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THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935

Address by

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THE FEDERAL RESERVE SYSTEM AND THE BANKING ACT OF 1935.

In the course of my duties, I have occasion from time to time to visit different parts of the country, and it happens that week before last I was in the state of Washington, the extreme opposite corner of the United States from where we are today. Such visits as these, with the opportunities they afford to observe from place to place the special economic activities in which people are engaged, always give me a fresh idea of how important and significant the business of banking is, and how firmly it ties the interests of different communities and regions into one great whole. Banking has both a local and a universal significance.

In one sense, banks are local institutions engaged in local extensions of credit; and banking from this point of view is a question of one risk after another - who can be safely financed and to what extent and on what security, and who can not. But that is not all. In another and larger sense every local bank is part of a nation-wide, even a world-wide, credit system; and individual banks are constantly engaged with one another in moving the products of their regions out to the markets and consumers of the world and in moving in to their own population the things it buys in exchange. The communities which you bankers represent are partly agricultural and partly industrial, for Georgia is one of the states that has considerable diversification of economic activity.

Your economic activity is partly devoted to the production of commodities which are disposed of outside the state, and partly to the production of commodities which find their market within the state. You

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ship to outside markets your cotton, cottonseed-oil, and cotton goods, your lumber, furniture, and naval stores, your sugar cane syrup, your fruit, and your tobacco; Georgia peaches, Georgia peanuts, Georgia watermelons, and Georgia marble are known everywhere. Great shipments of these products are made annually from the state, by rail, by truck, and by sea. And it is through you bankers that they are exchanged for what your people buy from outside. As these products are sold in New York, Chicago and Liverpool, the reserves of your banks accumulate and those reserves enable your customers to purchase the special products of other regions, such as flour, meats, oil, gasoline, automobiles and electrical apparatus.

Here in this delightful and interesting old city, where we are today, we must remember that the climate and the beauties of your state are also products which increase your wealth; they bring money into your state quite as substantially as do the physical commodities you produce and sell.

Your banks are also instrumental in the exchange of products which are consumed as well as produced within the boundaries of Georgia, such as fertilizer and cotton goods. It is through the banks that the fertilizer manufacturers are able to receive payment from farmers in all parts of the state. It is through the banks that the producers of the fruit and vegetables, which are consumed in your cities, receive their payment. It is through the banks that payment is made to producers and distributors of clothing, groceries, printed matter, and similar

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things sold in every community. Wherever producers are situated and whatever their products, nine times out of ten they receive payment for those products in bank funds.

It is unfortunate that people generally fail to realize this fundamental function of the banks in effecting payments between consumers and producers in different communities and regions. They think of the banks as merely local affairs, which they have a hard time borrowing from at one season of the year and a hard time repaying at another. They do not see that because of the banks, credit is enabled to flow into the region to pay them for their products, and is enabled to flow out again in payment for the products they buy elsewhere. Your customers see very plainly that steamers and trucks and railways carry away their cotton, their fruit, and their yellow pine, and in exchange bring in to them from other regions the clothing and the automobiles they need, but it is not so easy to see that without the system of credit the system of transportation would be of little use.

The importance of bank credit in the form of deposits is indicated by the fact that people almost invariably prefer it for payments in large amounts. A farmer who is selling his year's crop usually expects a check and would be surprised and inconvenienced if he were paid in currency or coin. The check represents bank credit; and when the farmer takes or sends it to the bank, the credit goes on the bank's books under his name. The arrangement is safe and convenient.

But there is far more to be said for bank credit in the form of deposits than that its use is convenient and safe. In our economy it

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has become indispensable. Without it how would it be possible for the people all over the United States and all over the world, who use the products of your state, to pay for the things you furnish them? Should currency be shipped in to pay for it all; and then shipped out again to pay for what your people buy?

The system of bank credit covers the whole country like a net-work of power lines; it supplies means of payment wherever needed. Where-ever and whenever local bank reserves run low, as must regularly be the case in a region where productivity is seasonal, the temporary deficiency can be made up. Whenever things produced in one place are paid for and consumed by people in another place the system of bank credit makes it possible to effect the payment readily. There is, however, one essen-tial - the credit must be everywhere liquid and based on sound values; otherwise the system becomes clogged and stops working. The loss in that event is more than a loss to local stockholders and depositors. The loss is to the community whose processes of production and consumption have been to some extent disrupted.

Before 1914 this country had quite inadequate means of mobilizing its bank credit. Every bank in the country constituted a separate pool of credit - a pool that was not always adequate for local purposes, and yet that had no close connection by which it could always be replenished swiftly and easily. The banking system bore the same relation to what we have now, as a scattered number of independent power plants with po-tential connections would bear to an articulated power net-work. The banks in regions such as yours were comparatively well off under such

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an arrangement because your economic activities are diversified. But in regions which are dominated to a greater extent than Georgia is by a few great cash crops, and where everyone is being paid at one period of the year and is paying out the rest of the time, the difficulties of mobilizing bank credit were extreme.

It was such difficulties as these that led to the establishment of the Federal Reserve System. They were difficulties that arose from the fact that the inter-regional exchange of commodities and services had to be accomplished with banks whose interests and facilities were primarily local. In order that banks might meet the requirements of their communities more adequately, they needed closer interconnections with other communities, and a system through which means of payment for their regional products might be always and unfailingly available. The Federal Reserve banks were established to meet that need. They bind the 6,400 member banks of the country into a system which can make credit available for production and trade wherever and whenever it is required and in any amount.

In the course of the twenty-two years which have elapsed since the Federal Reserve banks were established, much experience and knowledge have been accumulated. Some problems which the System was devised to remedy have now been settled and others have taken their place. At the same time the conception of central banking functions has changed in many respects. The net result is that the System presents in certain ways a different aspect from what it did formerly.

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The instrumentality that is now considered the most important for the control of credit is one that in the original reserve act was given only rudimentary attention. I refer to open market operations. These operations are important because they make it possible for the central banking organization - in this case the Federal Reserve banks directed by the Federal Open Market Committee - to exercise control over the volume of bank deposits and reserves. This means control over the volume of "money", or means of payment, required by the people in their economic life.

The principle of open market operations is of course simple. If securities are sold in the market by the Federal Reserve banks, they must of necessity be paid for with bank funds, for they will be bought either by the banks themselves or by bank customers. Consequently, in the process of paying for them there will necessarily be debits to be entered against the reserve accounts maintained with the reserve bank by the member banks. Upon completion of these entries, the reserve bank will have disposed of certain assets and simultaneously will have decreased the total amount outstanding to the credit of member banks in their reserve accounts. The Reserve bank does not know in advance of its transactions what particular member bank accounts will be affected nor by how much, but it knows that if it sells securities, bank credit in general will be diminished.

If, as a consequence, reserves are reduced to a minimum, the member banks are immediately impelled to restrict their extensions of credit, for they cannot continue making loans and increasing the deposit credit

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outstanding on their books without incurring a deficiency in their reserves. The result of the Reserve bank's action in selling securities, therefore, is to curtail the lending power of member banks and to tighten the money market.

On the other hand, if securities are bought by the Reserve bank, the result will be that in the process of paying for them the Reserve bank will have to credit the reserve accounts of member banks. Again it does not know to what extent particular member banks will be affected, but it does know that reserves in general will be increased. By the same token the lending power of the member banks will be increased and general credit conditions will be eased. In the first stages of a buying program, the effect will be to enable banks to pay off any obligations they may owe, but if a buying program is continued long enough it may result in an accumulation of excess reserves.

In addition to the effect upon the reserves of member banks, there is also an effect upon bank deposits in general - even non-member bank deposits; because, if an investor or an institution buys some of the securities sold by the Reserve bank, payment will ordinarily be made out of a checking account and deposits will be decreased by so much. If, on the other hand, the Reserve bank is buying securities, and institutions and individuals are selling to it, the payments made by the Reserve bank will increase the deposit credit outstanding on the books of banks. Accordingly, banks which are not members of the Federal Reserve System and banks which themselves have not purchased or sold securities as a result of the Reserve bank's action, will nevertheless be affected

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by it, either in their reserves or in their deposits, or in both. The money market as a whole will be influenced.

In the early days of the System, the Federal Reserve banks attempted to carry on their open market operations independently of one another, but it soon became clear that their actions must be coordinated. Otherwise they might find themselves competing with one another, and in conflict as between their own transactions and those transactions which as fiscal agents of the Government they were conducting for the United States Treasury. Accordingly, in 1922 a committee of Reserve bank officers was appointed for the purpose of coordinating the operations. About the same time the purpose of the operations was clarified. The principle laid down was: "That the time, manner, character, and volume of open-market investments purchased by Federal Reserve banks be governed with primary regard to the accommodation of commerce and business and to the effect of such purchases or sales on the general credit situation."

For some time prior to this there had been a tendency to allow purchases and sales of securities to be influenced by profit as an objective. The statement of principle which I have just quoted meant a definite abandonment of that objective. This was in line with the general policy of central banks in conducting open market operations; they do so definitely with the idea of correcting market tendencies and not for the purpose of making earnings.

The Banking Act of 1935 gave open market operations more specific recognition than they had had in the original Act. It gave statutory standing to the Federal Open Market Committee, which by then comprised

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one representative from each Federal Reserve bank. No Reserve bank could engage in open market operations except in accordance with regulations of the Board. At the same time the Act adopted substantially the same statement of purpose which had already governed open market operations.

The Banking Act of 1935 gave still further attention to the machinery of open market operations and to recognition of their importance. The Federal Open Market Committee was reconstructed to comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen regionally by the twelve Federal Reserve banks. This made the members of the Board constitute a majority of the Committee, and marked considerable development away from the original informal arrangements by which the Federal Reserve banks first conducted open market operations on their own initiative and then under the direction of a Committee on which the Board was not specifically represented. Furthermore, under the terms of the Banking Act of 1935, the Federal Reserve banks may neither engage nor decline to engage in such operations except in accordance with the directions and regulations of the Committee.

Another requirement of the Act is that a complete record be kept of the action taken on all questions of policy relating to open market operations, including a record of votes taken in connection with the determination of open market policies and a statement of the reasons underlying the action taken, and that this record be included in the Board's annual report. The publication of this record will give the public an opportunity to study the decisions as to open market policy and credit

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policy in general, and should help clarify public discussions of national credit policy. It will also accentuate the individual sense of responsibility, for members of the Committee will be called on not only to decide on credit policy, but to give publicly the reasons for their decisions.

It is clear, I think, that as a result of experience and statutory amendments, open market operations have taken a far more important place in general credit policy than they formerly had. It is also clear, I think, that open market operations have become a more important or at least a more positive device of credit control than discount rates. When the Federal Reserve Act was adopted the prevailing idea probably was that discount rates were not only the most definite means of credit control, but the most important. The thought was that as banks felt more and more demand from borrowers and went to the Reserve banks to procure the funds to meet it, they would encounter a rising discount rate, which would have the effect of tempering the demand and preventing an excessive use of credit. Conversely, as conditions improved, business activity would be encouraged by the fact that banks could procure funds to lend at a progressively lower rate. The most obvious difficulty with this theory, however, is that banks have not shown a disposition to borrow from the Reserve banks in order to relend. Banks don't like to borrow, and as a general thing they won't borrow unless they have to, no matter how low the discount rate is. Consequently, the effectiveness of the Federal Reserve discount rate is, by itself, rather limited. It is

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significant as an index of the cost of credit, but it does not come into action otherwise until a member bank finds it necessary to replenish its reserves. As I have already indicated, however, a member bank may be forced into such a position as the result of sales of securities by the Reserve bank, and the discount rate then becomes effective.

In other words, an important difference between discount rates and open market operations in practical effect is that open market operations give the central banking organization the initiative in the control of credit, whereas the discount rate by itself offers the controlling authority no handles to seize; it must bide its time passively until the situation is so bad that demand for funds is voluntarily made. This delay may seriously impair the power of the Federal Reserve bank to help the situation.

With respect to discount rates the Banking Act of 1935 made only one change. This was to require that they be established every fourteen days or oftener. It is not necessary that the rates be changed every time, but they must at least be reviewed and reestablished.

With respect to the reserves which member banks are required to maintain, the Banking Act of 1935 makes a very important change, by simplifying the conditions under which the Board of Governors of the Federal Reserve System may alter the amount of reserves which is prescribed in the law. Prior to 1933, there was no authority to change reserve requirements administratively, but an act of May 12 of that year empowered the Board, with the approval of the President, to declare that

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an emergency existed and during the emergency to increase or decrease the reserve balances to be required. The Banking Act of 1935 allows reserve requirements to be changed by the Board without declaration that an emergency exists and without approval of the President. It does not permit, however, requirements to be reduced below the percentages stated in the statute nor to be more than doubled. The purpose of any change made in the requirements must be, in the words of the law, "to prevent injurious credit expansion or contraction."

The Banking Act of 1935 also made important changes in the constitution of the governing body of the Federal Reserve System, which is no longer known as the Federal Reserve Board, but as the Board of Governors of the Federal Reserve System. The Secretary of the Treasury and the Comptroller of the Currency ceased to be ex officio members of the Board February 1, and provision was made for the Board to consist thereafter of seven members appointed by the President. The members now in office have terms ranging from 2 to 14 years and upon the expiration of the present terms all succeeding members will be appointed for terms of 14 years instead of 12 years as under the previous law.

Since March 1, under the provisions of the Act, the chief executive officer of each Federal Reserve bank has the title "president", instead of "governor", and the title "vice-president" replaces that of "deputy governor". Both the president and the first vice-president are appointed by the Board of Directors for a five-year term with the approval of the Board in Washington. Formerly, as you know, the offices of governor and deputy governor were not specifically recognized by statute.

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The responsibilities of the Federal Reserve banks as fiscal agents of the United States were not changed by the Banking Act of 1935, except for a provision which permits the Reserve banks to buy government obligations only in the open market; direct purchases from the Treasury are not authorized.

I think I have covered sufficiently the more prominent changes which the Banking Act of 1935 made with respect to Federal Reserve functions, and I wish to speak now of those features of the Act which more directly affect the operations of member banks.

The first of these has to do with lending powers.

Indirectly, the Act tends to broaden member bank lending powers by giving the Reserve banks authority to make advances to member banks on any satisfactory security. The former provisions still stand as to paper that is known under the original terms of the Federal Reserve Act as "eligible" for discount - paper, that is, which originates in connection with industrial, commercial or agricultural transactions - and they also still stand as to advances to member banks on notes secured by eligible paper or by Government obligations. The new provisions are added to these old ones without altering them. Advances authorized by the new provisions are simply required to be secured to the satisfaction of the Reserve bank, to bear a rate of interest at least one-half percent above the Reserve bank's discount rate, and to have maturities of not more than four months. At present, when the banks have large excess reserves, this new provision in the law may not seem very important. But times may change. If and when they do, the new provisions mean that, assuming a

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bank's assets are good, the Federal Reserve bank will be able to advance money on them, no matter what the type of paper, or the nature of the transactions in which they originated. In other words, borrowing from the Federal Reserve bank has now been made possible on other than technical conditions of eligibility alone. This is very important. Many banks in recent years would have had much less trouble if they could have taken to the Reserve bank some of their assets which were good, but not legally eligible under the old terms of the law, instead of having to sacrifice them on a demoralized market. Provision for such advances was first adopted as a temporary, emergency measure in 1932, but the Banking Act of 1935 made it permanent.

The original provisions of the law with respect to eligible paper were based on the principle that since the liabilities of banks were payable on demand they should be offset by short-term self-liquidating paper based on specific transactions involving the exchange of goods. The amendments added by the Banking Act of 1935 are based on the principle that in fact American banks do not specialize in one type of credit as against another. They deal in credit of all sorts. They combine long term and short term credit functions. There is not enough short-term commercial paper to fill more than a small part of their portfolios. They accept the savings and time deposits of their communities and they also hold long term obligations of their communities. The new provisions for eligibility make the Federal Reserve Act cognizant of these realities and adapt the powers of the Reserve banks to them.

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In a more direct way, the Banking Act of 1935 broadened lending powers by liberalizing the conditions under which National banks may make real estate loans. The old stipulation that the real estate upon which such loans are made must be situated in the bank's Federal Reserve district or within a hundred miles of the bank, has been removed; and loans which are amortized are now permitted in amounts up to 60 percent of the appraised value of the property and with maturities of as much as ten years, provided installment payments are sufficient to repay at least 40 percent of the principal in that time. The Act also increased the permissible aggregate of real estate loans which a national bank may hold.

I have covered the most important provisions of Title II of the Banking Act of 1935. I think it is not necessary to go further into details of the Act; they are numerous, but most of them, which I have not mentioned, are technical and minute. In my judgment the principal effects of the Banking Act of 1935 may be summarized as follows:

In the first place, while the Federal Reserve banks remain essentially unchanged in organization and function, the importance of their central banking activities has been more clearly recognized.

Second, the Federal Open Market Committee has been given a more effective position in the System and more definite authority.

Third, the Board of Governors has been given larger powers and more direct responsibilities, and the principles upon which the System is to be administered have been more clearly developed.

Fourth, the 6,400 member banks have broader lending powers, and the facilities of the Federal Reserve banks have been made available to them on less technical and restrictive terms.

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