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THE FEDERAL RESERVE SYSTEM AND BANKING ACT OF 1935

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In speaking before the American Institute of Banking it is appropriate to stick to facts and fundamentals.

I want to describe the Federal Reserve System from the point of view first of the Federal Reserve Banks and then from the point of view of the Board of Governors in Washington, and in passing to indicate such changes as were effected by the Banking Act of 1935.

Federal Reserve Banks

The Federal Reserve Banks have direct relations with about 6,400 banks which are members of the Federal Reserve System. This is less than half the banks in the country. However the banks which belong to the System do about 70 percent of the banking business of the country; and the proportion of the total banking business handled by them has shown in recent years a strong tendency to increase.

Holding Member Bank Reserves

The fundamental purpose of the Federal Reserve Banks is to hold reserves of member banks. Before the establishment of the System it was long recognized that one of the greatest weaknesses of our banking was the lack of a scientific system of reserves. The requirements for national banks thirty years ago, for example, just before the panic of 1907, - which had much to do with bringing about the establishment of the Federal Reserve Banks - was that each country bank should keep reserves of 15 percent, of which at least 6 percent was to be kept as cash on hand and the rest on deposit in correspondent banks in reserve or central reserve cities. National banks in reserve cities had to

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keep reserves of 25 percent, at least $12\frac{1}{2}$ percent in cash and $12\frac{1}{2}$ percent on deposit with correspondent banks in central reserve cities. There were three central reserve cities: New York, Chicago, and St. Louis. The banks in these cities had to keep reserves of 25 percent - all in vault cash.

The percentage of reserves which such banks are now required to keep on demand deposits is 7 percent for country banks, 10 percent for reserve city banks, and 13 percent for central reserve city banks; and on time deposits all banks must keep 3 percent.

The great difference, however, is that whereas at that time the banks partly kept their legal reserves in their own vaults and partly kept them with one another, and had no certain means of augmenting their reserves except when everything was easy, the banks now have to keep their legal reserves with the Reserve Banks and they have in the Reserve Banks a means of augmenting their reserves by the discount or sale of assets.

The Federal Reserve System substitutes a flexible arrangement for a rigid one; and a bank with sound assets can no longer find itself without the means of maintaining its reserves.

These conditions remain the same substantially as they were in the original act. With respect to the assets which a bank can discount at the Federal Reserve Bank, however, the law has made important changes.

Lending Powers

The original act sought to encourage banks to make commercial loans

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and it therefore definitely discriminated in favor of such loans by limiting the class of paper eligible for discount. This comprises, in the words of the act, "notes, drafts, and bills of exchange issued or drawn for agricultural, industrial or commercial purposes." Moreover, such paper, to be eligible, had to mature in three months or less from the time of discount, except that agricultural paper might mature in six months.

Whatever the intention, this limitation did not in fact result in a preponderance of such paper in the portfolios of banks. On the contrary eligible paper has showed for many years a tendency to occupy relatively a smaller and smaller place among bank assets. In 1929 it was only about 12 percent of loans and investments of member banks, and in 1934 it was only 8 percent. This change is due to a variety of factors. In the large it represents the fact that American banks, instead of specializing in any one type of credit, have tended to deal in all kinds of credit, long term as well as short, required by their communities. The effect of this was to limit the power which it was originally intended that the Reserve Banks should have of enabling banks with sound assets to maintain their reserves. Consequently, banks which still needed to convert assets into reserves after having discounted their eligible paper were often forced to dump other sound assets on the market and get what they could.

The Banking Act of 1935 sought to correct this condition by amending the Federal Reserve Act to authorize the Federal Reserve Banks to

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make advances to member banks for not to exceed four months on any security satisfactory to the Reserve Bank. Previous legislation had already enlarged the lending powers of the Reserve Banks, but this change went farthest by making it possible for a member bank to discount any sound asset at the Reserve Bank regardless of type.

Currency

At the time the Federal Reserve Act was adopted, probably its most important purpose in most people's minds was to furnish an elastic currency. The difficulties at which the System was aimed were thought of mainly as currency problems and not as credit problems. It is now generally recognized, however, that the supply of currency is principally a routine matter that presents no difficulties so long as credit and banking conditions are sound.

This brings me to the matter of general credit control and to the functions which pertain largely if not mainly to the Board of Governors of the Federal Reserve System.

Discount Rates

The establishment of discount rates as authorized by the Federal Reserve Act is partly the responsibility of the Federal Reserve Banks and partly the responsibility of the Board of Governors. The Reserve Banks, in the words of the act, are to establish the rates "subject to review and determination of the Board". Since discount rates affect other rates in the money market and since the rate in one district should take into account the rates in other districts, the Board has

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to consider the question from the point of view of general credit conditions. It has, therefore, the final responsibility.

The Banking Act of 1935 strengthened the Board's power by requiring that rates 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.

The great limitation upon discount rates as a means of general credit control is that they are not effective except as banks voluntarily seek to discount their paper. When the Federal Reserve Act was adopted the importance of this limitation was not fully realized, and discount rates were generally regarded as the most prominent means of credit control. At the same time a device that is now regarded as most important received at that time very little consideration. This is open market operations.

Open Market Operations

Open market operations are now regarded of great importance because they are not subject to the limitation just referred to. They enable the central banking organization to take the initiative instead of having to wait on individual banks to take the initiative. Moreover, their effect is comprehensive rather than local.

Open market operations consist of purchases and sales of securities - mainly government securities - by the Federal Reserve Banks. By selling securities the Reserve Banks withdraw funds from the market and there is a decrease in the supply of credit, because as the

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securities are paid for the reserves of member banks are diminished. By purchasing securities the Reserve Banks put funds into the market, and tend to ease credit, because their payments increase the reserves of member banks.

It was not till 1922 that open market operations became large enough to affect the money market. As a result of war financing the Federal debt had increased from one to twenty-six billions with a correspondingly large volume of government securities. It then became necessary for the individual Reserve Banks to coordinate their purchases and sales. Accordingly a committee was formed for that purpose. At the same time it was definitely established that the purpose of the operations was not profit but control of credit. The principle was as follows:

> 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.

The Banking Act of 1935 gave statutory recognition to the Federal Open Market Committee, and forbade any Reserve Bank to 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 as had already governed the operations.

The Banking Act of 1935 went still further. It directed that the

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Federal Open Market Committee should consist of all the members of the Board of Governors and five representatives chosen by the Federal Reserve Banks regionally. This was a definite centralization of control.

Reserve Requirements

The Banking Act of 1935 increased the Board's power in another respect also by authorizing it to change the statutory reserve requirements, which have already been mentioned. The Board may increase them to as much as twice the present requirement, but may not lower them below the present. This is a very important power because the volume of credit which any member bank may extend is limited by the amount of reserves it is required to hold.

Formerly this power could be exercised only in emergency and with the approval of the President of the United States. The matter is now one simply of the Board's discretion.

Other Changes

The most important changes effected by the Banking Act of 1935 have been covered in the foregoing. A few others may be mentioned.

The title "president" was given to the chief executive officer of each Federal Reserve Bank instead of the former title "governor".

The old designation "Federal Reserve Board" was changed to "Board of Governors of the Federal Reserve System", and the title of the chief executive officer of the Board, which was formerly "governor", was changed to "chairman".

The ex officio membership of the Secretary of the Treasury and

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the Comptroller of the Currency was discontinued and appointment of seven appointive members was authorized.

Other Activities

The Federal Reserve Banks and the Board of Governors have a variety of duties which cannot be mentioned in brief space. Notable among these is the compilation and publication of information bearing on banking and credit conditions, here and abroad, and including data on production, employment, trade, and prices. In the Federal Reserve Bulletin, which is published monthly, and in the Annual Report of the Board, a comprehensive view is presented of the current banking and financial situation. Each of the Federal Reserve Banks also publishes a monthly review and an annual report.

No other central banking organization in the world makes available such comprehensive information on domestic banking and business developments, and on the considerations taken into account in formulating credit policy, as does the Federal Reserve System.

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