less drastic form of credit regulation provided by the discount rate promises to play the role of leading importance in Federal Reserve practice.

An added and more immediate impulse to this shifting of emphasis in Federal Reserve procedure is likely to result from the serious impairment of prestige which the open market policy of the Federal Reserve has recently sustained, because of untoward developments in connection with its adventure in the autumn of last year in undertaking to ease and stabilize the international situation. The American stock market on that occasion took advantage of the Federal Reserve's policy of cheap and easy money. The volume of credit involved in speculative loans grew rapidly and in the early part of the year 1928 attained such magnitude as to awaken widespread concern in the United States and to place the Federal Reserve in a position of uncomfortable responsibility. The lesson of this experience will not soon be forgotten and is likely to register itself in the flexible mind of the Federal Reserve as a change of front. For the circumstances which have occasioned the partial miscarriage of Federal Reserve policy in the course of the last ten months are of the kind that are likely to repeat themselves. The exuberant temper of the American speculative community can usually be counted on to respond to a sufficient stimulus in the way of cheap and easy money. This recent experience suggests the hazard to which a policy of cheap and easy money is always exposed in the United States. Unless and until therefore some effective method can be devised for preventing the diversion of the flow of Federal Reserve credit into speculative loans, open market policy will be handicapped and at a disadvantage.

But whatever the outcome of the differences developing between the adherents of discount policy and those of open market policy may be, the future is not likely to see any change of general outlook on the part of the Federal Reserve or its major responsibilities toward the economic and credit situations. Nor any weakening of its faith in the indispensability of the economic approach to its problems. The credit system is envisaged by the Federal Reserve as a vital influence in the economic process. The full capabilities of a wise dispensation of credit, however, have not yet been fully realized in the United States even though conditions here have been so unprecedentedly favorable to their exploitation. That credit is an energizing influence and an integrating force of vast potentialities in the modern economic system is coming to be more and more deeply appreciated on this side of the Atlantic. But the full measure of its economic potency has not yet been taken even in the United States. It remains for the future to vision credit as the <u>élan vital</u> of the modern body politic and economic.