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THE FEDERAL RESERVE SYSTEM AND CREDIT CONTROL

ADDRESS BY

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It is now nearly three years since I left Chicago to take up my present duties in Washington. In those three years the administrative organization and functions of the Federal Reserve System have undergone important and interesting changes, mainly brought about by the Banking Acts of 1933 and 1935.

In general terms, I think the most important accomplishment of recent legislation so far as the Federal Reserve System is concerned is that it strengthened and clarified the lines of credit control. A few changes affecting the organization and functions of the Federal Reserve banks were made, but they were not changes in essentials. The most conspicuous of these changes was that the title of President was given to the principal executive officer. Formerly his title was Governor. The title of Vice President now replaces the former title of Deputy Governor. As you know, the former titles, Governor and Deputy Governor, were not mentioned in the Federal Reserve Act. The office of Governor was originally created under the general authority which the Federal Reserve Act gave the directors of the Federal Reserve banks to arrange for such officers as were necessary for the administrative work of the banks. Originally, the only office specifically mentioned by the Act, other than that of director, was that of Federal Reserve Agent and Chairman, with assistant agents and deputy chairmen. The Banking Act of 1935 in designating the President of the Federal Reserve bank as its chief executive officer merely

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recognized an arrangement that had developed under general authority and that had proved itself desirable from the point of view of Federal Reserve bank administration.

The organization of the governing board of the System was changed considerably by the Banking Act of 1935. In the first place, the old name "Federal Reserve Board" was changed to "Board of Governors of the Federal Reserve System". At the same time, the chief executive officer of the Board was designated as Chairman. Furthermore, the number of members of the Board was changed from eight to seven and all of these members were made appointive. Formerly, as you know, the Secretary of the Treasury and the Comptroller of the Currency were ex officio members of the Board.

The term of office of the members of the Board was formerly 12 years. Under the new law, the terms of members now in office range from 2 to 14 years and their successors in office will have terms of 14 years so arranged that the term of one member will expire every 2 years. Since a member who has served a full term of 14 years is not eligible for reappointment, there will be a regularly recurring change in membership; one member leaving the Board and a new one being appointed every 2 years, unless more frequent changes occur from deaths or resignations.

The most important changes effected by the 1935 Act, however, have not to do with these matters of organization so much as with the function and authority of the governing Board in the field of credit.

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In the course of the twenty-two years that 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.

Twenty-two years ago the ideas prevailed that the important functions of the Federal Reserve banks were to furnish an elastic currency, to lend to member banks which were short of money some of the reserve funds accumulated by other member banks, and to curb the speculative use of credit by rediscounting only paper representing self-liquidating commercial transactions. These ideas now appear quite inaccurate, or at least inadequate. Furnishing currency is seen to be less important than it was thought to be, because currency cuts a very small figure in the total of payments that are made by people in their dealings with one another. What they use for the most part is bank credit in the form of deposits. The control of bank credit as a whole is, therefore, of greater importance than the control merely of the currency supply; it is also incomparably more difficult.

In the second place, the reserve banks do not depend on the deposits which member banks maintain with them for the ability to make loans and buy securities. They pay for such assets by entering deposit

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credits on their books in favor of the member banks whose paper they discount or whose investments they buy. If a member bank's reserves are deficient, it can turn over some of its assets to the Reserve Bank and receive a credit to its reserve account. The Reserve Bank in such a transaction is not lending to one bank what it owes to another; it is exercising the familiar banking power of paying for assets by the entry of deposit credit.

In the third place, it is recognized that there is no necessary connection between the form in which credit is procured from a bank and the form in which it is used. Money may be borrowed on acceptances and yet be used in the stock market. It may be borrowed on a real estate mortgage and yet be used to buy merchandise. It may be borrowed on the security of speculative stocks and yet be used to finance the production and shipment of commodities. Consequently, any discrimination for or against a certain type of paper offered for discount does not mean that speculation is being controlled or that credit is being supplied for the needs of commerce. The task of controlling the use of credit is far more difficult than such a supposition would imply.

Under various provisions of federal law there are five principal means of credit control which the Federal Reserve banks or the Board of Governors may use. These are:

Discounts
Open Market Operations
Direct Action
Reserve Requirements
Margin Requirements

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Discounts

The Federal Reserve Act has from the beginning provided that each Federal Reserve bank establish from time to time rates of discount to be charged by it on various classes of paper; these rates to be subject to review and determination by the Board of Governors of the Federal Reserve System, and to be fixed with a view of accommodating commerce and business. To this the Banking Act of 1935 added the new requirement that such rates shall be established "every fourteen days, or oftener if deemed necessary by the Board". This does not mean that the rates must be changed every time, but that they must be regularly and frequently reviewed. In general the initiative in making changes in discount rates rests with the Federal Reserve banks, but the Board has authority to make changes on its own initiative if the public interest demands.

When the Federal Reserve Act was adopted the prevailing idea seems to have been that discount rates were not only the most definite means of credit control but the most important. This idea was apparently based upon a belief that member banks would seize the opportunity to borrow funds from the Reserve banks at a low rate of interest, in order to relend them to their own customers at a higher rate. This was a logical supposition and it appears to be widely held even at the present time. As a matter of fact, it has not worked out that way in practice at all. Member banks rarely show a disposition to borrow from the Reserve banks for the purpose of relending. They do not like

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to borrow and as a general thing they will not borrow unless they have to, no matter how low the rediscount rate is. Custom appears to exercise a very imperious control over them in this respect. As a consequence, they borrow from the Reserve banks as a usual thing only when they have to augment depleted reserves.

The Federal Reserve Act formerly limited the classes of paper which Federal Reserve banks could discount for member banks, but the Banking Act of 1935 eased these limitations. The principle followed in the original provisions was that a definite preference should be maintained for short-term credit based on self-liquidating commercial transactions. The Reserve banks were, therefore, given the power to discount only such paper, that is notes, drafts, bills of exchange and bankers' acceptances arising out of commercial, industrial and agricultural transactions, or paper backed by United States Government obligations. These were narrowly defined classifications. Advances on a wide range of other assets which made up an important part of the total earning assets of banks were not authorized.

Moreover, as a result of various financial and economic developments the classes of paper which could be used as a basis for borrowing from the Reserve banks had for many years constituted a decreasing proportion of the assets of member banks. In 1929 it was only about twelve percent of their total loans and investments, and in 1934 it was only eight percent. Consequently, in 1931 and 1932 when the great liquidation occurred, many banks whose assets as a whole were good

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nevertheless had very little that was technically eligible for use in borrowing at the Reserve bank. They therefore had to dump their assets on a falling market in order to raise the funds they needed.

The new banking act increases the powers of the Federal Reserve banks so that such a necessity may be avoided. It authorizes advances to be made to member banks for periods not exceeding four months on any security satisfactory to the Reserve bank. This amendment modifies and makes permanent the emergency legislation which was adopted in 1932.

Beside the foregoing general powers of discount and purchase, special authority was given the Reserve banks in 1934 to discount loans which member banks and other financing institutions may make to established industrial and commercial businesses for the purpose of supplying them with working capital.

These changes made by recent legislation enlarge very greatly the kind of credit which the Federal Reserve banks may deal in directly, and allow greater freedom of action in meeting the requirements of the money market.

Open Market Operations

It must be obvious, however, that the power of a Federal Reserve Bank to grant credit at predetermined rates of discount and interest can be exercised only when credit is asked for. Consequently, if the Reserve bank had no other means of credit control than the power to discount the paper of member banks at given rates, it might have to

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wait passively and idly until individual member banks decided that they would like to borrow. Then only would it have opportunity to act and what it might do then would be far from constituting real credit control. As a consequence of the need of meeting the Federal Reserve System's responsibilities more positively, two other means of credit control have been developed. These are open market operations and direct action. Both are outgrowths of experience, primarily.

Open market operations consist of the purchase and sale by the Reserve banks of certain classes of securities, mainly government obligations, for the purpose of increasing or decreasing the supply of credit available in the money market as a whole. By selling securities the Reserve banks withdraw funds from the market and less credit becomes available. The reason for this is that in the process of paying for the securities that are sold the reserves of member banks become diminished, because every payment means a debit sooner or later to some member bank's reserve account. And as a member bank's reserves decline toward the legal minimum it is less able to make extensions of credit.

On the other hand, by purchasing securities the Reserve banks put funds into the market and more credit becomes available; because the funds which are released in payment flow directly or indirectly into the reserve accounts of the member banks and enlarge them. And as their reserves expand, they are in a position to extend more and more credit.

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In principle, therefore, the Reserve banks can increase or decrease the funds available for lending, accordingly as they buy or sell securities. Of course, there are in practice many limitations on the effectiveness of open market operations, but their tendency is to enable the Federal Reserve banks to take corrective action with respect to abnormal credit conditions on their own initiative.

The powers of the Reserve banks to buy and sell securities in the open market were granted in general terms in the original Federal Reserve Act, and at the time were not generally considered to be of very great importance. The first operations were carried on by the Federal Reserve banks independently of one another, but it was soon found that action would have to be coordinated; otherwise the banks would be buying or selling in competition with one another and following different, and perhaps conflicting, policies. To avoid this, a committee representing several banks was formed for the purpose of directing the operations. About the same time the purpose of the operations was clarified. For some time purchases had been made with the idea of providing income to meet expenses, but it was eventually realized that such an objective was in conflict with that of moderating a given condition of the money market, and must, therefore, be subordinated or even abandoned.

The Banking Act of 1933 gave specific recognition to open market operations as a System matter and established a Federal Open Market Committee of twelve members, one representing each Federal

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Reserve bank, to take the place of the former non-statutory committee. At the same time the law adopted substantially the statement of purpose which had already governed open market operations. This was to the effect that they be conducted "with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."

The Banking Act of 1935 made a further change by providing that the Federal Open Market Committee should comprise the members of the Board of Governors of the Federal Reserve System and five representatives chosen by the twelve Federal Reserve banks. The law also makes the decisions of this committee obligatory upon the Federal Reserve banks and provides that the record of the Committee's actions shall be included in the annual report of the Board submitted to Congress. Thus an activity which was barely recognized in the original Federal Reserve Act, and which was gradually developed in the process of administration of the System, has come to be emphasized in the law as one of the System's most important functions.

Direct Action

I also mentioned direct action as a means of credit control. Direct action means efforts by the Federal Reserve banks or the Board to discourage credit policies of given member banks in given circumstances. Opportunity for it occurs on various occasions, but particularly when a member bank is being examined, and when it is seeking to rediscount some of its paper. In this sense, direct action is

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aimed at the correction of specific conditions in particular banks. It may also be resorted to, however, with reference to general conditions and for the purpose of enforcing general credit policy.

The effectiveness of direct action was specifically strengthened by the Banking Act of 1933 in several particulars. If a member bank makes undue use of bank credit for any purposes inconsistent with sound credit conditions, it may be suspended from recourse to credit facilities of the Federal Reserve System. Furthermore, authority has been given to the governing Board of the System to remove from office any officer or director of a member bank who continues to violate the law governing the bank's operation or who has persisted in unsafe and unsound practices in conducting the bank's business. The Board also has power to limit for each Federal Reserve district the individual bank capital and surplus which may be represented by loans secured by stock or bond collateral.

Power to Change Reserve Requirements

Recent legislation has also established two other new forms of general credit control which previously did not exist. The first of these is the power given the Board to change the reserve requirements now imposed upon member banks by the statute. For most banks (chiefly those outside the larger cities) the requirement is and has been for years that they have reserves on deposit with the Federal Reserve bank equal to at least 7 percent of their demand deposits, and 3 percent of their time deposits. The power to alter these

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reserve requirements was first given the Board in 1933, but under limitations which were later removed by the Banking Act of 1935. The Board is now authorized to change the reserve requirements "in order to prevent injurious credit expansion or contraction", but it is not permitted to lower them below the present requirements nor increase them to more than twice the present requirements. The result of raising them - which is the only action that could now be taken, since the minimum is already in effect - would be to decrease the lending power of member banks and consequently the amount of available credit. The effect of lowering them later on would be, of course, to enlarge the lending power and the amount of available credit.

Margin Requirements

The second new form of general credit control recently authorized pertains to margin accounts and loans made for the purpose of purchasing or carrying registered securities. Authority for the Board to issue regulations in this field was granted by the Securities Exchange Act of 1934. This grant of authority was in line with various provisions of the Federal Reserve Act, such as I have already referred to, aimed at restricting the use of credit for speculative purposes.

Pursuant to these provisions the Board has issued twin Regulations, T and U. Regulation T, following Sections 7 and 8(a) of the Securities Exchange Act of 1934, governs the extension and maintenance

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of credit by brokers and dealers in securities for the purpose of purchasing or carrying securities. Regulation U, following Section 7(d) of the Act, governs loans made by banks for the purpose of purchasing or carrying stocks registered on exchanges. In general, these regulations fix the maximum loan value of securities subject to their provisions at 45 percent of their current market value. This means a margin requirement of 55 percent. This loan value applies equally to margin accounts with brokers and to similar loans made by banks.

In the case of brokers who are financing other brokers in order to enable them to carry accounts of their customers - as may happen, for example, when a large city broker is financing a correspondent broker in a smaller community - loan values of 60 percent are permitted. Special provision is also made to facilitate the financing of securities' distribution.

The Board has authority to change the loan value percentages as necessary in order to prevent, in the language of the Act, "the excessive use of credit for the purchase or carrying of securities."

The provisions of the law and of the regulations are too technical and too numerous for me to discuss in detail, but I shall mention a few distinctions and exceptions which are to be observed. To begin with, Regulation U does not prevent a bank from taking collateral in addition to that required by regulation; it does not require a bank to have any outstanding loan reduced or paid, nor additional collateral put up. Neither regulation applies to loans on

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government obligations, nor on a number of similar types of exempted securities. They do not apply to loans, however secured, which were not made for the purpose of purchasing or carrying registered securities. I wish to emphasize this last point. Regulation U does not restrict the right of a bank to extend credit, whether on securities or otherwise, for any commercial, agricultural or industrial purpose, or for any other purpose except the purchasing and carrying of stocks registered on a national securities exchange. In other words, it does not interfere with the available supply of credit in general. Instead, it achieves its purpose by imposing restrictions upon the demand for credit from the speculative quarter.

For example, under the regulation last issued, it is possible to borrow $45 on each $100 of stocks, valued at the market. That obviously means a very definite restriction upon the extent to which speculators can expand their holdings. If market prices nevertheless rise so that the $100 worth of securities becomes worth $125, $150, or $200, at the market, the amount that can be borrowed, namely 45 percent, becomes of course progressively greater, until such time as the Board finds it advisable to reduce the ratio of loan value. As the Board reduces the ratio, the effective demand is checked. In principle, therefore, the Board has the power to prevent the use of too much credit for speculation and to prevent an expansion dependent too largely upon the ease with which money can be borrowed. Moreover it is enabled to do this without making credit any the less available

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for commercial, agricultural or industrial purposes, and without raising its cost for such purposes. It is not the function of the Board to attempt control of security prices nor to do anything in conflict with the responsibilities of the Securities and Exchange Commission in its supervision of securities exchanges. The function of the Board is confined to control of credit.

As you will recall, one of the conditions at which the original provisions of the Federal Reserve Act were aimed was the use of bank funds to finance stock market speculation. It has always been clear that the Act sought to make credit ample for commercial, industrial, and agricultural purposes without encouraging its speculative use; but the difficulty has been to make measures of control work in one field without producing corresponding but undesired results in the other. A discount rate that was advantageous to agriculture was advantageous to speculation, and a rate that was disadvantageous to speculation was disadvantageous to agriculture. This difficulty in the way of discriminating between the possible uses to which credit might be put was characteristic of attempts to reach the objective by control from the angle of supply. It appears to be obviated in the new provisions, which, as I have said, attempt to reach the objective from the angle of demand.

This is because the power which has been given the Board to impose and relax restraints upon the demand for credit for speculative purposes is definitely selective. It is aimed at a particular use

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of credit and at the specific channels through which demand becomes effective. For this purpose, it extends the powers of the Board outside the Federal Reserve System to reach directly brokers and non-member banks. It differs from powers of discount, because while these powers may be exercised to discriminate against paper directly involved in speculative uses, they cannot prevent the speculative use of funds procured by the discount of paper not directly involved in speculation. Moreover, the discount power is not of effect until such time as individual banks make up their minds to dispose of some of their assets.

Open Market Operations are even more general in their effect. They influence the total amount of funds but not the uses to which they can be put. The same thing is true of the power to alter reserve requirements. Direct action can be used to discriminate against the speculative use of credit, but only in individual cases. It cannot be applied comprehensively, uniformly, and simultaneously in all relevant cases as can the power to fix the loan values of securities.

In the case of margin accounts, the regulation is directed at an unmistakable objective and cannot miss affecting the speculative use of credit. In the case of loans by banks for purposes of speculation it may be felt that the objective is less distinct, since the purpose of such loans may be disguised. This may appear especially possible since Regulation U permits a bank to rely upon a signed statement, accepted in good faith, as to the purpose of a given loan.

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Of course if means of evasion develop, they will have to be dealt with, but the Board has chosen to avoid imposing inquisitorial investigations in the absence of reason for believing that evasions will be deliberate or of serious consequence.

I have alluded to the exemptions from these new regulations; I imagine they are of special interest to you and should be mentioned in detail. The regulations covering brokers and dealers do not apply to United States Government obligations, State, county, and Municipal obligations, and such other securities as the Securities and Exchange Commission may exempt. These regulations also do not apply to credit extended by a broker for bona fide commercial or industrial purposes or extended for limited periods to finance bona fide cash transactions in securities.

In the case of the regulations covering bank loans made for the purpose of purchasing or carrying stocks, the following are some of the transactions to which the regulations are not applicable:

Any loan made for any agricultural or industrial purpose, even though the loan be collateraled by stocks.

Any loan for the purpose of purchasing or carrying securities not registered on a national securities exchange.

Any temporary advance to finance the purchase or sale of securities for prompt delivery which is to be repaid in the ordinary course of business upon completion of the transaction.

Any loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange.

Any loan to a broker or dealer that is made in exceptional circumstances in good faith to meet his emergency needs.

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Conclusion - Limitation on Means of Credit Control

Although the five means I have discussed by which credit control may be exercised - discounts, open market operations, direct action, reserve requirements, and margin requirements - appear to be very comprehensive and powerful, it would be a mistake to convey the impression that a perfect control of credit will be effected through them. In the first place, their application cannot be mechanical nor governed by simple unvarying rules. Credit and economic relationships are extremely intricate, and the circumstances under which the need for action arises are always to some extent different and special. Let me mention a few things that complicate the task of credit control.

For one thing, there has never been a time when the membership of the Federal Reserve System included as many as half the banks in the country. It does not now. The majority of banks in the United States are outside the System. Although it is true that the System includes most of the large banks and that it, therefore, includes the bulk of the banking business of the country, still from the point of view of the communities they serve and of relations with other banks, the importance of the thousands of small banks which are outside the System is not negligible.

For another thing, there is always the important consideration that United States Treasury activities must be taken into account. These have to do in part with the operations of the Exchange

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Stabilization Fund and the issue of circulating media, e.g., coins, silver certificates, and United States notes; and in part with the public debt, and the government's receipts and expenditures. These operations involve large sums and intimately affect the banking and credit situation.

Finally there are conditions that arise not only outside the System, but outside the country, and yet affect the domestic banking situation powerfully. There is, for example, the recent great movement of gold to the United States from abroad - a movement that in the last two years has added over three billion dollars to the reserves of member banks and created a quite unprecedented credit situation.

These factors, among others, necessarily limit and modify the exercise of credit control.

In concluding I want to assure you how much I appreciate the opportunity you have given me to discuss these matters with you. In the first place, it is particularly important to me because I am at home here. I feel as if I were coming back to report to friends who have more than a formal interest in what I have to say; certainly in addressing you I feel more than a formal interest in my subject matter.

In the second place, it is important to discuss matters with people such as yourselves who have understanding and who are able to enlighten others. I feel, as I have probably said before, that

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an administrative agency cannot function properly without having behind it a well informed and sympathetic public interest. Credit control unfortunately is a matter which bristles with technical difficulties and abstract ideas; but it is nevertheless essential, if the important objectives of credit control are to be achieved, that at least their general purpose and philosophy be understood.

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