

X-6618

For release - 12 o'clock noon, Central Time,  
June 12, 1930.

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Before the Michigan Bankers  
Association, Grand Rapids,  
Michigan.  
June 12, 1930.

MEMBER BANK CREDIT AND RESERVE BANK CREDIT

I propose today to talk on a somewhat technical subject, but one to which I have had of necessity to give a great deal of thought and which I believe will interest you and help you understand the workings of our banking system as seen from a national point of view. The subject to which I refer is the relationship and differences between Federal reserve bank credit and member bank credit.

From the point of view of objective, the greatest difference between the operations of commercial banks and of the Federal reserve banks is that the former are operated primarily for profit, and, therefore, strive to have all their funds productively employed at all times, while the Federal reserve banks are operated primarily for the purpose of serving the banks and the public, and, therefore, use only such part of their lending power as is needed to meet the legitimate demand of the banks for reserves and of the public for currency.

Out of this difference between commercial banks and the reserve banks arises a difference in the effects that financial developments have on the operations and condition of the two kinds of banks. The balance sheet of a Federal reserve bank is quite similar in many of its outlines to the balance sheet of a commercial bank. Both have capital and surplus, reserves, loans, investments, deposit and note liabilities. But the effect on the balance sheet of changes in fin-

ancial conditions are often the opposite in a reserve bank from those in a commercial bank. A commercial banker, for example, is accustomed during a period of heavy cash receipts to look around for profitable outlets for his funds, and normally expects at such periods to increase his earning assets. If there is no local demand for funds, he buys investments, or puts his money at work in the open market. A reserve bank, on the other hand, finds that heavy receipts mean a decrease in its loans and investments, because the receipts indicate a diminished demand for reserve bank credit, and it is both difficult and not permissible for the reserve bank to attempt to increase its operations just because it has additional funds at its disposal. In the reverse case, a commercial banker expects to call loans or dispose of investments when withdrawals from his bank are large, in fact he is forced to this course if he wishes to meet his outpayments without borrowing. The reserve bank, on the contrary, increases its loans most rapidly when heavy withdrawals of gold or currency cause an increase in the demand for reserve bank credit. A commercial banker, furthermore, can meet an increased demand for funds by his customers through the sale of securities or other open-market investments, but a reserve bank cannot increase its funds through this means, because a sale of securities by a reserve bank results in an equivalent increase in the demand for discounts. In short, while our balance sheets are similar to yours, their significance

and consequently our method of dealing with them is radically different.

As I have already indicated, the fundamental reason for this difference is that a Federal reserve bank, not being a profit-making institution, does not seek outlets for its funds, but stands ready to supply these funds, whenever there is a legitimate demand from its member banks. Such a demand arises from three principal sources: an outflow of gold, an increase in currency needed for circulation, and a growth in member bank reserve requirements. Reserve bank loans and investments increase when there is an outflow of gold, because the reserve banks hold practically all of the available gold in the country, so that member banks, when they have to meet an export demand, ~~must~~ come to the reserve banks to obtain the gold. Since member banks rarely have excess reserves with which to pay for this gold, they must borrow from the reserve banks an amount equivalent to the gold exported. On the other hand, when gold comes in from abroad, member banks generally use this gold to retire an equivalent amount of their indebtedness at the reserve banks.

An increase in the public demand for currency, such as usually occurs between midsummer and Christmas, has much the same effect on the demand for reserve bank credit as an outflow of gold. Our commercial banks do not as a rule hold currency in excess of their immediate till money needs, and every increase in the public demand for cash, such as accompanies enlarged pay-rolls or increased needs for cash at harvesting time or heavy

retail trade at holiday seasons, is passed on by the member banks to the reserve banks. The reserve banks furnish this cash and charge it to the member banks' reserve accounts, which thereby fall below legal requirements and cause member banks to borrow an equivalent amount from the reserve banks. Here again a decrease in currency requirements, such as occurs after Christmas, results in member banks having excess cash which they generally use to diminish their indebtedness to the reserve banks.

The third channel through which the reserve banks feel an increase in the demand for their credit is a growth in member bank reserve requirements. This source of demand for reserve bank credit differs from the two already described in several important particulars. First, this demand arises from the voluntary operations of the member banks, rather than from outside sources. Member banks have little control over the demand for gold or for currency, but they can exert an influence over their own reserve requirements, because these requirements bear a definite ratio to their deposits, and deposits in turn are to a large extent the result of loans or investments. Therefore, member banks taken as a whole, by curtailing or expanding their own operations, can diminish or enlarge their deposits, and consequently their legal reserve requirements.

In the second place, a demand by the public for currency or for gold results in a dollar for dollar demand for reserve bank credit, while a demand for additional loans creates

additional deposits and an increase in reserve requirements equal to only about one-fifteenth of these deposits. This is for the reason that the law requires member banks to carry a 3 per cent reserve against their time deposits and a 7, 10, or 13 per cent reserve, depending on the location of the bank, on their net demand deposits. On the average member banks carry about 7 per cent in reserves against their combined demand and time deposits. This means that an increase of \$100,000,000 in member bank deposits (or loans and investments) gives rise to only about \$7,000,000 of additional reserve requirements by these banks. This is a ratio of nearly 15 to 1.

It is in this ratio that lies the greatest difference between reserve bank credit and member bank credit. The ratio is the measure of the greater power of the reserve dollar as compared with the ordinary dollar. When the banks of the country increase their loans and their investments - they create deposits; these deposits increase reserve requirements, but only at the rate of one dollar of reserves to 15 dollars of deposits. A growth of \$1,500,000,000 in member bank credit outstanding, therefore, creates only about \$100,000,000 of additional demand for member bank reserves and consequently for reserve bank credit and, conversely, member banks as a whole would have to liquidate \$1,500,000,000 of their credit outstanding in order to pay off a debt of \$100,000,000 at the reserve bank.

Of the three principal factors which affect the demand for

reserve bank credit, two, namely gold movements and currency demands, respond to reserve bank policy only slowly and indirectly. These two factors also are the ones which are reflected dollar for dollar in the loans and investments of the reserve banks. Changes in the direction of gold movements or in the demand of the public for currency, therefore, are bound to be reflected immediately in the operating position of the reserve banks; the reserve banks must furnish the credit necessary to meet those demands when they arise, regardless of whether reserve bank policy is directed toward easier or firmer conditions in the money market. The third principal factor in the demand for reserve bank credit, member bank reserve balances, on the other hand, can be influenced by reserve bank credit policy much more promptly and directly, because these balances arise from operations voluntarily undertaken by member banks, and firm money conditions exert a restraining influence on credit extension by member banks. Member bank reserve balances are also that channel of demand for reserve bank credit which operates on the 15 to 1 ratio, so that a dollar released by the reserve banks forms the basis for 15 dollars of deposits placed at the disposal of the public, while a dollar of reserve bank credit will produce only one dollar of gold or currency for the public's use. It follows, therefore, that a rapid and even an unhealthy expansion in member bank credit may be reflected only slowly in a demand for funds at the

reserve banks, and may even be entirely offset or obscured by relatively unimportant changes in the demand for currency or gold. This must be taken into consideration in formulating reserve bank credit policy; a change of \$100,000,000 in the demand for reserve bank credit being much more important if it reflects a change in the demand of member banks for reserve balances than if it reflects changes in the demand for currency or gold.

It is largely because of this relationship of 15 to 1 that the reserve banks are obliged to resort to open market operations. Growth of reserve requirements arising from growth of deposits is too slow to afford an adequate means of credit control, particularly in view of maladjustments in our reserve law. When the reserve banks find that credit growth is too rapid they can supplement the effects of growing reserve requirements by sales of securities in the market, which also take funds out of member bank reserves and make it necessary for them to increase their borrowings. When, on the other hand, member banks are too heavily in debt, the reserve banks may find it advisable to assist them in their efforts to pay up by purchasing securities in the open market, because repayment of the reserve banks through liquidation requires credit contraction on a scale practically inconceivable to our banking system.

We, of the reserve system, deal in high-power dollars. It behooves us, therefore, to exercise great care in letting these dollars out of their resting place in our vaults to



multiply manifold in the community; and to exercise just as much care in calling them back after they have had the time to become the basis of large banking operations.

To learn the nature and behavior of the reserve dollar is our principal endeavor. If we can learn thoroughly to understand it we shall have made great strides toward knowing how to control it. And if you will keep in mind its peculiar characteristics and the difficulties they create for the Federal reserve authorities, you will better understand our efforts to devise a technique of handling this high-power dollar in such a manner as to assure the country of the greatest possible stability in its credit structure.